March 2019 WHITE PAPER

Strategies for Managing Concentrated Equity Positions

Introduction

It is not unusual for wealthy individuals or families to have a large portion of their wealth concentrated in a single asset, perhaps in shares of a publicly traded company, a private business, or real estate. Often these investments have grown in value far beyond their initial cost basis. Holding a concentrated position may maximize return in an investment portfolio over the long term, but it can also increase price volatility. Many Hawthorn, PNC Family Wealth® clients face this dilemma.

While maintaining a concentration makes both investors and their portfolios more vulnerable to company-specific/idiosyncratic risk, selling shares may result in a considerable tax bill. Research has shown that diversifying from one concentrated equity position into as little as 20 stocks can help reduce the volatility of a portfolio by more than 50%.[1] In one extreme example, between December 2007 and March 2009 Bank of America's stock price dropped 92%. An individual or a family with a large position in this diversified multinational investment bank would have experienced a significant decline in their net wealth, perhaps jeopardizing their financial wellbeing at that particular time. Even if selling shares is not an option, it may be prudent to develop a strategy to minimize the risks of a concentration since there is no guarantee an asset will provide a consistent rate of return indefinitely.

A family or individual can develop a concentrated position in a number of ways, and each has its own personal circumstances and perspectives. While some families may focus on the growth outlook for the asset, others may be more motivated by legacy issues or the income the asset provides. When determining how best to address a concentration, a family's particular situation and key goals for their wealth should be considered. Central to the discussion are such factors as the family's personal dynamics, the tax and legal backdrop, and any emotional attachments to the asset in question. Before identifying a specific solution or deciding whether action is even necessary, it is vital to define the family's foremost objectives when managing the asset, which may include creating liquidity, hedging the risk, diversifying, or accepting the risk of the concentration.

Dynamics to Consider

Liquidity

How easily can the asset be sold or the number of shares owned be reduced? Does the asset have limited daily trading volume? Does the family hold restricted stock or need to consider time windows when selling is permitted?

Taxes

What are the tax consequences from reducing the position? It will depend on the strategy since there are multiple ways to manage the tax impact of diversification. Individuals and families should consult with their tax advisors regarding their individual situation.

Company-Specific/Idiosyncratic Risk

What is the financial status of the asset, and what should investors expect in terms of risk and return going forward? What would a worst-case scenario look like in a simulated stress test, and how likely is that scenario?

Role in the Portfolio

Does the family rely on the steady income produced by the asset, or is it used more for its growth properties? Can the important characteristics of the asset be replicated with a diversified portfolio?

[1] E. Munshower, *Strategic Thinking: Managing Equity-Concentration Risk*, Citi (June 2009): 4.

Client Perspective

Is there an emotional attachment to the asset that should be considered, such as loyalty to a family business or former employer? Is there a benefit to maintaining the concentration that wouldn't be clear from merely a financial analysis; for example, does the family have a good understanding of the company and its business model? How does this influence the family's perception of concentration risk?

Risks Inherent in a Concentrated Equity Position

A single equity position comprising more than 10% of a total investment portfolio is typically referred to as a "concentrated position." A concentration is frequently the result of accumulated stock shares in an employer retirement plan, an inheritance, employee stock options, or via the sale of a private company for publicly traded shares. A company stock may experience solid returns over an extended period of time, such as Microsoft Corporation, Alphabet Inc., or Apple Inc., or rise in value through dividend reinvestment opportunities and stock splits. A family or individual may be hesitant to diversify the asset as it becomes a larger percentage of their total wealth due to such factors as the tax consequences of realizing capital gains, a sense of allegiance to a company that has performed well in the past, a worry over missing out on future positive returns, or a feeling of confidence and trust investing in a company where there may be a controlling interest. As a result, a family or individual may be susceptible to unexpected company-specific and macro stress, business cycle risks, and tax liabilities during times when stability in returns and a source of liquidity are most needed. In our view, a concentrated equity position may be more exposed to downside risk relative to a more diversified investment portfolio over the long term.

