William Blair

Corporate & Executive Services

Managing Concentrated Equity Risk through Strategic Diversification

While concentration may *create* wealth, diversification can *preserve* wealth.

Concentrated equity positions occur when a significant portion of an investor's wealth is tied to the stock of a single company. This may result from a variety of situations such as executive compensation, sale of a business, founding or creating a company, or an inheritance.

Regardless of the source, concentrated equity positions present both opportunity and risk. When the company is doing well, the holder of a concentrated position can enjoy tremendous rewards. When the company experiences volatility, the holder's financial security can be at risk. In some circumstances, barriers such as potential tax liability, SEC regulations, a need for liquidity, or even emotional ties to the company can also present challenges.

If you hold a concentrated equity position, there are strategies you can employ to help you take advantage of upside potential while reducing your risk and addressing other challenges associated with the stock position. Multiple considerations are involved with managing concentrated equity positions.
The following topics will be reviewed:

I. Sources of Concentrated Equity Positions

II. Balancing Risk vs. Reward

III. What to Consider Before Diversifying

IV. Diversification Strategies

V. Hedging Strategies

I. Sources of Concentrated Equity Positions

Concentrated equity positions come from multiple sources and exist in many forms. Properly managing these positions requires understanding the selling restrictions, tax implications, and portfolio impact of each type of equity.

If your concentrated equity position is in a company you work for currently, diversification is especially important. Not only is a substantial portion of your net worth tied up in the company via your concentrated position, but your income is also tied to the company—in the form of your salary, bonuses, and perhaps future equity-based compensation.

Considerations for Executives of Public Companies
Executives of publicly traded companies may face unique challenges that make diversification more difficult. The Securities and Exchange Commission places significant restrictions on the sale of securities owned by corporate insiders, such as senior executives and directors. Executives need to be aware of any restrictions related to their shares (i.e., employment contracts, issuer's insider trading policy) and the available exemptions for selling the shares through 10b5-1 plans and SEC Rule 144/145.

Often, corporate executives receive these shares through stock options, restricted stock, or restricted stock units. It is vital for executives to work with their financial and tax advisors to understand the varying tax implications of these different compensation mechanisms.

Considerations for Owners of Private Companies
Large equity positions in privately held companies create a distinct set of considerations relative to publicly traded equity. Foremost of these concerns is liquidity. Because shares of privately held companies are not traded daily on an exchange and are generally owned by a small number of

Comparison of Concentrated Equity Position Sources

Equity Type	Description	Tax Implications	Sale Considerations
Public equity	Shares of a publicly traded company	Appreciation above "basis" is taxed as capital gains	Identify tax basis, holding period, and whether shares are held in tax-advantaged retirement accounts; SEC selling restrictions for corporate insiders
Private company	Shares or ownership stake in a private company	Appreciation above "basis" is taxed as capital gains	Liquidity can be severely limited
Incentive stock options (ISO)	Opportunity to buy shares at the stock's fair market value as of the date of the option grant	No tax owed when ISO is granted; long-term capital gains if stock sold > 2 years of grant date and > 1 year of exercise date; selling earlier creates ordinary income; potential AMT liability when exercised	Expiration date; market price relative to grant and exercise prices; holding period from grant and exercise dates
Nonqualified stock options (NQSO)	Opportunity to buy shares at the stock's fair market value as of the date of the option grant	Create taxable ordinary income when exercised; no AMT implications; may trigger need to file estimated taxes	Expiration date; market price relative to grant and exercise prices; holding period from grant and exercise dates
Restricted stock	Shares that are granted with risk of forfeiture and cannot be sold until listed conditions are met	Lapsing of restrictions creates ordinary income at stock's fair market value; or Sec. 83(b) election allows immediate income recognition and capital gains treatment of future appreciation	SEC Rule 144 allows public resale of restricted shares only if the rule's conditions are met; the basis of the stock is the market value at time of vest or exercise
Restricted stock unit	Right to receive stock (or cash equivalent) after the award has vested	No opportunity for Sec. 83(b) election; opportunity to defer income recognition by agreement with employer to not deliver stock immediately upon vesting	SEC Rule 144 allows public resale of restricted shares only if the rule's conditions are met

shareholders, identifying and capturing the market price for these shares can be a difficult proposition.

Owners of closely held private businesses need to be especially proactive in planning how to generate liquidity from their equity positions. Often, selling these shares is a process that can span multiple years or even generations. Whether the plan is to sell the shares to a younger generation in the family or identify outside investors, these business owners need to work closely with their financial and legal advisors to develop a strategy that is aligned with their overall wealth management goals. Owners of privately held companies should also consider wealth transfer opportunities created by any liquidity or minority discounts associated with the shares.

