How Much is Your Concentrated Position Really Benefiting You?

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KLINGENSTEIN FIELDS
WEALTH ADVISORS

Introduction

Family wealth often comes from the substantial appreciation, over time, of a single holding. It could be company stock or options awarded to a senior executive or the holdings of a once-family owned company that has gone public or been sold for the stock of the acquirer. You may have created this wealth or perhaps inherited it. The end result, however, may be that a significant portion of your wealth is tied up in a single asset, exposing you to greater risk and opportunity costs than you may realize.

There are pros and cons to each way you can diversify and mitigate the risks that accompany a large holding. Before deciding on any strategy, it is important to determine what you are trying to accomplish with your assets and to understand how the different investment strategies impact your portfolio and your ability to reach your investment goals.

A concentrated position can be defined as a position in a security or a company that represents a large portion, typically greater than 10%, of your portfolio. Often, this investment has a cost basis that is significantly lower than its fair market value.

All Concentrated Positions are Not Created Equal

There is a tendency to lump all forms of concentrated positions into one bucket, but in reality, concentrated holdings may originate in a variety of ways. Depending on their source, there may be different tax considerations and sales restrictions, as well as differences in how they may affect your portfolio. Some of the most common types of concentrated positions are:

TYPE OF HOLDING	DEFINITION	POTENTIAL SELLING CONSIDERATIONS	POTENTIAL TAX IMPACT*
Public equity	Shares of publicly traded company	If deemed to be a corporate insider, there may be restrictions on how much and when stock can be sold	Depending on tax basis and holding period, will incur short- or long-term capital gains tax on appreciation over basis unless held in tax-deferred accounts
Private equity	Investment in privately held company	Liquidity may be extremely limited	Will incur capital gains tax on appreciation over basis
Stock options	Option to buy shares of a stock at the option's strike price within specified timeframe	Fixed expiration dates require regular monitoring and review and mean they can potentially expire worthless	• For non-qualified stock options (NQSO), difference between strike price and market price when exercised is taxed as ordinary income • For incentive stock options, type of tax liability depends on how long after grant date options are exercised
Restricted stock	Ownership of shares with certain restrictions on selling or trading (such as a vesting period)	Must meet conditions specified in order to sell	Taxation will depend on terms and conditions allowing sale

*Please consult with your tax accountant for more specific tax details regarding your potential tax liability, including Alternative Minimum Tax (AMT) implications.

Although diversification may reduce your overall portfolio risk, the type of holding can have a significant impact on the tax ramifications and your ability to sell outright. If, for example, you are a senior executive of a public company and have received company stock as part of your non-qualified compensation, you are probably considered a corporate insider. In addition, the shares you have received may have appreciated in value considerably above the original cost basis. As a result, you face two major hurdles if you wish to sell:

- The difference between the original cost basis and the selling price will be taxed as capital gains
- As a corporate insider, you are likely subject to restrictions on when and how much you can sell at any one time, plus disclosure requirements

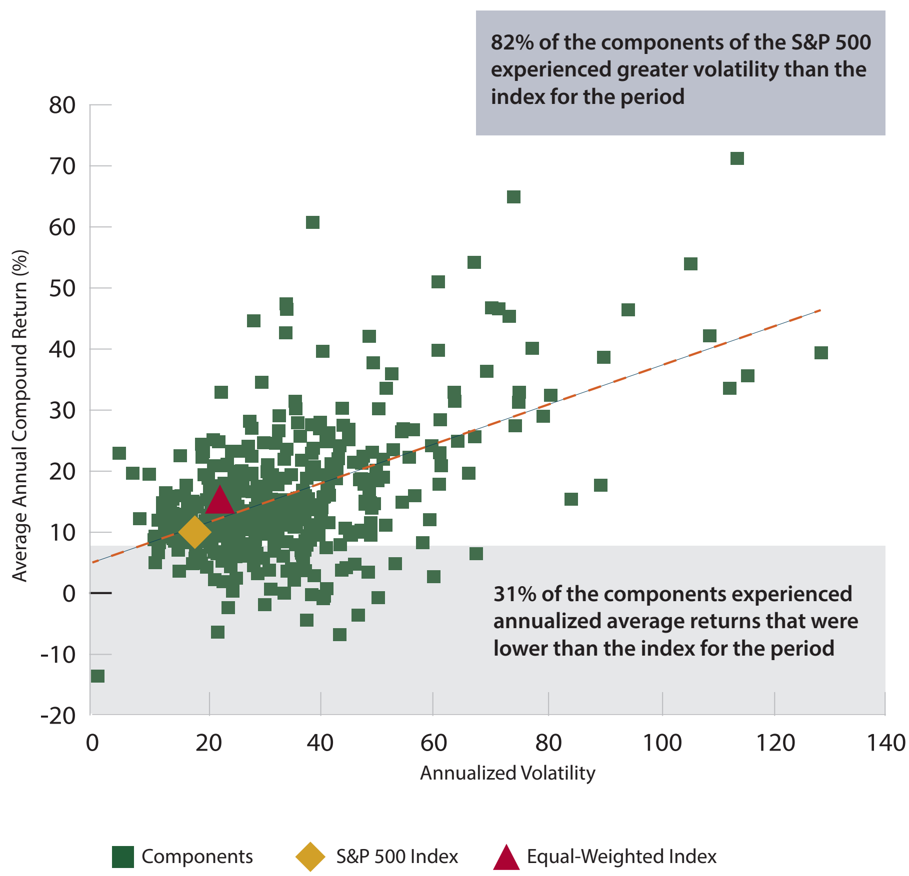
Each type of holding has implications which should be carefully considered before taking any kind of action.

