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TIM KOCHIS

WITH MICHAEL J. LEWIS

MANAGING CONCENTRATED STOCK WEALTH

SECOND EDITION **2**

AN ADVISOR'S GUIDE TO BUILDING

CUSTOMIZED SOLUTIONS

MANAGING CONCENTRATED STOCK WEALTH

**An Advisor's Guide to Building
Customized Solutions**

Second Edition

Tim Kochis

with

Michael J. Lewis

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Foreword

Concentrated stock positions are among the most familiar issues financial advisors face—and one of the oldest. They long predate the booms and busts that threatened so many portfolios in the past 20 years—and may do so again. They're likely to remain part of the job of managing wealth as long as entrepreneurs create new wealth and as long as stock, options, and other stock-based measures are part of executive compensation. Since the publication of the first edition of this book, many more options have been granted and, even more so, restricted stock and/or stock units have become heavy components of overall executive compensation. The very large grants of options made in the depths of the global financial crisis of 2008 and early 2009, to take advantage of much depressed stock prices, have since grown greatly in value and are now reaching the later years of their 10-year terms. Based on median grant data from S&P 1500 companies, presented by Equilar's¹ 2012 report on executive compensation, options for more than 1.3 *billion* company shares were granted in 2009 . . . at *2009 prices!* For 2013, Equilar reports that the value of other stock-based compensation (restricted stock and performance shares) was nearly *22 times greater* than the value of the 2013 options grants for S&P 1500 CEOs. And these data only represent the 1,500 largest U.S. companies. No reliable data exists for what has occurred in the thousands of smaller companies, but a reasonable guess is that the potential wealth creation—and concentration—in publicly traded stock, overall, has been vast.

It's fair to say that almost every investor is aware of concentration as an important investment issue and that every financial advisor recognizes the need to be able to respond to the concerns investors have about it. Virtually every book on investing describes the risks of concentrated wealth and identifies at least a few techniques for dealing with it—as a problem. Very few treat concentration as a potential opportunity.

¹ www.equilar.com.

In 2014, Equilar published the *CEO Pay Strategies Report*, which examines how the most influential companies in the United States motivate and reward their top executives. The report highlighted a few key trends:

1. Stock awards, especially restricted stock with performance-based vesting conditions, are becoming an increasingly large share of total CEO compensation.
2. Stock *options*, while still quite large in absolute terms, constitute a smaller portion of these pay packages.
3. CEOs are getting younger, thus with more time to either enjoy the benefits or suffer the burden of these potentially highly concentrated positions.
4. Meanwhile, total compensation packages tend to be even larger than ten years ago at the publication of the first edition of this book, with some of that increase coming from heightened cash compensation elements.

These factors suggest an even more nuanced compensation regime than was in effect during the first edition of this book. Executive compensation continues to be a favorite target of legislative and regulatory attention. The Dodd-Frank legislation of 2010 adds to the key earlier issues (Sarbanes-Oxley, the required expensing of options, and the constraints on flexibility in deferred compensation plans) that were top of mind when this book was first published. Executives and their advisors must still grapple with ways to address the lack of diversification inherent in their concentrated stock positions and the environment has become even more complex.

The first edition of *Managing Concentrated Stock Wealth: An Advisor's Guide to Building Customized Solutions* was designed to put in one place a thorough review of the many techniques advisors have available to manage their clients' concentrated stock wealth—both to reduce risk and to maximize opportunity. This new edition is an attempt to bring this message to advisors even more emphatically. The wealth-building opportunities today are even greater; the risks remain; but some of the tools to manage those risks are even sharper today. This second look sets out more than 40 years' experience with thousands of clients, most of whom have had some form of stock holding that others, at least, would call concentrated. Some of these clients hadn't recognized any special issues associated with their stock holdings; they were neither aware of any particular risks nor eager for any particular excess returns. Others, however, were quick to dismiss any concerns about such risk as naive, uninformed, or unworthy of the entrepreneurial spirit they wanted to cultivate in themselves or others. Most, however, were very happy to have a guide through the often-confusing maze of managing this aspect of their

wealth. Here, then, is what we've learned about how to educate clients on the risks and opportunities related to concentrated stock positions and how best to manage these assets to achieve their objectives.

