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4 Critical Factors in Managing Concentrated Stock

We meet with a lot of executives, directors, and other highly compensated employees of publicly-traded companies. Many of these people have a tremendous amount of wealth in their employer's stock. This wealth could be built a number of different ways: 1) The gradual accumulation of vested restricted share units ("RSUs"); 2) A significant increase in the value of compaany stock; 3) Or a major liquidity event (e.g. IPO or company acquisition), just to name a few. But regardless of how this wealth was accumulated, there are generally a few smart and effective things to do, which often put you in a better position. Read on for the four smart things you can do to get more out of your company stock and reduce risk.

1. The math and odds are stacked against the average concentrated stockholder. So it's critical to develop a strategic diversification plan to reduce risk.
    - Individual stock investments have the potential to be more risky than an index. First, individual stocks are more volatile (and can decline in value much quicker) than the S&P 500 Index. Just remember what happened to Enron in 2001.
    - Secondly, most companies underperform the market as a whole. In fact, a J.P Morgan study found that two-thirds of all individual stocks underperformed the Russell 3000 Index (the broad US market) between 1980 and 2014. Even worse, 40% of the stocks delivered negative absolute returns.[1]
    - And don't forget that your current paycheck is tied to your company. Think of all the risks your company is subject to: broader economic downturns, new competition, and product misfires, poor leadership and governance (Enron) to just name a few. Each of these can cause a decline in stock price and lead to layoffs (potentially your paycheck).
    - Given this, it is important to develop a strategic diversification plan. This is a plan to thoughtfully sell

[1]"Agony & Ectacy", JP Morgan, 2014.

your company stock, while investing the proceeds into a broader basket of securities.

- The simple goal here: ensure your financial future and goals aren't tied to just one company.

2. Diversification is important. But being mindful of taxes is important, too.
   - As we just discussed, diversifying your company stock is a great way to reduce risk.
   - But selling company stock can often lead to tax consequences. Especially if your stock has materially increased in value. The impact of taxes can be compounded, if you are a highly compensated employee, and already in a high tax bracket.
   - So as you build your diversification plan, evaluate the impact selling the stock will have on your taxes. For instance, will selling the stock lead to your capital gains rate increasing from 15% to 20%? Will selling the stock lead to additional Medicare taxes?
   - For instance, a smart tax strategy to evaluate is selling your company shares right up to the maximum income limit ($488,850 for married couples, filing jointly[2]) to remain in the 15% capital gains bracket.
   - There are likely a number of tax considerations you'll want to evaluate, so consult with a financial advisor or CPA to optimize your diversification strategy for taxes.

ORDINARY, LONG-TERM CAPITAL & QUALIFIED DIVIDEND RATES:
INDIVIDUAL VS. MARRIED FILING JOINTLY

INDIVIDUAL			MARRIED FILILNG JOINTLY		
Income Up To:	Ordinary Income Tax Rate	Capital Gains Tax Rate	Income Up To:	Ordinary Income Tax Rate	Capital Gains Tax Rate
$9,700	10%	0%	$19,400	10%	0%
$39,373	12%		$78,750	12%	
$39,475		15%	$78,950		15%
$84,200	22%		$168,400	22%	
$160,725	24%		$321,450	24%	
$204,100	32%		$408,200	32%	
$434,550	35%		$488,850	35%	
$510,300		20%	$612,350		20%
$510,300+	37%		$612,350+	37%	