The (Not So Hidden) Dangers of Concentrated Equity

If you hold a concentrated position, chances are it has done very well. All too often, investors fall prey to the thought that past performance will continue, making it emotionally difficult to contemplate reducing one's holdings. However, holding too much of one stock may expose you to higher volatility and lower returns than a more diversified portfolio. If you have a large holding, and its price has a serious downturn, the value of your portfolio (and net worth) can be dramatically affected.

Not only are you at risk due to lack of diversification, there may be meaningful opportunity costs related to your inaction. You may miss out on attractive investment possibilities by maintaining your concentrated holding. In addition, other investment strategies could position your portfolio to be better suited to your goals and risk/return requirements.

Ten-Year Annualized Volatility and Return of the S&P 500 Index Components 2006-2015



Only 430 Stocks are included because of insufficient and inferior data due to entrances into and exits from the S&P 500

Source: Morningstar

Even in the extended bull market environment the U.S. markets have experienced, most individual stock prices were more volatile than the index and a significant portion underperformed the S&P 500 Index for the ten year period 2006-2015.

Why Don't We Sell?

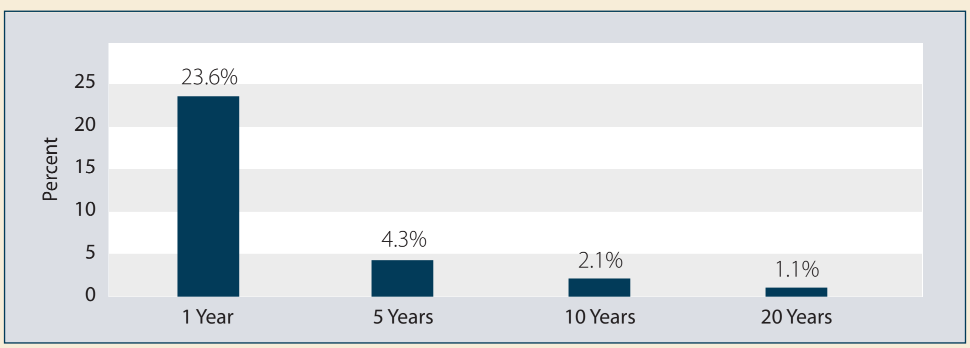
Even if you understand the additional risk associated with a concentrated holding, you may be reluctant to sell your holdings for a variety of reasons. Some of the most common explanations are:

- **Tax considerations.** As discussed, a large single holding may have sizable unrealized gains associated with it. Long-term federal capital gains rates for the highest income brackets are 20% (plus 3.8% for the Affordable Care Act). Together with state and local taxes on long-term capital gains, the average combined marginal tax rate on long-term capital gains is 28.6%[1], but can be much greater in the highest tax states and cities
- **Feeling of loyalty.** If you inherited your holding or work for the company in which you have a large position, you may feel an emotional attachment to the stock
- **Overestimation of positive prospects.** This is probably one of the most common reasons; the stock has always done well by you, so why sell? Possible tail risk (risk of a meaningful downturn) is frequently underestimated
- **Don't want to sell low.** The stock may have come down from previous highs, and you may be waiting for it to recover
- **Strong growth potential.** You believe the company is a leader in an attractive industry in which you wish to continue to participate

Hypothetical Tax Impact of Long-Term Capital Gains on Sale of Security

Original cost basis of investment:	$400,000
Current market value (assuming 200% appreciation):	$1.2MM
Taxable gain if sold:	$800,000
Estimated taxes if sold:	**$228,800**

