Concentrated Equity Position

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Managing a Concentrated Equity Position

Defining a Concentrated Position

Holding a large position in one stock increases your risk level compared to a well-diversified portfolio. The definition of a large or concentrated position will vary based on the investor's specific risk tolerance, asset allocation model and other factors. Consider discussing all or some of the strategies below with your clients or prospects to help manage their concentrated positions.

Gradually Sell and Reposition

May be appropriate for clients with these goals: diversify, reduce risk, increase income, and/or to raise cash.

Clients can spread a gain (and corresponding tax liability) over time, perhaps several tax years (discuss with the client's tax advisor). Capital gains taxes can be reduced by

- Offsetting gains with capital losses
  - Ask clients if they have any capital-loss carryforwards.
- Identifying specific lots to sell that have the highest cost basis, or
- Spreading the liability over a number of years by gradually selling shares and then investing the proceeds in other securities.

Clients can also:

- Diversify a portfolio, maintaining full control of after-tax proceeds
- Retain control of their financial situation, stopping and starting the sale of shares as needed
- Give themselves the chance to reinvest proceeds over time

Limit and/or stop orders may be used to set price targets that will help clients stick with their selling plans. Selling covered calls may also accomplish this (see next section).

Need help?

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Listed Option Strategies

Several option-based alternatives can help clients manage a concentrated equity position. Clients may want to explore these alternatives if goals include helping to guard the position from price declines, generating additional income, setting price targets at which to sell the position or creating liquidity.

Keep in mind that option investors may lose the entire amount committed to the option strategy in a relatively short period of time. Some of the option strategies include:

Selling Covered Calls
May be appropriate for clients with these goals: diversify, increase income, and/or to raise cash.

The covered call is a strategy in which an investor writes a call option contract while at the same time owning an equivalent number of shares of the underlying stock.

- A covered call writer foregoes participation in any increase in the stock price above the call exercise price and continues to bear the downside risk of stock ownership if the stock price decreases more than the premium received.
- If the stock price falls, the client is still the stock owner, and the client is subject to the full loss of the stock investment, reduced only by the premium from the sale of the call.
- Covered call selling is not a protective strategy.
- Writing an option on a stock with a low cost basis has tax consequences to consider upon assignment.
- Listed options may be exercised at any time prior to expiration. Therefore, clients who are subject to trading windows on employer stock should **not** use this strategy. Consider custom options as one alternative.

  Example: A client holds XYZ stock trading at $60 per share and wants to sell his shares at $65. He could sell a call with a strike price of $65. In return he receives a "premium" at expiration. If the stock goes above $65, his stock would be called away. If this happens, he is obligated to sell his shares to the buyer of the call at the strike price. If the stock price never reaches $65, the call will expire and the client retains the stock and the premium. At $65, the client keeps the premium and the stock.

Buying Puts
May be appropriate for clients with these goals: reduce risk and maintain the position.

This strategy consists of adding a long put position to a long stock position.

- The protective put establishes a "floor" price under which the investor's stock value cannot fall.
- If the stock keeps rising, the investor benefits from the upside gains.
- Yet no matter how low the stock might fall, the investor can exercise the put to liquidate the stock at the strike price.
- **Caution #1:** When clients buy a put on a stock they have held short-term, they destroy the holding period. The holding period starts over when the put is lifted.
- **Caution #2:** Hedging stock, by holding a put, disqualifies dividends received on the hedged stock from the current preferential tax treatment for qualified dividends. They will be taxed as an ordinary dividend.
- Given no change in the price of an underlying stock, the value of a put option premium will fall over time and eventually expire worthless. The erosion of a put option premium may reduce overall portfolio returns.
- This strategy raises the break-even on the underlying by the amount paid for the put.

- Generally, employees are restricted from hedging their own company stock. Clients should check with their company before utilizing this strategy.

Example: A client holds XYZ stock trading at $60 per share. She is afraid the price will decrease and wants to protect her position if the price drops below $50 per share; so she buys a put with a strike price of $50. At expiration, if the price of the stock is below $50 per share, the put option would be exercised and she would lose her stock and be paid $50 per share for the stock. At $50 or above, the option would expire worthless but she would still own the stock, however, she would lose the premium paid for the option.

Creating a Collar
May be appropriate for clients with this goal: reduce risk.