The book follows the organizational structure of the first edition. The most straightforward solutions are introduced first, followed sequentially by others, each increasingly more complex. That path has two purposes. First, it allows us to more thoroughly address the cumulative nature of the more complex strategies. Deploying a costless collar, for example, presumes a considerable degree of understanding of the more fundamental techniques. The second purpose is to lay out a pattern of choices to consider for the client. If the client's problem can be solved with one of the simpler approaches, there may be no reason to go further. This triage is valuable even if you expect that the optimal strategy for a particular client situation is far along the scale of complexity. Clients often surprise us. Once exposed to a *simple* course of action, they often abandon what we thought was their taste for something more elaborate, and, once exposed to the costs and risks of those more elaborate strategies, they often want to go back to something more tame. Nothing about that trait of human nature has changed in the past 10 years.

The chapters that follow are grouped broadly into three areas—one dealing with various approaches to the *disposition* of the stock by selling (or not buying), the second dealing with gifts to family and to charity, and the third dealing with managing *retention* of the holding. As will become clear, no approach needs to be deployed in isolation. Very often, in fact, several of them can be combined to meet the idiosyncrasies of a particular client's range of needs and desires.

Although financial advisors remain the primary audience for this book, clients should find it valuable as well. They'll identify with the many examples we've drawn from actual clients to illustrate the concepts presented. They'll be comforted to know that they aren't the first or the only ones to face the particularly thorny financial situations that concentrated stock can create—especially if the eventual outcome on display is good. Perhaps even more important, clients can develop much greater confidence that objective, experienced help is available. Their advisors truly are in a position to help and have many effective tools at the ready.

Since the first edition of this book, many advisors have become more adept in helping public company executives deal with these issues, but there are still large gaps in the sometimes more complex situations of concentration in *private* companies. This book continues to address primarily opportunities relevant to public company stock. But, where relevant, we also explore risks and opportunities in the private company setting, especially regarding strategies for the investors in and the founders, executives, and early employees of private companies on a trajectory to go public or which are an acquisition target.

Acknowledgments

I have many people to thank for their help in making this book possible. Let me begin with my wife, Penelope Wong, herself a writer, for her inspiration and for her patience with me over the many evenings and weekends devoted to this work . . . for the second time around.

Special thanks go to my former Aspiriant colleague and collaborator, Michael J. Lewis, for his great insight into the many intricate nuances of these management strategies and his unflagging enthusiasm for bringing this story to a new generation of wealth creators. Thanks also to our research assistant, Victoria Wong, for nearly overwhelming us with updated material.

But I owe my greatest debt of gratitude to the many clients with concentrated stock positions who have given us the opportunity, over many years, to learn how best to help them achieve their financial goals. This book is about them and for the benefit of others like them.

Introduction

Holding a concentrated stock position is unwise, at least theoretically, because of the downside risk. Mainstream investment theory holds that one is not compensated for taking risks that can be reduced.¹ Since diversification of a concentrated position would mitigate its risk, failing to diversify means one is accepting risk for no *expected* reward—well, at least not expected by other investors in the marketplace.

Most people, of course, are eager to maximize their risk-adjusted investment returns. But some can't easily do so because of concerns over tax liability on holdings with large capital gains. Particularly for executives of public companies, the alternatives for addressing the problem are often constrained by post-initial public offering “lockups,” specific employer-mandated shareholding requirements, and Securities and Exchange Commission restrictions on short-term trading or on the use of inside information. Concentration issues are becoming increasingly important for founders, and employees in private companies and for their advisors. For many, the amount of new wealth being created is very large, is being created at very young ages, and is very often the *only* wealth they have.

