"Not From Concentrate" -

When There's Too Much Juice in the Portfolio - Part 2

August 2021

In last month's newsletter, we commented that in recent past, we have attended several client meetings where the focus of the conversation was on dealing with the risk/reward considerations of the client's single-security concentration. In nearly every case, the client intuitively understood the risks inherent with his or her current investment strategy, but for various reasons, found it difficult to do anything about it.

REASONS FOR CONCENTRATION AND RELUCTANCE TO DIVERSIFY

We previously discussed that in our experience, individuals have several reasons for holding onto a concentrated stock position. For example, they may have:

- Inherited a large holding
- Exercised options to buy company's stock
- Sold a private business, or founded a company that subsequently went public
- Benefitted from price appreciation or repeated stock splits over the years
- Accumulated restricted or common stock as part of compensation

Just as there are many different reasons for accumulating a concentrated stock position, there are many considerations involved when deciding how to address it. Some of the most common issues we see investors deal with are:

- **Emotional attachments**
- **Fear of "missing out"**
- Reluctance to sell because of adverse **tax consequences**
- **Legal constraints**
- **Company "black-out" periods**
- **Practical considerations**
- **Optics:** Particularly for C-Suite executives

RANGE OF STRATEGIES

Last month we reviewed a variety of strategies that are available for the investor's consideration. Other than doing nothing, one or more strategies might provide multiple benefits – in addition to diversification.

STRATEGIES DISCUSSED IN LAST MONTH'S NEWSLETTER

- **Do nothing**
- **Selling your shares**
- **Establish a 10b5-1 for Company Shares**
- **Monetizing the position**
    - Prepaid variable forward (PVF) agreements
    - Borrowing against the Stock to diversify
- **Exchanging your shares**

HEDGING STRATEGIES

In this month's newsletter, we'll discuss strategies that involve hedging a concentrated position Often, concentrated stockholders wish to retain the stock, but also need to protect against the risk of a substantial drop in its value. There are multiple ways to try to manage that risk by using options.

> **CAUTION**: Options also can involve substantial risk and are not suitable for all investors. Prior to buying or selling an option, a person must receive a copy of "Characteristics and Risks of Standardized Options." Copies of this document are available at http://www.theocc.com.

PURCHASING PROTECTIVE PUTS

Buying a protective put essentially puts a floor under the value of your shares by giving you the right to sell (or "put") your shares at a predetermined price. Buying put options can help limit potential losses on the underlying equity while allowing you to continue to participate in any potential appreciation or dividends paid. However, you also would lose money on the cost of the option itself if the stock's price remains above the put's strike price.

> **Example**: Pete owns 50,000 shares in JCL Corp. He bought them at $50, and they are now trading at $75. Pete wants to protect at least some of his $1.25 million in gains but does not want to sell. He decides to buy long-term put options for all 50,000 shares. The puts expire in 2 years, have a strike price of $68, and are selling for $3.45. Since each option contract covers 100 shares, Pete pays a premium of $172,500 for his puts (500 contracts x 100 shares per contract x $3.45 per share). Eighteen months later, one of JCL's major factories burns down and the stock price plummets to $55. Pete can exercise the put and sell his shares for $68; his shares are still worth $900,000 more than he paid for them (not counting the $172,500 he paid for his options). Without the puts, his $1.25 million paper profit at the time he bought the options would have shrunk to only $250,000.

SELLING COVERED CALLS

Selling (or 'writing") covered calls with a strike price above the market price can provide additional income from your holdings that could help offset potential losses if the stock's price drops. By selling the calls, you are agreeing to sell your shares to another investor at the call's strike price, which is almost certain to happen if the stock's price rises above the strike price. This strategy is known as a covered call; because you already own the stock, you are covered in case you are obligated to turn over shares. However, if the stock price never reaches that point, you will retain the premium you were paid for the call.

The tradeoffs with covered calls include:

- You are still exposed to downside risk on the stock holding, which could exceed any gain from selling the calls.
- Selling a covered call limits the extent to which you can benefit from any further price appreciation. As the stock price appreciates past the strike price, it will be "called away."
- If the price reaches the call's strike price, you will have to sell shares to meet the call (unless you are able to buy back the call contract). Depending on how much you paid, this could trigger capital gains taxes.
- If you decide you want to sell shares before the call option expires, you will have to close out the call contract before you can sell your shares. There is no guarantee you will be able to do so, and you could pay more to unwind the position than you were paid for the option originally (though that loss also might be offset by profit on the sale of the shares themselves).

STOCK COLLARS

A collar involves buying not only protective puts to limit losses on the underlying stock, but also selling call options whose premiums offset the cost of the puts. A collar where the cost to buy puts is completely offset by the premium from selling calls is referred to as a "Zero Cost Collar."

> **Example**: In the example above, if in addition to buying puts, Pete had also sold calls with an $83 strike price on his 50,000 shares of JCL Corp. stock,

he would have established a collar. The calls would have expired worthless when the stock price dropped to $55, since no investor would have exercised the option to pay $83 for shares that had a market price of $55, and Pete would have retained the premium. That income from selling the calls would also have blunted the impact of the price drop on his JCL position.

Considerations: As with a covered call, the upside appreciation on the concentrated position is limited to the call's strike price. If that price is reached before the collar's expiration date, the investor would not only lose the premium paid for the option, but unless he could unwind the position by buying back the calls - and there is no guarantee that he would be able to do so—the forced sale may result in capital gains taxes due.

The prices set for a collar must not violate the rules against a so-called constructive sale. Under the Taxpayer Relief Act of 1997, a hedging strategy that eliminates all risk is effectively a sale and thus subject to capital gains taxes. With a collar, this can happen if the strike prices of the put and call are too close together, or too close to the market price of the stock holding.

CAUTION: Be careful about closing one side of the collar while the other side of the trade remains outstanding. For example, if an option holder exercised the put and then the shares sold are later called away prior to the expiration date, he or she could find themself with an uncovered call (referred to as a "naked" call option). The option holder could potentially suffer a significant loss if there was a need to repurchase the shares at a higher price to fulfill the call.

Practical Pointer:

Many publicly traded companies do not allow their employees to hedge the company's stock. Certainly, most executives will be reluctant to hedge their company's stock due to the public nature of all company stock transactions in which they engage.

CONCLUSION

When dealing with a concentrated stock holding, consider your time frame. Some strategies, such as hedging, might be most suitable in the short term or if you are restricted from selling. Other strategies that we discussed in previous newsletters, particularly those that involve donating stock to charitable trusts, may be more suitable for individuals with a longer-time horizon. As always, consult professionals who can help you determine a strategy that is ideally suited for your personal situation.

Sincerely,

James Landry, ChFC
Chief Operating Officer, Director of Planning
Pallas Capital Advisors

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