Smart Strategies To Optimize Your Concentrated Stock

OSBORNE PARTNERS
Capital Management, LLC

Over the years, we at Osborne Partners have met with many successful individuals who have accumulated a tremendous amount of wealth in a single stock. This wealth has been built a number of different ways:

1. A major liquidity event, like an initial public offering ("IPO") or company buy-out.
2. A gradual accumulation of vested equity awards, such as incentive stock options or restricted share units ("RSUs").
3. A purchase and hold of a growth stock many years ago.

While there is upside in having a material amount of your net worth in a single company stock (as any individual who has built wealth that way will tell you), there is also significant risk. Additionally, owning a large, concentrated position in a single stock will require the stock owner to make many challenging financial decisions in areas where they often have little experience, such as the alternative minimum tax ("AMT").

Given the risks and complexities, the team at Osborne Partners have developed a process and set of strategies that helps put our clients in a more optimal position.

To learn more about this process and key strategies, please read on.

The numbers are stacked against the individual concentrated stockholder. Additionally, there are many complex decisions to make. It is critical to start the planning process sooner rather than later.

Individual stock investments have the potential to be riskier than an index. Put differently, individual stocks are more volatile (and can decline in value much quicker) than the S&P 500 Index. Just remember what happened to the value of hundreds of companies in the early 2000s, or financial institutions like Lehman Brothers in 2008, or many recent IPOs of 2020 and 2021.

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It was very common for these stock concentrations to lose more than half, and sometimes all of their value.

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.*

In addition to the odds being against an individual stock, these same stock owners face many difficult financial decisions in areas where they often have minimal experience.

- For instance, owners of incentive stock options ("ISOs") often do not exercise them, citing concerns around generating a significant alternative minimum tax liability. Deferring exercise of these ISOs can lead to a much larger tax liability in the future.
- However, what most ISO owners do not realize is that through thoughtful tax planning, they can utilize a strategy which will help recover all of the AMT tax payments generated from exercising their ISOs.
- This strategy often enables ISO owners to exercise their stock options earlier, which often leads to a much more favorable tax outcome over the years.

The take-aways here are simple:

1. Ensure your financial future and goals aren't tied to a single company.

2. Start the financial planning process early to avoid making costly financial mistakes.

* Source: Agony and Ecstasy, JP Morgan 2014.

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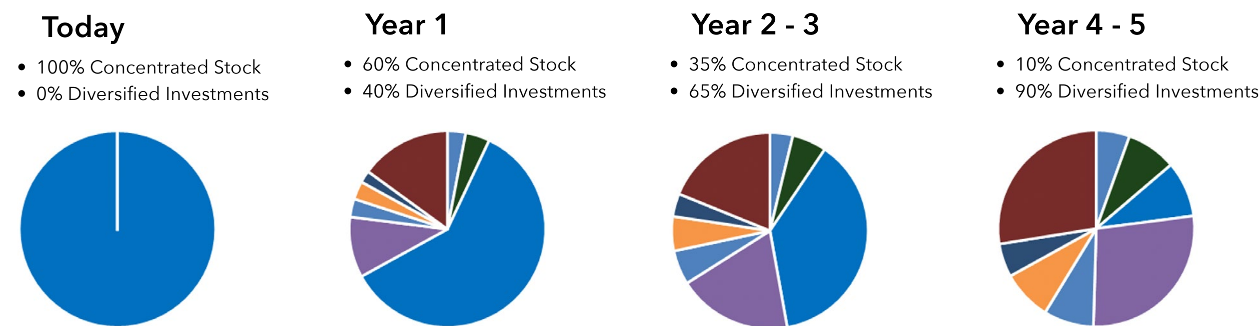
To get started, design a flexible diversification plan. Utilize a robust data and analytically driven approach, while remaining unemotional as you execute your plan over time.

The first step is developing a flexible diversification plan that is most often executed over a number of years. In fact, many plans will unfold over the course of 3–5 years. This means we generally recommend gradually selling relatively small amounts of company stock and reinvesting the proceeds into a more diversified portfolio including US and international stocks, bonds, real estate, natural resources and alternatives. See the following high-level, phased diversification illustration:



Source: OPCM

During this multi-year period, the concentrated stock will undoubtedly fluctuate in price. 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.

Luckily and strategically, Osborne Partners has a team of experienced CFA® Charterholders who focus on researching, analyzing, and valuing companies. For instance, there are times when the price of your concentrated stock will decline in value despite evidence and data that suggests your company stock price should be valued higher. During these periods, we generally recommend selling relatively less (or slow down your diversification plan). Conversely, if our analysis concludes the price of your concentrated stock is high, it is advantageous to sell relatively more (or accelerate the diversification plan).