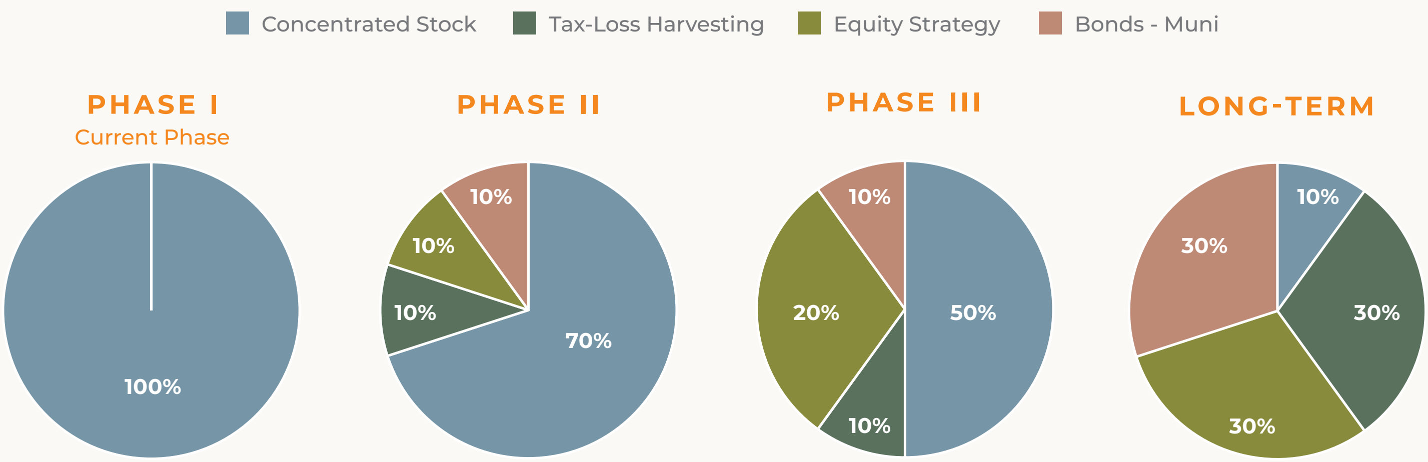
Source: Michael Kitces, "Marginal Tax Rates Chart For 2019". Baker Avenue Asset Management LP is not a tax or legal advisor.

[2]https://www.irs.gov/taxtopics/tc409

3. Build a flexible diversification plan. Execute the plan in the context of the market.

- Quite often, a strategic diversification plan can be executed over a number of years. For instance, many plans target 3 – 5 years for completion. This means you plan to gradually sell relatively small amounts of company stock, and reinvest the proceeds into more diversified investments.
- During this multi-year period, markets will move up, and markets will move down. Therefore, it is important to be flexible and execute your diversification plan based on market conditions at the time, and how your stock is valued.
- For instance, there may be times when your company stock price will decline in value, despite evidence and data that tell you that your company stock price should be valued higher. During these periods, you may want to consider selling relatively less at this time. Conversely, if markets or your stock is priced high, you may want to evaluate selling relatively more.

DYNAMIC DIVERSIFICATION STRATEGY



For illustration purposes only.

4. Protect your shares, while using them to generate additional income.

- The two most common goals we hear from corporate execs and directors with concentrated stock are: 1) "Protect my shares from declining in value"; 2) "I'd like my shares to generate additional income to support my goals."
- Since a diversification plan can take multiple years to implement, a top priority is protecting shares from declining in value (since you'll still own the stock until the diversification plan is complete). And if given the opportunity, of course everyone would like additional income.
- A financial advisor can help guide you through a strategy (utilizing what are called 'options'), which aim to achieve both of these goals.
- See the illustrative example below, of how options can be utilized to generate additional income for holders of large concentrated positions.