Even before selling the stock, owners of private companies need to think about how the ownership stake affects their overall investment portfolio. The public equity portion of the portfolio should be adjusted to account for increased risk and industry exposure the investor faces through owning the private company. For example, a founder of a company that provides electronic recordkeeping for hospitals should reduce his public equity portfolio's allocation to the healthcare and technology industries.

10b5-1 Plans, Rule 144 Restricted Stock, and Option Exercising
For more information about tools for diversifying a corporate executive's concentrated equity position, please consult your William Blair advisor on restricted stock issues and planning with options.

II. Balancing Risk vs. Reward

When an investor holds a variety of stocks, the potential upsides and downsides are moderated because, when one stock goes up, another stock may go down, and vice versa. With a concentrated equity position, the impact of any volatility is magnified.

As a company performs well, a concentrated equity position can provide tremendous benefits. In fact, the reason many investors have concentrated positions is because the company has done tremendously well over a period of time. No matter how well-managed a company is or how well it has performed in the past, there is a chance that its performance could change in the future.

In a market environment where volatility is the rule rather than the exception, owning a concentrated equity position is inherently risky. Diversification reduces a portfolio's overall volatility by spreading risk exposure and return opportunities across multiple industries and asset classes. In particular, diversification can help reduce two major types of risk: company-specific risk and macroeconomic risk.

Company-specific Risk

Company-specific risk—such as the loss of a key executive or the failure of a new product launch—could cause a stock's price to fall precipitously. No company is immune to these risks. Because of the amazing pace of technological innovation, today's Apple could become tomorrow's Hewlett-Packard or Eastman Kodak. Additionally, from Enron to WorldCom to MF Global, one does not need to look far to find an example of a once-powerful corporation that was brought down by the poor decisions of a few executives.

According to the cruel math of risk, losses with a concentrated stock position have a disproportionately large impact on your portfolio. The table below shows what percentage gain you would need in Year 2 following a price decline in Year 1 to return to your original purchase price. For example, if a stock declines by 20% in Year 1, then it would need to gain 25% in Year 2 just to return to the value at the beginning of Year 1.

The Cruel Math of Risk

Loss in Year 1	Gain Needed in Year 2 to Break Even
-5%	5.3%
-10%	11.1%
-20%	25.0%
-30%	42.9%
-40%	66.7%

Macroeconomic Risk

Although macroeconomic risk—that is, changes in conditions such as unemployment, inflation, and GDP growth that affect all industries—cannot be avoided, it can be mitigated. Diversifying by investing in stocks across different industries, market capitalizations, and geographic areas can reduce an investor's exposure to these macroeconomic risks. For example, although the recession from 2007 to 2009 affected companies across all industries, investors whose portfolios were concentrated in the financial and real estate industries were hit especially hard by this downturn.

Macroeconomic risks can be further mitigated by diversifying beyond equities into asset classes such as cash, fixed income (bonds), and alternative investments (such as real estate and commodities). Each asset class reacts differently to prevailing economic conditions, and having an asset allocation strategy that is aligned with your objectives, risk tolerance, and time frame can allow for reduced volatility.

Liquidity Needs

Risk is not the only challenge presented by a concentrated equity position. Another is liquidity. Regardless of how much net worth you have on your balance sheet, you will still need to be able to generate sufficient cash to pay for major expenses, such as education or a vacation home. The need for liquidity becomes even more acute as you approach retirement.

Having a significant portion of your wealth tied up in the stock of a single company can create liquidity constraints. If the price of the stock experiences a sharp decline and then a need for cash arises soon thereafter, you may be forced to sell the stock at an unattractive price, or even a loss. Diversification not only reduces the potential negative impact of the stock's volatility on your cash needs, but it allows you to reinvest in some assets that may produce income in the future.

III. What to Consider Before Diversifying

Diversification can offer significant advantages over owning a concentrated equity position, but many investors experience roadblocks to diversifying. Some of these barriers are external and others may be internal.

While these roadblocks may be significant, few of them are insurmountable. Using an approach that is based on a thorough understanding of the regulatory and legal implications of a potential sale as well as your wealth-management objectives, a diversification strategy can be designed that is tailored to your unique situation.

Regulations and Legislation

Taxes. Often, concentrated equity positions consist of highly appreciated, low-basis stock. Even at the current long-term capital gains rate of 15% or 20%, which is still very low by historical standards, the sale of such stock could result in a significant tax liability. For example, at the 20% rate, selling $11 million of stock that was acquired for $1 million would produce a $2 million federal tax liability (not taking into account possible offsetting losses). Holders of concentrated positions might prefer to hold on to their stock to defer that liability.

SEC restrictions. The SEC restricts the sales of securities by corporate "insiders," such as directors, senior executives, and those who received securities in a transaction that did not involve a public offering. Complying with these restrictions can make selling more complicated.