Table 1
Total Percentage of Companies Experiencing Catastrophic Loss

Sector	1980 - 2014
All sectors	40%
Consumer Discretionary	43%
Consumer Staples	26%
Energy	47%
Materials	34%
Industrials	35%
Health Care	42%
Financials	25%
Information Technology	57%
Telecommunication Services	51%
Utilities	13%

Source: FactSet Research Systems Inc., J.P. Morgan

Company-specific risk, such as flat or downbeat earnings, the loss of a chief executive officer, or a failed product launch, may cause a stock's price to fall abruptly. It is rare for a company to generate above-average returns consistently over the long term, and even profitable and well-managed companies have been hurt by poor management decisions, strategies that do not execute as anticipated, and disruptive technology. A 2014 J.P. Morgan study found that since 1980, 40% of the companies listed in the Russell 3000® Index (3,000 large-, mid-, and small-cap stocks representing 98% of the investable U.S. equity market) suffered declines of more than 70% from their market highs (Table 1). Telecommunication Services, Energy, Consumer Discretionary, and Information Technology stocks had the worst pullbacks, with biotech and metals & mining garnering losses of more than 50%.[2] It was not just smaller, **thinly traded stocks** that suffered extreme drops but also regularly traded multinational companies, such as Macy's, Inc., General Electric Company, Procter & Gamble Company, and Exxon Mobil Corporation.[3] Further, the study showed the median stocks in the Russell 3000 Index underperformed the market by 54% over their

[2] E. Munshower, *Strategic Thinking: Managing Equity-Concentration Risk*.

[3] M. Cembalest, *Eye on the Market. The Agony & the Ecstasy. The Risks and Rewards of a Concentrated Stock Position*, J.P. Morgan (December 2014): 4.

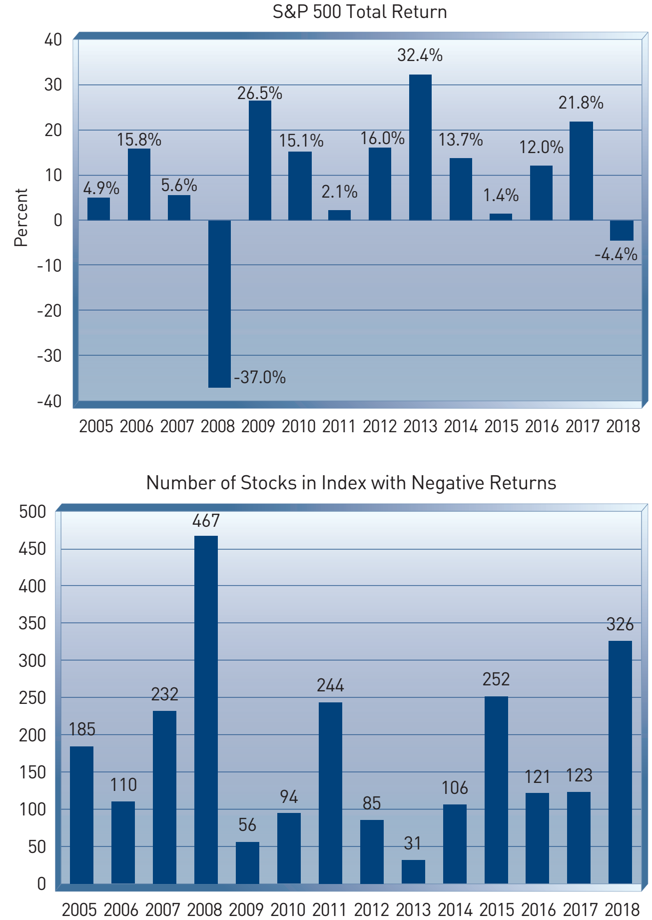
lifetimes (from the point the security first traded as a publicly owned company in 1980 through 2014), with 66% of the companies earning a negative excess return on a relative basis versus the Russell 3000 and 40% earning a negative absolute return.[4] We believe the results of this research highlight an investor's vulnerability to a significant and sometimes permanent loss in their total wealth if not properly diversified or protected from company-specific risk.

Thinly traded stocks are stocks which trade on lower volume and therefore susceptible to higher price volatility.