The investor adds a collar to an existing long stock position as a temporary hedge against the effects of a possible near-term decline.

- The long put provides a minimum selling price for the stock, and the short call sets a maximum price.
- Transaction costs may be significant in multi-leg option strategies, as they involve multiple commission charges.

You may have heard of a zero-premium collar, but that does not mean zero cost.

- Clients purchase a put to protect their downside and use the premium received for selling a covered call to help pay for the put.
- There are transaction costs as well as limited upside potential with a collared position.
- Your position could be called away, triggering capital gains.

Important Options-Related Disclosures

By purchasing options, an investor has the opportunity to earn profits while limiting his or her risk of loss. Of course, an options purchaser may lose the entire amount committed to options in a relatively short period of time.

Options involve certain risks and may not be appropriate for every client. Before opening an option position, a person must receive a copy of "Characteristics and Risks of Standardized Options." If you wish to view and print an online version of "Characteristics and Risks of Standardized Options", please visit the following web page: https://www.theocc.com/Company-Information/Documents-and-Archives/Options-Disclosure-Document For a hard copy, send an email to: options@theocc.com. Keep in mind that commission costs are an important consideration. Supporting documentation for any claims, comparisons, statistics or other technical data will be supplied upon request.

See story name options transactions for the tax treatment of listed options.

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Custom Option Strategies

May be appropriate for clients with these goals: diversify, reduce risk, and/or to raise cash.

Custom collars work like listed collars in that clients protect their downside while capping their upside. However, there are several differences, including:

- Custom options are privately-negotiated contracts between the client and a third party.
- The third party for clients of Wells Fargo Advisors will be Wells Fargo Bank.
- Custom options do not trade on exchanges.
- Custom options are *European-exercise*, which means they can be exercised only at expiration date. Listed options are *American-exercised*, which means they can be exercised anytime up to the expiration date.

- Custom options can sometimes be used for stocks that do not have listed options.
- Restricted stock can sometimes be hedged using a custom collar since they are *European-exercised*.
- If, at the end of a custom contract, clients want to hold on to their shares, their contract can be settled with cash. Or in some cases, the client may negotiate a continuation of the contract.

The initial-minimum custom-options requirement is usually $1 million. For requirements on a specific stock call 212-214-6281.

Variable Prepaid Forward Contract allows clients to:

- Establish floor protection at a minimum price.
- Monetize a significant portion of current holdings.
- Participate in upside appreciation up to the cap level.
- Possibility to defer tax liability until contract is closed. (discuss with tax advisor)
- Minimum position of $1 million dollars or more.

Generally, clients receive "a discounted present value percentage" of the market price in cash at the time they execute the agreement. In this type of contract, clients agree to deliver a quantity of shares (or its cash equivalent) at expiration. This technique gives clients the opportunity to participate in some upside appreciation (to the call price).

(See also referral process for submitting a Custom Options referral)

Borrow Against the Position

May be appropriate for clients with these goals: maintain position and to raise cash.

Borrowing against the stock position can help you:

- Generate cash without selling your securities
- Avoid an immediate tax liability

Securities-based lending allows you to use your eligible marketable securities held with Wells Fargo Advisors as collateral. The amount of cash you are able to raise may be limited by the characteristics of the underlying security. Such factors as share class, credit quality, trading volume and size of position may affect the amount you can borrow. While the loan is outstanding, you receive credit for all dividends* and still maintain voting control over your stock. Of course, at any time, you may repay the loan by depositing additional cash or selling securities in your account.

Securities-based lending has special risks and is not appropriate for all investors.

- Market conditions can magnify the potential for loss
- Market value of the securities may decline below required levels
    - Investor may be required to pay down the loan or pledge additional eligible securities or cash in order to maintain the loan in good standing
    - Investor may be required to sell some or all of your pledged securities

The sale of the pledged securities may have an adverse tax impact.

*Dividends paid on securities held in a margin account could be taxed at ordinary income tax rates rather than capital gains rates. You'll want to work closely with your tax advisor on how this strategy will affect your tax situation.

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Charitable Strategies

May be appropriate for clients with some or all of these goals: benefit charity, diversify, increase income, receive a tax deduction or reduce taxable estate.

