

## Single-Stock Risk Management

Concentrated equity positions occur when a significant portion of an investor's wealth is tied to the stock of a single company. Whether the position is the result of accumulated executive compensation, the sale of a business, founding or creating a company, or an inheritance, concentrated equity positions present both tremendous opportunity and risk because of the lack of diversification.

The heightened risk-return profile of concentrated equity positions, along with the legal, emotional, and practical barriers to diversification, call for a strategic approach to single-stock risk management. William Blair & Company has extensive experience working with corporate executives and other owners of concentrated equity positions. We can assess your current position, along with your financial needs and goals, and help you determine the best course of action for your particular situation.

### Factors to Consider Before Diversifying

Diversification can offer significant advantages over owning a concentrated equity position, but many investors encounter roadblocks to diversifying. While these roadblocks may be significant, few of them are insurmountable. Using an approach that is based on a thorough understanding of the regulatory and legal implications of a potential sale as well as your wealth-management objectives, a diversification strategy can be tailored to your unique situation.

Before deciding on a diversification or hedging strategy, you should consider the following factors:

**Taxes:** Concentrated equity positions often consist of highly appreciated, low-basis stock. As a result of the potential capital gains tax liability, holders of concentrated equity positions may prefer to hold on to their stock and continue deferring the tax liability.

**SEC restrictions:** The SEC restricts the sale of securities by corporate "insiders," such as directors and senior executives; these restrictions can make selling more complicated.

**Public perception:** Officers and directors of public companies, as well as anyone owning more than 10% of a public company's stock, are required to report any transactions involving the stock. When a large block of stock is sold by someone closely associated with the company, it can raise concern among other investors.

**Market impact:** If the stock is lightly traded, the sale of a large block could put downward pressure on the stock's price, reducing the proceeds of a sale.

**Emotional attachment:** Company founders and long-time executives often feel a strong loyalty to the company that they put years of hard work into building. This loyalty, which may be passed on to future generations, can make it difficult for investors to part with the stock.

### Diversification, Hedging, and Charitable Strategies

Diversification and hedging can help owners of concentrated equity positions take advantage of upside potential while reducing risk and achieving liquidity. When diversifying is not an option because of legal and practical roadblocks, hedging can provide valuable downside protection, as well as liquidity in some cases.

#### *Diversification*

- Immediate sale
- Staged sale
- Exchange fund

#### *Hedging*

- Protective puts
- Covered calls
- Zero-premium collars
- Prepaid variable forward sales

#### *Charitable*

- Charitable Remainder Trust (CRT)
- Donor-Advised Funds (DAF)

## Strategies for Concentrated Equity Positions

Strategy	Advantages	Disadvantages
<b>Diversification</b>		
<b>Immediate Sale:</b> Sell all or part of the stock immediately and reinvest proceeds	No delay in achieving diversification and liquidity	May be prohibited by SEC restrictions; no deferral of capital gains tax; market impact and public perception risk
<b>Staged Sale:</b> Sell blocks of stock over multiple years and reinvest proceeds	Retain some upside while gradually achieving diversification and liquidity; defer capital gains tax; comply with SEC restrictions through 10b5-1 plan; reduce market impact and public perception risk	No immediate diversification; risk that capital gains tax rates may increase
<b>Exchange funds:</b> Trade stock for shares in a fund that pools stock of other owners of concentrated equity positions, along with illiquid investments (usually real estate)	Diversification; defers capital gains; no market impact or public perception risk	Limited liquidity; minimum seven-year lock-up period; investment risk; leverage risk and credit risk associated with fund's real estate purchases
<b>Hedging</b>		
<b>Protective puts:</b> Purchase put options to create a price floor	Downside protection while allowing full participation in stock's future appreciation	Out-of-pocket expense for purchasing puts; no liquidity or diversification
<b>Covered calls:</b> Selling (or "writing") call options	Full participation in appreciation up to the strike price; proceeds from options sale can be used to enhance returns or diversify	No downside protection; no participation in appreciation above strike price; proceeds from options sale create taxable income
<b>Zero-premium collars:</b> Simultaneously selling calls and buying puts to create a price ceiling and floor	No up-front premium; full participation in appreciation up to call strike price; full downside protection below put strike price	Downside exposure until put strike price is reached; no participation in appreciation above call strike price; no liquidity or diversification
<b>Prepaid variable forward sales:</b> Investor receives cash in exchange for delivery of a variable number of shares at a future date	Immediate liquidity; downside protection and some upside participation; voter maintains voting rights and dividends until delivery of shares	Proceeds for the stock are discounted from present market value; may create unique tax circumstances
<b>Charitable</b>		
<b>Charitable Remainder Trust (CRT):</b> Stock is contributed to the CRT, which then pays annual distributions to the donor for a given term; at the end of the term, the remaining assets in the CRT pass to the designated charity	Creates an annual income stream; income tax deduction at the time of the contribution; assets are removed from donor's taxable estate; CRT is able to sell stock without immediately paying capital gains	Capital gains tax owed on a portion of the annual distributions
<b>Donor-Advised Funds (DAF):</b> Stock is contributed to a DAF; donor makes recommendations for charitable grants from the DAF over time	Avoid capital gains on contributed assets; assets grow tax-free; immediate tax deduction; extended timeframe for making grants; opportunity to make anonymous donations	Unlike private foundations, no employment opportunities for family members

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