Narrowing the analysis to companies held in the S&P 500®, while the market-cap-weighted index has advanced 12 of the trailing 14 years since 2005, not every stock has followed suit. Chart 1 illustrates that although the S&P 500 had an overall total return of 1.4% in 2015, half the stocks in the index were down for the year, and in 2016 the index had a return of 12.0%, but about a quarter of stocks in the index had a negative return. In a market-cap-weighted index, changes in the market value of larger securities typically move the index's overall path more than those of smaller companies.[5]

In extreme cases, some stocks do not recover at all, with Blockbuster LLC, Borders Group, Compaq, Enron Corporation, Pan American World Airways, Pets.com, and Trans World Airlines just a few examples of well-known and previously stable publicly traded companies that declared bankruptcy and no longer exist. Diversification can be an effective solution to help reduce these risks, but the ability to do so while also managing the underlying tax costs and other issues in a family's personal circumstances can be quite tricky.

Chart 1
The Historical Performance of the S&P 500 Illustrates the Benefits of Diversification



Source: FactSet Research Systems Inc.

Creating Liquidity

There may be times when an individual or family needs to generate cash to pay for unexpected major expenses, such as sizable health care costs, education, or taxes. The need for liquidity becomes even more acute as retirement age approaches. Having the bulk of your net wealth linked to a single equity position has the potential to create last-minute complications because you may be forced to sell shares at an unattractive price or even at a loss. Diversification not only helps reduce the impact of the holding's volatility on cash needs but also allows for the reinvestment of funds to create a diversified portfolio.

[4] Ibid: 6.

[5] Calculated using data from FactSet Research Systems Inc. Returns reflect the reinvestment of dividends, interest, and other earnings for each annual period between January 1, 2005 and December 31, 2018. Stocks in the index with negative returns represent individual holdings in the index with returns less than 0.0% for the annual period.

Sell the Position

The most straightforward strategy to create liquidity is to reduce the position by selling shares. This may temper price risk and provides the ability to reinvest the proceeds in a diverse portfolio of investments. Although selling in most cases generates a taxable event, we believe it may be a reasonable solution given the current maximum long-term federal capital gains tax rate of 20%. Higher income earners are subject to an additional 3.8% net investment income tax on realized gains. On the other hand, trimming your position may prevent participation in any future price appreciation.

Selling shares outright or even gradually can be complicated. For instance, a company executive or other corporate insider must consider policies related to so-called **open window** periods and regulatory limitations. Stock sales, including those of restricted and control stock, can be executed via open markets, private placements, registered offerings, and re-sales to the issuer. If you own restricted shares, their sale must be executed according to the Securities and Exchange Commission's (SEC's) Rule 10b5-1. The sale of restricted sales is also regulated by SEC Rule 144, which was established to prevent insider trading violations. A plan that meets 10b5-1 criteria demonstrates that the decision to make a transaction was made prior to obtaining insider knowledge regarding a specific company.

An **open window** is determined by the company in accordance with its then-effective policy on trading in company securities, or on a date when one is otherwise permitted to sell shares of common stock on an established stock exchange or stock market (including but not limited to under a previously established company-approved 10b5-1 trading plan).

Borrow Against the Position

Borrowing against an equity position provides a source of liquidity, but it also carries the risk of a decline in the market value of the collateral (equity shares pledged as a guarantee of repayment of the loan). If the price of the shares declines, you may be required to post additional shares or cash to maintain the value of the collateral, reduce the loan amount, or sell shares. Combining a loan with a zero premium collar strategy may help mitigate this risk. This strategy not only provides limited upside participation if a stock price rises but also creates a source of liquidity and helps minimize any downside impact. The borrowed funds can be used for expenses such as investing in a business or nonprofit, real estate, health care costs, or educational pursuits. Since the shares are not sold, you continue to participate in any price movement. In some cases, it is possible to borrow against a restricted stock position, but there are limitations on the amount you can borrow, and it will probably include interest expense.

Hedge the Risk of a Concentrated Position

Reducing a concentration probably is not feasible for families who expect to bequeath their assets in the near future. Upon the death of the asset owner, the heirs may be entitled to a step-up in the cost basis of the equity position, which means they could sell the holding and owe little in the way of capital gains taxes. In this scenario, we believe hedging the position might be a more practical strategy. Hedging is used to reduce the price volatility of a concentrated position by implementing a derivative strategy for a relatively minor cost without selling shares and receiving taxable gains.