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Determining if your concentrated stock is over or undervalued is not an easy undertaking. Plus, it is challenging to remain unemotional throughout the process. Therefore, we utilize a data and evidence driven approach that we have refined over decades.

Utilizing stock and market fundamentals, valuations, competitive analysis, seasonality and option variables, are all critical components we continuously evaluate as we help clients execute diversification plans. This is a full-time job worth hiring a specialist for.

Your diversification plan should align to your larger financial goals.

One of the first questions we ask a client who has a significant concentration of their wealth in a single stock is,

"what are your primary goals?"

And while the goals clients share with us aren't always put the exact same way, the spirit of the most common goals we hear are:

1. **Reduce risk in my portfolio**
2. **Lock in my lifestyle**

Following a data and evidence driven process to diversify your concentrated position will help achieve the first goal of reducing risk.

The second goal of "locking in a lifestyle" requires thoughtful financial planning and is critically important. The overarching goal of "locking in your lifestyle" is simple: Diversify enough of your concentrated position into a balanced, multi-asset class, and lower risk portfolio, where the diversified investments generate enough growth and income to support your lifestyle (your annual budget) for the duration of your life.

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It is critical to develop a multi-year tax strategy & evaluate potentially advantageous trust vehicles.

Diversifying your company stock is a great way to reduce risk and help achieve goals such as "locking in your lifestyle". But selling company stock has tax implications. Especially if your stock has materially increased in value. So, it is important to be "tax aware" and develop a multi-year tax strategy that aligns to your diversification plan.

As we build out your diversification plan, we help clients evaluate the impact selling the stock will have on their taxes and capital gains. For instance, will selling the stock lead to your capital gains rate increasing from 15% to 20%? Will selling the stock introduce additional "net investment income" taxes?

- A smart tax strategy to evaluate is selling your company shares right up to the maximum income limit ($501,600 for married couples filing jointly**) to remain in the 15% capital gains bracket.

To further illustrate the importance of designing a multi-year tax plan, lets refer to the earlier example of owners of ISOs being hesitant to exercise for concern about generating an AMT liability.

- From a traditional tax perspective, it is advantageous to exercise an ISO early, and sell shares one year after initial exercise (gains are taxed at the more advantageous long-term rate, as compared to the less advantageous short-term rate).
- While exercising ISOs can introduce AMT liability the year of exercise, most taxpayers are not aware of "AMT tax credits".
- By thoughtfully developing a multi-year tax plan, clients can utilize the AMT tax credit to reduce future year tax bills (one dollar for every AMT dollar paid in a previous year).

** Source: IRS, 2022

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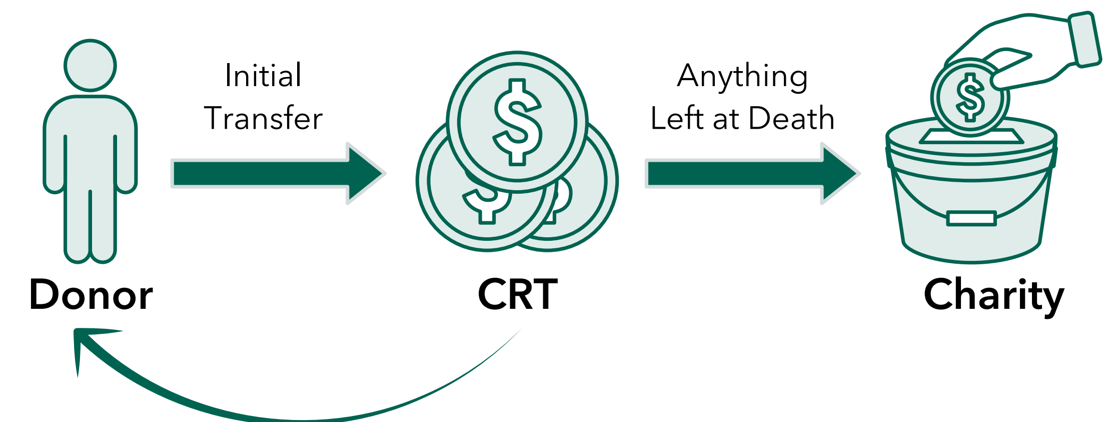
Lastly, a critical component of many multi-year tax plans (and financial plans) is the integration of tax-advantaged trusts. **It is important to evaluate relevant trust vehicles that can help:**

1. **Optimize or defer taxes**
2. **Support financial goals, such as "locking in your lifestyle"**

- As an example, a Charitable Remainder Trust ("CRT") is a trust vehicle that can be particularly advantageous for concentrated stockholders to evaluate. More specifically, CRTs can:
  - ✓ Create a tax write off.
  - ✓ Create a lifetime stream of income.
  - ✓ Defer capital gains income over the life of the trust.

