



## Financial and Charitable Strategies for Managing Concentrated Stock Risk

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Despite the market turmoil over the past several months, and the corresponding dramatic fall in the price of many stocks, concentrated, low basis stock positions continue to constitute a significant percentage of the net worth of many investors and families.

Investors seeking either to protect the value of their stock without selling it or, conversely, sell or gift it in a tax-effective way, have several financial and charitable strategies at their disposal.

### Financial Strategies

- **Completion Strategies:** The stock can be sold in a disciplined and tax-effective manner. The concept behind completion strategies is simple – sell out of the stock in an orderly manner and reinvest the after-tax proceeds in a portfolio that is as uncorrelated as possible to the remaining concentrated stock. For example, if an investor holds a concentrated position in a bank stock, the reinvestment proceeds should go into strategies and asset classes that are as uncorrelated as possible to the financial services sector. The purpose is to reduce as much as possible the unsystematic risk associated with the concentrated stock position. Investors can also improve the tax-effectiveness of this strategy by reinvesting some of the sales proceeds into tax-enhanced index strategies, and use the tax loss harvesting associated with these strategies to offset the taxes realized as the underlying stock is sold.
- **Hedging Strategies:** These are options-based strategies whereby the investor purchases a put option for protection and partially or fully pays for this by selling a call option. This protected position can then be borrowed against, with the proceeds redeployed in a more diversified portfolio. The primary vehicles utilized are Equity Collars and Variable Prepaid Forwards (VPF). There are differences between these two structures, especially in how much liquidity can be generated from each (the amount is usually higher with a VPF if the intent is to reinvest in marginable securities), but the underlying premise is the same – protect the value of the stock at or near today's market price, and then borrow against the position to



effectively “monetize” the position without selling it for tax purposes. Executed properly, the investor will defer taxes on the sale of the stock until the maturity of the collar or VPF.

- **Exchange Funds:** Under these strategies, investors contribute their concentrated stock position to a larger, more diversified pool of stocks (that come from other investors doing the same thing), and receive in exchange a *pro rata* position in the larger pool. Executed properly, the result is that the investor has improved his/her overall diversification without triggering a tax event.

Most people believe that, regardless of who wins political control in the next election, we are in for a higher tax regime. Employing a tax deferral strategy (i.e., a collar, VPF, or Exchange Fund) may thus result in deferring taxes into a future where the ultimate tax bite will be larger. Given this, the preferred approach for most investors is to consider a completion strategy first, and then consider the other strategies only if there are particular and compelling reasons the completion strategy can't or doesn't meet investor objectives.

### **Charitable Strategies**

**Charitable Remainder Trust (CRT):** CRTs are a hybrid between gifting and selling the stock. The investor gifts the stock to a pre-established Trust, which then sells the stock with no immediate tax hit. The proceeds are then redeployed in a diversified portfolio. Each year, the trust pays out a pre-specified amount (either a fixed amount or a specified percentage of the Trust's NAV) to a beneficiary (usually the donor or donor's family), and at the end of either the Trust's or donor's life, whatever amount that is left in the Trust is then gifted to charity. The amount paid out each year to the beneficiary is taxed, using certain mandated guidelines, so the donor, while not immediately realizing a taxable event upon the disposal of the stock, will pay taxes over time as proceeds are paid out. The net result for the investor is tax deferral, planned annual cash flow for lifestyle or retirement income purposes and, ultimately, a gift to a preferred charity.

**Private Foundations (PFs) and Donor Advised Funds (DAFs):** Private foundations and DAFs represent slight variations of pure charitable gifting of the low basis asset. In both cases, the investor receives a charitable deduction against income tax for the gift but otherwise receives no economic benefit.

Both PFs and DAFs are tax-exempt entities established for the purpose of supporting qualified charitable organizations. While there are some regulatory, cost, and tax differences between the two (most of which, generally, favor Donor Advised Funds), the main difference between a PF and a DAF is in the visibility of the philanthropic activity



and the role that philanthropy plays in the donor family. With a PF, the donor is frequently seeking a means of “putting his/her stamp” on a charitable endeavor, of including family members in that endeavor, and of perpetuating a legacy after they are gone.

DAFs are a similar concept, but the gifting of the low basis asset is not made to a family-specific organization established for that purpose. Rather, the donor gifts the assets to a “host organization” established to accept gifts from multiple donors. DAFs are, in essence, “co-mingled” pools of the charitable gifts of many investors. A donor might gift a low basis asset into the DAF, which sells the securities (tax-free) and adds the proceeds to the overall investment pool of the fund. The donor can then *suggest* how the DAF makes charitable gifts out of that pool (hence the name “donor advised”). The fund is not obligated to follow the suggestions of the donors, but as long as the charity named by the donor is an eligible and legally organized public charity, it is rare for the trustees of the fund to not follow the donors’ suggestions.

As compared to PFs, DAFs are more flexible, less expensive to set up and maintain, offer a better income tax deduction, and will be a better alternative for investors who seek to make charitable gifting a part of their lives but do not wish to devote all or a significant part of their daily lives to do so. Private foundations offer the advantages of more control over the gifting process, a way of bringing family members together in a charitable endeavor, and establishing a public legacy organization for the donor, who typically plans to devote an increasingly amount of time in the management and ongoing operations of the foundation (e.g., retirees).

### **Matching Disposal Strategies to Client Objectives**

No one disposal technique is the preferred alternative in every situation. The investors’ tax situation, investment objectives, time horizon, and charitable inclinations all must be taken into consideration. Frequently, the best course of action is a combination of techniques – for example, a combination of completion fund, hedging, and CRT for investors with modest charitable inclinations who seek tax-advantaged diversification and a subsequent lifestyle income from the reinvestment portfolio. Perhaps a combination of hedging and donor-advised funds will work for a charitably inclined investor who remains bullish on the future performance of the underlying stock, but recognizes the need for diversification.

A thorough understanding of the different disposal strategies combined with knowledge of the investor can help advisors formulate the overall disposal strategy that will most closely meet that investor’s goals and objectives, thereby adding value to and strengthening the relationship with that investor or family.



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