Public perception. Officers and directors of public companies, as well as anyone owning more than 10% of a public company's stock, are required to report their holdings and any transactions involving the stock. By taking a proactive approach to communicating about these sales and implementing a planned selling schedule, executives can mitigate much of the potentially negative market reaction that can arise when an officer or director sells a significant portion of his or her stock.

Financial Planning Benefits of Diversification

Wealth, in a concentrated position, may fluctuate substantially. This creates challenges for determining how to plan for financial goals such as a child's education or your retirement. Reduced volatility allows for reasonable projections of the value of your portfolio over time so you and your advisors can better determine how to achieve your financial goals.

Market impact. If the stock is lightly traded, the sale of a large portion could put downward pressure on the stock's price, reducing the proceeds of a sale.

Personal Challenges

Emotional attachment. Company founders and long-time executives often feel a strong loyalty to the company that they put years of hard work into building and that may be the primary source of their success—both financially and professionally. This loyalty, which may be passed on to future generations, can make it difficult for them to consider parting with the stock.

Fear of missing future appreciation. Behavioral finance experts have identified fear of regret as a strong impulse among investors—even stronger than the satisfaction of making a profitable investment. This psychological bias may cause many investors to put off selling concentrated equity positions because they do not want to forfeit the opportunity to benefit from future appreciation. In addition, investors have a natural tendency to stick with what has worked in the past, so it can be difficult to diversify away from a position that has had a long run of success.

Desire to invest in what you know. Company founders and long-time executives know their business and industry intimately and therefore may feel more comfortable concentrating their investments in that company. Similarly, some long-time investors may have gained extensive knowledge of the company over the years.

IV. Diversification Strategies

There are two primary strategies for diversifying a concentrated equity position: an immediate sale or a staged sale. Each strategy has its own advantages and disadvantages.

Immediate Sale

Selling most or all of the stock from the concentrated position immediately and investing the proceeds in a variety of other stocks, bonds, and alternative investments is perhaps the simplest and most straight-forward risk-management strategy. On the plus side, it would immediately protect you from the downside risk of the stock. In many situations, however, this is not a workable solution.

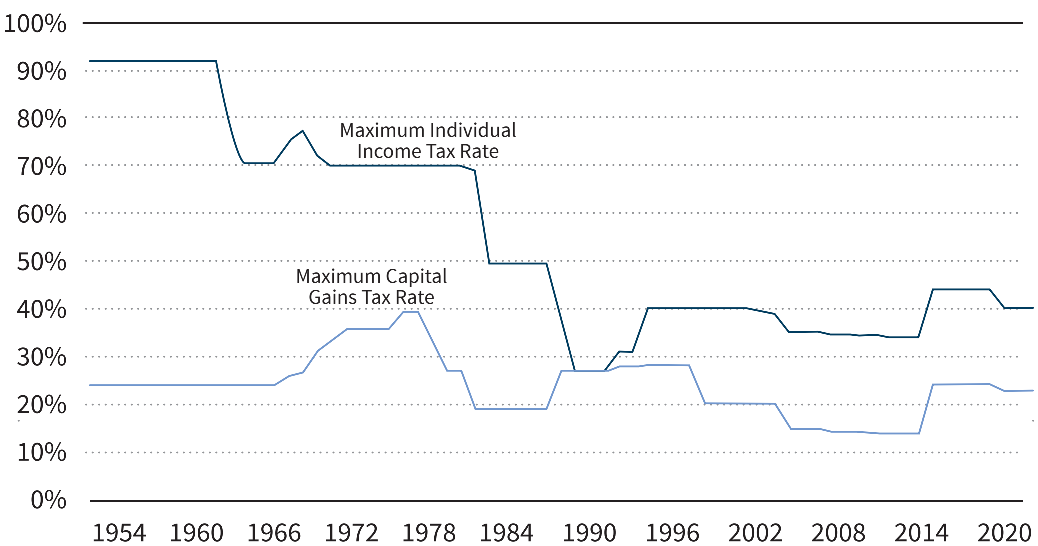
If you are subject to certain SEC restrictions, an immediate sale may not be an option. For example, if you are a company insider, you are prohibited from selling your stock during blackout periods throughout the year.

Even if you are not subject to such restrictions, an immediate sale may not be the best solution. If one or more personal challenges exists—whether emotional attachment, fear of missing future appreciation, or a desire to invest in what you know—you likely will not be comfortable with an immediate sale of your concentrated position. External barriers such as public perception and market impact also can make an immediate sale undesirable. But perhaps the biggest potential barrier to an immediate sale is the tax consequences.

Assuming your basis in the stock is low, an immediate sale may generate significant capital gains tax liability.