Charitable Remainder Trusts



To learn more about charitable remainder trusts (along with other tax advantaged trusts), see the article: https://osbornepartners.com/three-powerful-tax-strategies-to-evaluate-now/

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Markets and your stock will likely be volatile as you diversify your shares over multiple years. Protect your shares as you diversify.

Since most diversification plans we design for clients take years to implement, we often recommend a strategy which helps protect shares from significant declines in price.

To achieve this goal, Osborne Partners implements a strategy utilizing what are called "options" and a "collar" strategy. Essentially, a collar strategy is implemented to protect against large losses for a client's concentrated stock holding. The tradeoff, however, is that a collar can put a limit on potential gains.

The mechanics of the protective collar strategy involves two types of options:

1. A protective put

2. A covered call

Because you are selling one option (the covered call) to fund the purchase of another (the protective put), the total cost to implement this strategy can be quite low or even a credit to your account. The following illustration shows what a stock price movement and collar strategy would potentially look like.

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Options and protective collars are a complex topic we would be happy to expand on in a one-one-one meeting. For purposes of today's discussion, the take-away with a protective collar is that it gives the opportunity to protect your stock from significant losses at a low price (even a credit) as you diversify.

Protective Collar Illustration

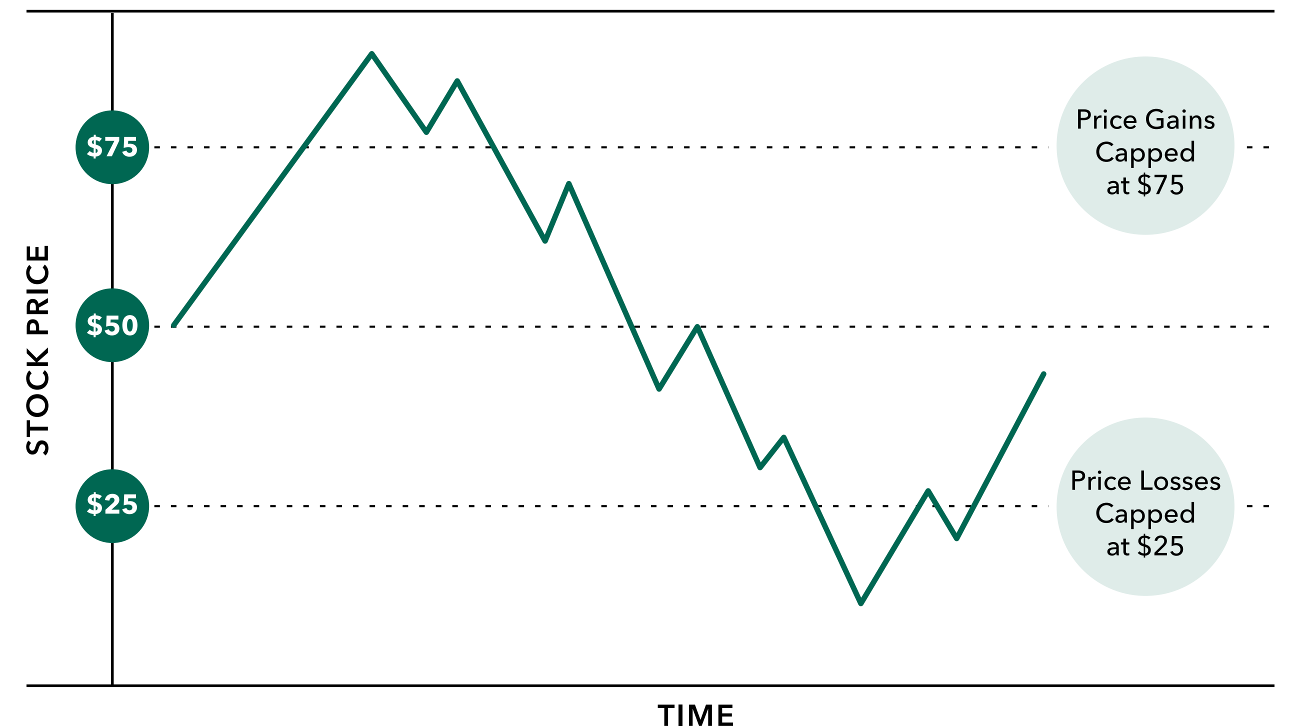

Illustration by OPCM

If you found these strategies helpful, would like to learn more about our process, or if you have questions about your own personal situation, please contact us: info@osbornepartners.com or 800-362-7734

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