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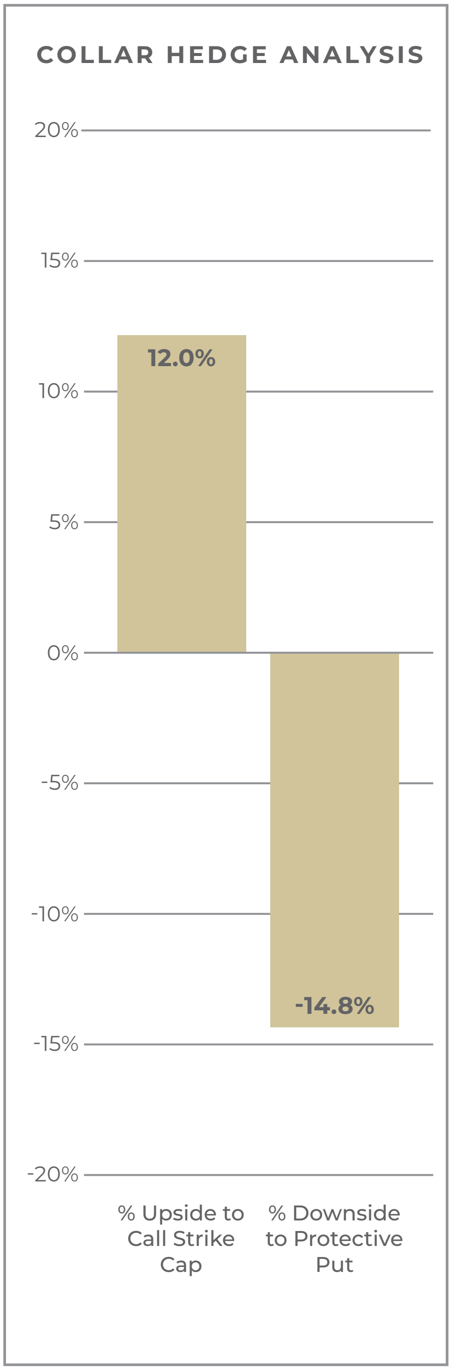
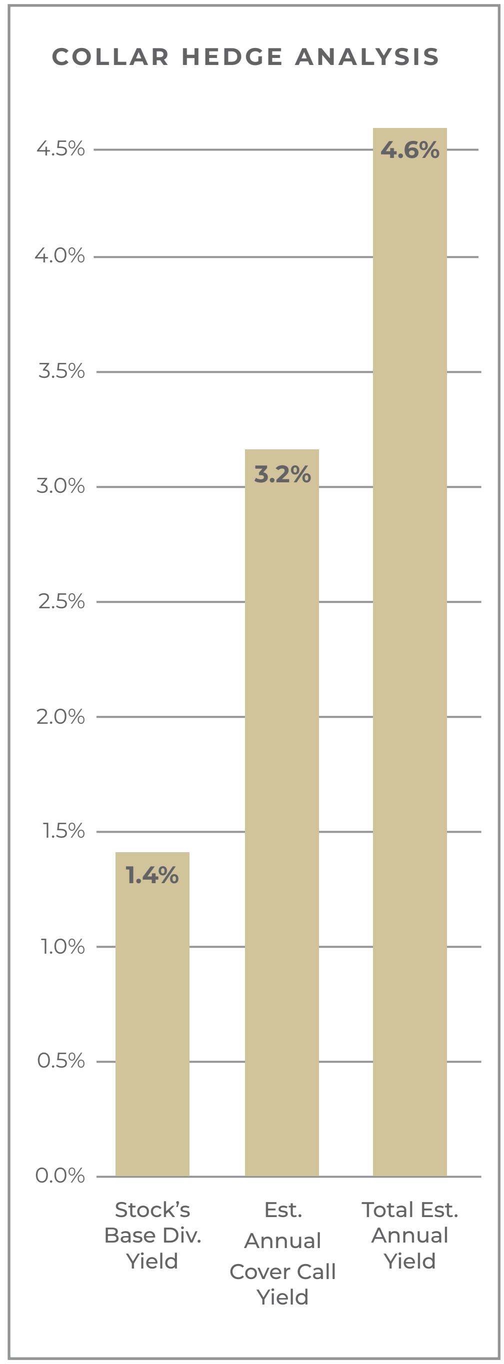
COVERED CALL | COSTLESS COLLAR STRATEGY

KEY STATISTICS	
Position Value	$3 MM
Estimated Shares	14,613
Estimated Contracts	146
Current Price	$205
Standard Deviation	18
Implied Volatility	23%
Options Expiration Date	6/21/19
Days to Expiration	53

COLLAR HEDGING STRATEGY	
Call Strike Price	$230
Put Strike Price	$175
Estimated Call Option Income	$13,737
Estimated Put Option Cost	$12,275
Net Cost/Gain on Collar	$1461
Percent Upside to Call Strike Cap	12.0%
Percent Downside to Protective Put	-14.8

COVERED CALL INCOME STRATEGY	
Estimated Call Option Income	$13,737
Estimated Annualized $ Income	$94,602
Stock's Base Dividend Yield	1.4%
Est. Annualized Covered Call Yield	3.2%
Total Estimated Annualized Yld	4.6%
Total Estimated Annual Income	$137,415
Estimated % Income Gain	221%





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CONTACT ME

If you found these four smart ideas helpful, would like to learn more, or if you have questions about your own personal situation, please contact me by email or by making an appointment.

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CLICK ICON TO MAKE AN APPOINTMENT

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