Maximum Capital Gains and Individual Income Tax Rate

Tax years 1954-2020



Sources: US Department of the Treasury, Office of Tax Analysis (2016); Urban-Brookings Tax Policy Center calculations.
Note: The maximum rates included in the 3.8 percent tax on net investment income (2013-) and adjusts for the phaseout of itemized deductions (1991-2009, 2013-2017).

Incurring such a liability will impact your investable assets and runs counter to the traditional tax planning strategy of deferring taxes to the extent possible.

While the tax hit can be substantial and take several years to overcome, tax consequences should not be the primary driver of your investment decisions. Rather, your decisions should be based on your financial goals and circumstances, with taxes being just one factor to consider.

In addition, even from a tax perspective, immediately selling the stock and paying taxes now may be the better option in certain circumstances:

1. If the price of the stock were to fall in the future, you may enjoy a greater after-tax return from selling the stock now—even if you pay more in taxes.
2. If tax rates go up, it may be beneficial to lock in lower rates while they are available. Even though the long-term capital gains tax rate on taxpayers in the highest income bracket increased from 15% to 20% in 2013, tax rates are still very close to their historical lows.

Staged Sale

For many holders of concentrated equity positions, staged selling is an attractive alternative to selling the entire position at once. It involves selling blocks of stock over time, typically a period of several years.

Benefits of staged selling:

- Retain some upside potential while gradually reducing risk through diversification
- Defer capital gains taxes
- Rule 10b5-1 plan allows pre-planned staged selling for executives subject to SEC restrictions
- Reduce potential negative impact on public perception of an executive selling shares

Drawbacks of stage selling:

- No immediate diversification
- Total tax cost would increase if capital gains rates increase over the course of the selling program

Staged selling can provide ample flexibility to achieve your goals, whether they are related to overcoming common barriers to diversification or other objectives. By working closely with your advisors, you can develop a plan that will be the most effective for your particular situation.

Charitably Inclined? Consider a CRT

If you would like to diversify your concentrated equity position, create an income stream for yourself, and benefit charity, a charitable remainder trust (CRT) may be worth considering. Here are some of the basic details:

- Stock is contributed from your concentrated position to the CRT.
- For a given term, the CRT pays an amount annually to the donor (some of which may be taxable).
- At the term's end, the CRT's remaining assets pass to one or more charities.
- When you fund the CRT, you receive an income tax deduction for the present value of the amount that will go to charity.
- The property is removed from your taxable estate.

Because a CRT is tax-exempt, it can sell the stock you contributed without paying tax on the gain. It can then invest the proceeds in a variety of stocks and bonds, providing diversification.

V. Hedging Strategies

Sometimes the barriers to diversifying a concentrated equity position are too high to overcome or will delay diversification. In these cases, hedging strategies can provide a risk-reduction alternative. Some strategies also may provide needed liquidity. This table outlines the advantages, disadvantages, and mechanics of various hedging strategies.

Concentrated Equity Positions Require Careful Planning

Regardless of how you accumulated a concentrated equity position, it is critical that you understand both the opportunities and risks of such a position. With careful planning, you can make the most of the opportunities and reduce the risks.

William Blair has extensive experience working with corporate executives and other owners of concentrated equity positions. We can assess your current position, along with your financial needs and goals, and help you determine the best course of action for your particular situation.

Comparison of Hedging Strategies

Strategy	Summary	Advantages	Disadvantages
Protective puts	Purchasing put options on the concentrated position to create a price floor at the put's strike price	Downside protection while allowing full participation in stock's future appreciation	Purchase of puts is an out-of-pocket expense; does not provide liquidity or diversification
Covered calls	Selling (or "writing") call options on the concentrated position	Full participation in appreciation up to the strike price; proceeds from options sale can be used to enhance returns or diversification	No protection from price decline; no participation in appreciation above strike price; exercise (called stock) may trigger capital gains
Zero-premium collars	Simultaneously selling calls and buying puts to create a price ceiling and floor	No up-front premium; full participation in appreciation up to call strike price; full downside protection below put strike price	Downside exposure until put strike price is reached; no participation in appreciation above call strike price; no liquidity or diversification
Prepaid variable forward sales	Investor receives a set cash payment up-front in exchange for delivery of a variable number of shares at a future date; number of shares delivered depends on future stock price	Immediate liquidity for the stock; downside protection and some upside participation; voter maintains voting rights and dividends until delivery of shares	Proceeds for the stock are discounted from present market value; may create unique tax circumstances

Note: Purpose and non-purpose loans use a hedged position as collateral. Purpose loans can equal up to 50% of the market value of a hedged position, while a non-purpose loan can equal up to 95%. These loans offer immediate liquidity and the investor maintains voting rights and dividends. There is interest expense related to both kinds of loans and the proceeds of a non-purpose loan cannot be used to purchase securities.

For additional information please contact your William Blair Advisor

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