Protective Put Option

Buying a put option gives investors the right but not the obligation to sell the underlying stock shares at a predetermined price, known as the strike price, on or before the maturity date. With a put, there is typically no downside risk below the strike price until the option expires. The strike price is usually below the current market price, thus creating a floor for the value of the stock. The investor participates fully in any future price appreciation, but the return and downside protection is reduced by the cost of the premium paid up front to participate in the option trade. The investor usually retains the voting rights and dividend income of the underlying shares throughout the term of the option contract.

Writing a Covered Call

A call option gives the purchaser the right but not the obligation to buy the underlying stock shares at a predetermined price (that is, the call strike price) on or before the expiration date. The seller of the call receives a premium for providing the purchaser with the option to buy the shares in the future. Selling a call option and receiving a premium can help increase the yield on a stock position and obtain limited downside protection. The potential tax consequences may be substantial if selling shares to cover the call option, but cash settlement of the call option can circumvent a sale of the shares.

Zero Premium Collars

A collar strategy can help protect the value of a stock position while allowing for participation in any future price appreciation. A collar is created by purchasing a put option with a strike price at or below the current stock price, and then selling a call option with a strike price above the current stock price (while holding shares of the underlying stock). The value of the position is protected below the strike price of the put option. By establishing a collar, both a minimum and maximum value are created around the stock position until the expiration of the contracts. A collar can be structured so that the premium received from the sale of the call option completely offsets the price of the put option (hence the term zero premium). Similar to writing a call, the transaction can be structured so the investor can settle at expiration of the contract in cash or by delivering the underlying shares.

Prepaid Variable Forward Agreement

A prepaid variable forward (PVF) is an agreement used to hedge a stock position and generate liquidity while deferring taxes until the contract's maturity. This strategy can be complicated, and a complete understanding of the structure is recommended before implementing it in an investment portfolio. A PVF helps provide downside protection and limited upside appreciation as well as flexibility in reinvesting the proceeds. The investor receives a cash payment of 70–90% of the current market value of the equity position and, in return, is expected to deliver shares or cash in the future. Like a collar, the PVF is a customized strategy whereby a range can be set for the value of the shares by creating a ceiling and floor price. Depending on the terms of the agreement, the investor retains the dividends and voting rights during the contract. PVFs are executed in the over-the-counter market and require the completion of the International Swaps and Derivatives Association master agreement.

Tax Efficient Diversification

A concentrated stock position may comprise highly appreciated low-cost-basis shares, and the potential tax impact can be overwhelming for a family when making the decision to sell. For example[6], at the 23.8% tax rate, selling $11 million of stock bought for $1 million would result in a $2.38 million federal tax bill. A family or individual may prefer to hold shares to avoid the tax liability but should weigh the 23.8% tax effect against the prospect of the stock price declining meaningfully over time or in a sharp market sell-off. On the other hand, there may be estate planning factors that make it advisable for a family to maintain the holding, such as the asset owner is in bad health or elderly and it is more tax efficient for the heirs to diversify after receiving a step-up in cost basis.

Exchange Funds

An exchange fund is a private equity investment or partnership formed by qualified investors to contribute their appreciated stock in return for shares of the fund. We believe it can be an effective way to diversify while also deferring capital gains taxes. After a number of years, usually seven, the limited partnership shares can be converted for a diversified basket of securities chosen by the fund manager. When exiting the fund, the original cost basis from a single security can be transferred to a portfolio of stocks. Any capital gain does not need to be recognized until the distributed shares are sold. Generally, you must be accredited and, in some cases,

[6] This hypothetical is for illustrative purposes only. Tax calculations have been simplified for illustrative purposes and do not take into account any tax attributes that may affect a taxpayer's particular situation (for example, state and local taxes, marital status, exemptions, or other withholdings, such as flexible spending accounts). Hawthorn does not provide legal and tax advice—consult with your legal and tax advisors regarding your individual situation.

qualify as a 3(c)7 "qualified purchaser" under the Investment Company Act, with net investments of at least $5 million.