Many techniques are available—some very simple, others quite elaborate—for easing this concentration risk.

Getting the Priorities Straight

Shortly before writing the first edition of this book, I met with prospective clients, a couple in their late 50s. The husband had just retired from a long and successful career with a large public company. Their largest individual holding was more than \$8 million in his employer's stock. Its price had been falling, and the couple was quite agitated about what to do to preserve this large value. They had already consulted other advisors and were confused. “Some people say we should do puts or buy a collar. One advisor told us to

do something called a ‘prepaid forward.’ Frankly, I don’t understand that. I hope you can help.”

“All of those things, and others, could be appropriate,” I explained, “but let’s start with the simplest steps. We could just sell it. Even if your basis were zero, the worst that would happen is you incur federal capital-gains tax of 20 percent.” (This was in an earlier tax environment, before rates had increased to now nearly 24 percent.) “With the remaining 80 percent, you get to do whatever you want,” I said. “Things get better if you have any basis at all.”

“We don’t have any net gains in this holding,” the husband shot back. “Overall, it’s at a loss.”

“Well, then, why don’t we just sell it—today?” At that suggestion, his wife jumped up, came around the conference table, and planted a big kiss on my cheek—and I had a new client.

The advice this couple had been offered as they shopped for an advisor demonstrates that too frequently advisors are so in love with fancy strategies that they neglect to inquire about the most basic facts of a client’s circumstances—such as the tax basis—and fail to gauge the client’s appetite for complex solutions. The simplest fixes are often the best in terms of controlling costs, reducing delay, and gaining clients’ confidence in the outcome.

It is crucial to recognize that a client’s appetite for complexity or for structural risks (will the counterparty to a custom put be solvent when the put is executed?) or for tax-compliance risks (will exchange funds continue to qualify for tax deferral?) is not necessarily the same as the advisor’s. Some clients are inclined to be very aggressive, in eager pursuit of elaborate techniques. In our experience, however, these people are the exceptions. Most clients are a lot less knowledgeable and, consequently, a good deal less comfortable with sophisticated strategy alternatives than their advisors are.

Moreover, their respective motivations can be very different. Every advisor has had the experience of attending a professional conference, hearing a presentation on a new strategy or a new enhancement to an old approach, and recognizing that he’s not up to speed on it. One of the presenter’s goals, of course, is to engender fear and guilt in his audience for their lack of complete mastery of every new, sophisticated technique. This is one of the ways a profession advances its art. Advisors are eager to achieve—and demonstrate—that mastery, motivated by the desire to maintain or advance their standing among their peers. But that’s not what motivates the client. And a demonstration of the advisor’s virtuosity in a particular strategy doesn’t help much if it isn’t, in fact, the best solution for the client. Often the best approach is one that’s simple, fast, low cost, and with little regulatory or tax exposure. Occam’s razor—first implemented in medieval philosophy and avidly

adopted by the physical sciences—applies here as well: The simplest answer is probably correct.

Knowing the Client

As in all aspects of financial planning, the only legitimate starting place for dealing with a concentrated stock position is an understanding of the client's objectives. Does the client want to accomplish a business goal (acquire or maintain control of an enterprise, for example) that necessitates some degree of concentration? Or does the client want to support an expense target that requires a reasonably predictable cash flow stream that would be jeopardized by the risks of concentration?

Advisors must be sensitive to clients' idiosyncratic risk/return parameters. I've seen many advisors make the mistake of starting off by asking clients about their risk tolerance. Clients don't really know how to respond—and might not tell the whole truth even if they did. They're likely to tell you what they think you want to hear or what seems consistent with the persona or image they'd like to cultivate. In my experience, any *a priori* risk-tolerance statements from the client are unreliable or even misleading.