Charitable Remainder Trust (CRT)

A charitable remainder trust helps clients reduce overall income and estate tax liabilities, receive an income stream and achieve philanthropic goals. To fund a CRT, the client contributes low-cost-basis stock into the trust. Next the trustee repositions the assets to provide the client and the beneficiaries current income for their lifetimes or for a specified number of years. Because the sale of the stock occurs within a charitable trust, the client does not incur capital gains tax liability.

This technique provides some diversification and reduction of estate taxes. Your client receives a current income tax deduction (subject to income limitations) based on the present value of the donated asset's future benefit. When the client dies, or after a specified number of years, the remainder in the trust goes to a charity of the client's choice.

Because the client has given a significant portion of his or her wealth to charity and lost control over those assets, he or she may want to use some or all of the income from a CRT to buy life insurance held in an irrevocable life insurance trust (ILIT). By doing this, the client hopes to help replace the wealth that was set aside for charity with future insurance proceeds for heirs. The income generated from the CRT can be gifted to the ILIT to pay insurance premiums. When the donor dies, the heirs receive the insurance proceeds income tax free and estate tax free.

> **Important Trust-Related Disclosures**
>
> Trust services are available through banking and trust affiliates in addition to nonaffiliated companies of Wells Fargo Advisors. Insurance products are available through insurance subsidiaries of Wells Fargo and underwritten by non-affiliated insurance companies. Not available in all states.

Private Foundation

A private foundation provides an income tax deduction (subject to income limitations) equal to the fair market value of the long-term appreciated security contributed. However, a foundation does not pay out an income stream. This vehicle would be for clients who want to leave a charitable legacy.

Charitable Funds

A pooled income fund and donor advised fund work similarly to a CRT and private foundation respectively. They are administered by a mutual fund company. These would be useful for clients who are charitably inclined, but do not want the expense or hassle of setting up or maintaining the larger CRT and foundation vehicles. These are also good for clients who want to give smaller amounts to charity.

- A Pooled Income Fund works like a charitable reminder trust in that the donor receives a variable income stream and an income tax deduction (discounted based on income stream). Assets are removed from the estate. The minimum contribution is $20,000.
- A Donor Advised Fund works like a private foundation in that the donor does not receive an income stream, but does obtain an income tax deduction based on the fair market value of the donated assets (deduction will be based on cost basis if donating assets with a short-term holding period). Assets are removed from the estate. The minimum contribution varies depending on the fund. Usually $5,000 or $10,000.

  Donor Advised Funds are a good alternative for clients who have large capital gains tax liability, or who receive a deferred compensation payment or other income in one year, but want the ability to spread the charitable giving out over multiple years.
- Prior to transferring assets, check on the IRS website to verify that the donee qualifies as a public charity for purposes of IRC Section 509(a), (1), (2), or (3).

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Exchange Funds

May be appropriate for clients with these goals: diversify, reduce risk.

An exchange fund can help diversify a concentrated position within a portfolio. It is usually created as a limited partnership composed of a number of participants who contributed a variety of securities. The purpose of this strategy is to exchange your position for a basket of stocks without a taxable sale, thereby achieving diversification without a taxable event.

The required initial minimum contribution is typically $1 million in one security. However, Wells Fargo Advisors offers one product with a $500,000 minimum. To participate, the investor must have $5 million in investable assets and his/her stock is subject to acceptance by the fund manager.

Upon contributing to an exchange fund, an investor is required to hold the shares in the fund for at least seven years to get the full benefit. At the end of seven years, she can receive a redemption, which includes various securities. This transaction is not a taxable event. Taxation occurs when she begins to sell off these new shares of stock. The new shares have a basis that is derived from the original basis of the contributed stock. For a redemption within seven years, the investor will receive either cash or her original stock and an early-redemption penalty could apply.

Important Disclosures Related to Alternative Investments

Alternative investments carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Alternative investments are subject to fewer regulatory requirements than mutual funds and other registered investment company products and thus may offer investors fewer legal protections than they would have with more traditional investments. Additionally, there may be no secondary market for alternative investment interests and transferability may be limited or even prohibited. Other risks may apply as well, depending on the specific investment product. Carefully review the prospectus, private placement memorandum or other offering documents for complete information regarding terms, including all applicable fees, as well as risks and other factors you should consider before investing.

Marketing Resources

- Managing the Wealth You've Accumulated in One Security (PDF)

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