The exchange fund must also have a need for a specific stock before the strategy can be applied. For example, you might have a concentration in Exxon Mobil Corporation, but if the fund already has enough energy exposure it cannot accept the security. Tax laws require at least 20% of the fund must be invested in qualified assets such as real estate properties, antiques, or art. Some funds allow for the withdrawal of shares prior to termination depending on fees and other limitations in the contract; in that case, you would receive all or a percentage of the shares initially invested. There are risks involved with exchange funds because the shares may be illiquid for several years, and any sale or distribution of the security prior to termination will result in a tax bill if there is a gain. There is also the risk current tax laws may change and eliminate the favorable treatment of exchange funds.

Net Unrealized Appreciation

A net unrealized appreciation (NUA) strategy could help moderate future tax hits for those investors who have built up a concentration of a former employer's stock in a 401(k) or other qualified retirement plan, provided they are at least 55 years old and no longer employed by the company. You can withdraw the company stock portion of your retirement plan as a lump sum distribution in certificate form, which requires payment of ordinary income tax based on the cost basis of the stock shares rather than on the market value. When the stock is eventually sold, capital gains taxes are paid on the appreciated value rather than ordinary income tax. If you do not use a NUA but roll over the stock portion of the distribution to an individual retirement account, you would pay ordinary income tax on the appreciated value as you make plan withdrawals, which may be higher than the capital gains tax at that particular time.

Qualified Opportunity Zones

Qualified Opportunity Zones are part of the Tax Cuts & Jobs Act of 2017 and were designed to spur economic development and job creation in struggling U.S. communities. There are more than 8,700 zones, selected by governors, in every state and U.S. territory. Governors are permitted to select 25% of their state's low-income community census tracts to designate as Qualified Opportunity Zones. In our view, this relatively new investment option offers a meaningful way for qualified investors to engage in impact investing while also potentially benefiting from three key tax incentives:

- Realized capital gains reinvested in a Qualified Opportunity Zone within 180 days can be deferred from taxable income until the earlier of December 31, 2026, or the date the fund terminates.
- The existing investment can include publicly traded stock, business and personal assets, and any other property qualifying for capital gains tax treatment.
- An investor can exclude up to 10% of the original realized gain if the investment in the Qualified Opportunity Zone is held for five years and up to 15% of the original gain if it is held for seven years. In other words, just 85% of the original gain will be included in taxable income if the investment is held for seven years. If it is held for 10 years or more, investors have the option to treat the cost basis as equal to the fair market value, allowing them to exclude any gain on the sale of the investment from taxes.

All three tax benefits are available only to those qualified investors who reinvest capital gains into a Qualified Opportunity Zone. Other sources of funding are not eligible for these benefits.

Transitioning Wealth to Charities and Family

Families or individuals who wish to pursue charitable endeavors or transfer assets directly to family members can take advantage of current tax laws to help minimize the tax impact of their giving.

Direct Charitable Gifts

Philanthropy is often an important part of one's long-term investment goals. This may entail gifting cash, company stock, or other types of property directly to a nonprofit organization. When making a charitable gift, the family is usually entitled to an income tax deduction of up to 30% of adjusted gross income (AGI) of the market value of the stock shares.

Donor Advised Funds

A donor advised fund (DAF) is a philanthropic vehicle that allows for charitable donations to a managed fund with an immediate tax benefit. A family or individual may contribute to the fund as often as desired and recommend grants be directed to specific charities. The contributed stock in the DAF can be sold and reinvested in a diversified portfolio tax free. An individual donating to the fund is eligible for an income tax deduction of up to 30% of AGI.

Private Nonoperating Foundations

Establishing a private foundation provides an income tax deduction of up 20% of AGI for gifts of stock. A private foundation may be an appropriate option for those who want to be more directly involved in a nonprofit organization, such as steering its mission, controlling the allocation of funds to selected charities, or determining the organizations and causes to support. There are added administrative costs to establishing a foundation, and Internal Revenue Service regulations require the foundation to make a minimum charitable distribution annually of roughly 5% of the assets, with certain adjustments, based on the previous year's market value.