Consequently, I strongly encourage advisors to be skeptical of the often-used risk-tolerance questionnaires. The chief merit to such exercises is perhaps in having a piece of paper that demonstrates that you actually talked to your client about risk—both the client's risk capacity and the client's risk tolerance. There are better methods and more convincing evidence to use if you ever actually need it to defend your professional actions. So, in addition to using a risk-tolerance questionnaire, it's best to perform the basic financial-planning exercise of determining the resources needed to meet the client's objectives (commonly called a capital-needs analysis) to determine the client's risk capacity; you can then use those conclusions to determine the client's required or acceptable investment returns. Only then can you translate what you've learned into the *required* level of risk the client must be willing to tolerate. If the client can't learn to tolerate that degree of risk, the only real alternative is to change objectives (lesser expense, later retirement, reduced gifts to family or charity, et cetera). In our experience, few clients are willing to lower their financial expectations; they're willing, instead, to accept a higher level of risk—often far more—than they would have let on at a first meeting. Risk tolerance, in our experience, is a *derived conclusion from careful analysis of client objectives*; it's not a reliable initial input. And it can be learned; we've seen thousands of clients do it. It is also dynamic. Both the

capacity for and the tolerance for risk can change over time as the client ages, objectives change, or investment performance (or lack of it) occurs. What is tolerable at one point may become intolerable as time goes on. And, of course, the reverse, the intolerable becoming tolerable, can also occur.

Consequently, concentration needs to be *managed* only if the current capacity and tolerance for risk must be reduced. It can be maintained if the current levels of risk are, in fact, acceptable or if even greater levels of risk are necessary to accomplish the objectives your client truly wants to pursue. Be careful, therefore, not to assume that every concentrated stock situation is a problem to be solved. Many are, but some are not. For example, I've worked with a client—the chief executive officer of a public company—whose company stock made up more than 85 percent of his net worth. The balance of that wealth, however, was more than \$30 million and was broadly diversified across an array of assets not closely correlated to that company stock. If concentration like that is a problem, it's one most people would love to have.

The strategies presented in this book move from the simplest and fastest and, generally, lowest-cost solutions for reducing concentrated stock positions to the increasingly complex and often more costly techniques. No one solution will be right for every client, and many of the techniques can be combined to accomplish clients' multiple objectives as well as to hedge against the potential for downside results that each of these strategies carries.

Another client, for example, had a very large holding of stock and options in the company he worked for and, after long deliberations, accepted our urgings to diversify the position. But that happened only after he became convinced he could pursue *many* approaches simultaneously. Once he gave himself permission to diversify, he was almost giddy with enthusiasm to try a little of everything. In short order, this client sold a large number of high-basis shares outright, exercised his lowest-priced stock options (and immediately sold the resulting stock), transferred substantial amounts of stock options to his children, and funded a multimillion-dollar private foundation with his lowest-basis shares. This was hardly the random search for an answer it may appear to be. The combination of tactics made a great deal of sense to this client, providing comfort that important progress would be made even if some of the techniques ultimately failed to measure up. In the end, the client still left himself with a very substantial position in the stock options—just in case the company's stock price increased. For this client to make any diversification progress at all, a many-faceted hedge was indispensable.

Let's consider, then, the approaches you can use—whether mundane or multilayered—to help your clients meet their objectives.

Chapter Note

1. Most people acknowledge 1990 Nobel laureate Harry Markowitz, beginning with his “Portfolio Selection” paper (*Journal of Finance* 7, no. 1 [March 1952]), as the first in a long line of distinguished thinkers who, together, have given us modern portfolio theory. Diversification of investment holdings to reduce overall portfolio risk forms the core of this school of thought. William Sharpe, also the 1990 Economics Nobel laureate (with Markowitz and University of Chicago economist Merton Miller), introduced the capital asset pricing model (CAPM) in the early 1960s and with it the now-familiar concepts of systematic (market) risk and nonsystematic (company-specific) *diversifiable* risk.

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