Incremental Annual Return Needed to Recoup Long-Term Capital Gains Tax Impact*



*Assumes annual compounding

[1] Source: The Tax Foundation

There may also be some very logical reasons for retaining your concentrated holding:

- **Legal selling restrictions.** The terms of a trust could prohibit selling certain holdings or you may be considered a corporate insider, if you are a senior executive at the company in which you have a holding, which may restrict how much and when you can sell
- **Control.** It is possible that retaining your share of a company is vital to maintaining voting rights or a shareholder majority in a company in which you still wish to be actively involved
- **Can "afford" to hold.** If your level of assets is sufficiently large that you can withstand significant volatility and you have conviction that the stock will perform well in the long term, you may decide to hold onto it
- **Short-term time horizon.** If you believe that your time horizon until you bequeath these assets is short, then it may not make sense to sell. In that case, your heirs may benefit from a step-up in the cost basis of the holding to current market value, basically eliminating capital gains taxes if they should sell immediately. Your wealth advisor can help you understand if retaining your holding as part of your estate plan is appropriate

Typically, inherited property that is part of an estate receives a "step-up" in cost basis to the market value at inheritance. The fair market value on the date of the benefactor's death becomes the new basis for tax purposes, and heirs do not have to pay capital gains tax on the difference. For example, if you received 10,000 shares of IBM stock as part of an inheritance that originally cost $10 a share for a cost basis of $100,000, the basis is stepped up to its current market value of approximately $1.54MM.[2]

Identifying Your Objectives

The first step in deciding what to do will depend on your individual objectives, as well as an assessment of the market environment. Working with your wealth advisor, some potential areas to explore include:

- If you feel your holdings have appreciated to a point where you are worried about the value declining, you may want to lock in a certain value
- If your concentrated holdings have a low cost basis you may be struggling to diversify without incurring a massive tax bite
- If you are restricted from selling, you may be looking for ways to diversify without divesting your holding
- You may be focused more on incorporating the disposition of your assets within an estate plan in a way that minimizes estate taxes

[2] Based on a share price of approximately $154 per share as of June 8, 2016. This example does not consider stock splits, etc. that may have additional ramifications on value. Please consult your wealth advisor, financial planner and tax advisor for more information.

Potential Solutions

Once you and your wealth advisor have determined what you are trying to accomplish and any potential obstacles, there are a variety of solutions that can help you:

- Create liquidity
- Hedge/protect position
- Diversify portfolio
- Cut back or sell over time

GOAL	POTENTIAL STRATEGIES	DESCRIPTION	PROS	CONS
Create liquidity	Outright sale	Sale of entire position	Obtain maximum liquidity	May incur significant capital gains tax
	Staged selling	Timed sale of position at intervals, determined either by timing, price threshold or other parameters	Tax burden is spread out over time	May not obtain liquidity quickly enough
	Borrow against position	Hold position and borrow against it	Gives liquidity which can be used for personal use or to diversify	Still at risk if stock goes down
	Charitable remainder trust (CRT)	Irrevocable trust with current beneficiary who receives a specified amount or portion of the trust each year for a specified period (not to exceed 20 years) and a remainder beneficiary, who receives what is left in the trust	• Can provide income stream • May provide tax deduction for beneficiary • May eliminate capital gains tax liability	There are costs associated with setting up a CRT
Hedge/ protect position	Covered call	Selling a call on the concentrated holding	• Allows for appreciation up to strike price • Income realized from proceeds of option sales • Creates liquidity upon sale	• Does not protect against downside • May create taxable event
	Protective puts	Buying put options on the concentrated position to set a floor	Protects against downside and allows participation in upside	• Cost associated with options • May create taxable event
	Collar	Simultaneous purchase of puts and sale of calls to set price floor and ceiling, creating a protective "band" around the stock price	Gives downside protection with some upside participation potential	• Cost associated with options • Limits upside participation
	Prepaid variable forward	Upfront payment in exchange for sale of variable number of shares, depending on stock price, at an agreed upon date	• Provides immediate income • Gives downside protection with some upside participation potential	• Limits upside participation • Complexity of tax implications
Diversify portfolio	Incorporate holding into asset allocation strategy	Select other investments to help balance concentrated holding	Allows investor to incorporate holding into asset allocation strategy	Doesn't eliminate concentrated holding

Conclusion

The issues that surround a concentrated equity position are multifold and complex. Determining the appropriate solution will depend on your circumstances, goals and risk profile. Your KFWA wealth advisor and our credentialed financial planner will work with you, and your outside experts to obtain an in-depth understanding of your situation, to help you understand the opportunities and risks and identify the most appropriate strategy to address your needs.