Charitable Trust Structures

A charitable remainder trust (CRT) offers benefits to those who want to make contributions to a charitable organization and entails the donation of stock shares to a donor-controlled trust. Once the shares are contributed to the trust, the shares then can be sold and reinvested in a diversified portfolio and the family receives the annual income from the trust over their lifetime or a specific number of years. When this period ends, the remaining assets in the trust become the property of the selected charity. Because this trust is tax-exempt, donating shares to a CRT helps protect individuals from capital gains taxes on the sale of the shares they gift. Additionally, the transaction may result in a charitable income and estate tax deduction.

A similar alternative is a charitable lead trust, whereby the chosen charity receives the annual income while the remaining assets are given to named noncharitable trust beneficiaries upon death or after a specified period. Individuals do not receive a federal tax deduction for transferring the shares unless they are the trust's owner (grantor). During the income period, the grantor must report the annual income even though he does not receive the income.

Gifting to Family Members

Another option is to gift shares of stock to family members or family trusts. The annual gift exclusion rule allows gifting up to a maximum value per beneficiary and has no gift or generation-skipping transfer taxes. Further, the lifetime transfer tax exemption permits larger gifts to be made over time. While the cost basis in the stock carries over to the beneficiaries, they also receive all existing and future income and price appreciation. This results in the reduction of one's future income and estate size.

Using Structured Note Products

Lastly, a structured note is a debt obligation incorporating an embedded derivative product that can modify a concentrated equity position's risk/return profile. The return performance of the structure will track an underlying debt obligation and the derivative. Structured notes are designed to meet a family's or an individual's specific needs by using customized and nonstandard features such as capital protection, leverage, and exposure to any asset class. They typically have an intermediate-term maturity of between one and six years and may include a significant coupon, on average 5–10%, depending on the underlying equity exposure and the terms of the structured note. The bond part of an equity note provides principal protection and comprises the bulk of the investment, while the derivative product offers upside potential through exposure to stocks, currencies, and commodities. It is usually linked to a specific industry, sector, index, or basket of equities. An issuer backs the debt, which makes the credit quality of the issuing firm important when using this strategy. The main characteristics of the equity concentration are aligned with the terms of the structured note, providing a targeted hedge. For example, a structured note to hedge a biotech stock could be structured with a principal-protected note (pays back principal in full at maturity) plus an additional payout linked to any decline in the biotech market to offset a loss in the position.

Hawthorn Risk/Return Forecasting Capabilities

The purpose of this white paper is to provide some insight into the potential benefits of divesting at least a portion of concentrated equity positions. But how much is sufficient? In searching for an ideal strategy for selling or maintaining a large holding, families and individuals tend to share similar concerns, such as:

- Will I be able to maintain my current lifestyle?
- How much volatility will I likely experience?
- How much is my net wealth likely to grow or decline?

Hawthorn currently uses proprietary risk/return data analytics that integrates a client's particular circumstances with our capital markets forecasts and single stock return analysis to develop a customized solution for diversification. Hawthorn clients may find this tool helpful in the decision-making process when weighing the pros and cons of various strategies to help manage equity concentration risk.

Conclusion

A concentrated equity position can yield significant wealth. Many families and individuals feel a responsibility to preserve that wealth for future generations, which may include leaving a meaningful legacy and accomplishing specific goals, such as the formation of a private foundation or a family trust. A concentrated equity position at times can be a major source of wealth; in fact, it was a key factor when *Forbes* magazine compiled its top 10 list of global billionaires in 2014. In the United States, the top 10 on the Forbes 400 list also accumulated their wealth through concentrated positions.[7] For some investors, though, these large holdings increase the risk they may not meet their return objectives and other important life goals. Indeed, even some of the most highly regarded companies have suffered steep pullbacks in their stock prices at some point.

Diversifying a portfolio can be complex and may be hindered by tax and legal constraints, emotional attachments to a particular company, or even the possibility that selling the shares may negatively affect the market for thinly traded stocks. It is essential to have a plan in place, but the most appropriate strategy will depend largely on your personal situation. Individuals and families should consult with their legal and tax advisors regarding their individual situation. We recommend being mindful that in some cases the costs of maintaining a concentration, especially over time, may be more than the price of diversification.

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[7] M. Cembalest, *Eye on the Market:* 36.