

## CONCENTRATED EQUITY STRATEGIES AND TECHNIQUES



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**MANAGE YOUR ASSETS.  
PROTECT YOUR WEALTH.  
BUILD YOUR LEGACY.**

Concentrated holdings of stock in a single company is one component of wealth management that affects many successful individuals and their families.

Strategies for management of these concentrated holdings involve complex and time-consuming issues that can be challenging for even the most sophisticated investor.

Because your Raymond James financial advisor understands your unique personal situation, he or she can help you determine how the following information may apply to you. Your advisor can then assist you in the development and implementation of strategies that are customized to your needs.

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Often, the very asset that has led to the creation of significant wealth is the one that poses the biggest risk to future financial security. Stock and option incentives from your employer allow for participation in a company's growth. A large inheritance may come in the form of a significant position in a single security. A sale at a closely held business for shares of a publicly traded company is increasingly common.

While each of these scenarios can create wealth within a family, it can also lead to the accumulation of a disproportionately large concentration of net worth in one security. This sort of concentrated equity position can add significant risk and volatility to your portfolio, since price changes in the security can have a major affect on the overall wealth and future financial security of you and your family.

Tax issues created by the sale of the stock, emotional attachment to the company, bullish sentiments on the stock's future or concerns about insider status at the company may paralyze otherwise rational investors. Here we present several strategies that may be appropriate for those who wish to mitigate the risk of over-concentration. Of course, as with all investment decisions, determining the right course of action is dependent on your individual circumstances. You should consult with your financial and tax advisors before employing any of the strategies described below.

The concentrated equity techniques discussed in the following pages can be summarized in four general categories:

- Hedging
- Monetization
- Tax-Efficient Diversification
- Tax-Efficient Gifting

There is a pronounced skew in single-stock returns. While the additional return potential for holding the right stock is substantial, significant underperformance has been four times as likely.

Source: Bernstein Wealth Management Research, 2004.

Options may be executed in the listed or over-the-counter (OTC) markets. Often, investors with larger positions (greater than \$1 million) can benefit from the customization of the OTC market. OTC options will, however, expose the investor to the credit risk of the counterparty on the trade. One way to address this situation is to use counterparties whose Moody's rating is A or better.

## Hedging

Options and other types of derivative securities can allow retention of the stock position and any ownership rights. This approach can help protect against downside risk, too, by allowing you to specify the amount of risk you're willing to take on – and then controlling that risk for a fixed premium. While one or more hedging alternatives may be appropriate as methods for decreasing the risk associated with concentrated positions, it's important to remember that options involve risk and are not suitable for all investors. You should obtain a copy of a current Options Disclosure Document from your financial advisor or from the address at the end of this brochure before choosing these types of strategies, which include:

### Protective Puts

The most common way to hedge potentially poor performance of a large holding is to buy put options. Put contracts give you the right to sell the underlying shares of stock at a predetermined strike price at or before a specified future date.

This places a definitive limit on any potential losses while preserving upside potential. However, this benefit comes at a price: the premiums associated with options can be expensive, contracts must be continually renewed, and you can lose the full cost of purchasing the protective put in a short period of time.

### Covered Calls

The selling of covered calls is a common strategy for increasing the income from a large stock position. A call option seller receives an upfront cash premium, therefore becoming obligated to sell the stock at a predetermined price (the strike price). If the stock appreciates above the strike price, it may be sold, thus limiting your potential upside in the stock and triggering capital gains taxes. It is important to note that the income earned from covered call option writing does provide limited downside protection, but only up to the value of the income. This strategy does not usually provide protection from significant downward price movements.

### Low-Cost Collars

This strategy is basically the combination of the previous two. It's used for hedging downside risk in the stock without incurring the full cost associated with a protective put. By selling a covered call option and buying a protective put option at the same time, you have the potential to offset some or all of the put premium's cost. Be aware that the call option component of this strategy limits the potential upside in the performance of the stock. Effectively, a collar allows you to lock in a minimum and maximum value of the holding until expiration.

#### SAMPLE COLLAR TRANSACTION

Number of shares	100,000
Current price	\$50
Total value	\$5,000,000
Put (floor) price	90% (\$45.00)
Call (ceiling) price	120% (\$60.00)
Time frame	24 months

Closing Price	Client's Value	Client's Total Value	Value Protected	Profit Participation
\$25.00	\$45.00	\$4,500,000.00	\$2,000,000.00	\$0.00
\$35.00	\$45.00	\$4,500,000.00	\$1,000,000.00	\$0.00
\$40.00	\$45.00	\$4,500,000.00	\$500,000.00	\$0.00
\$50.00	\$50.00	\$5,000,000.00	\$0.00	\$0.00
\$57.50	\$57.50	\$5,750,000.00	\$0.00	\$750,000.00
\$62.59	\$60.00	\$6,000,000.00	\$0.00	\$1,000,000.00
\$75.00	\$60.00	\$6,000,000.00	\$0.00	\$1,000,000.00

This example is for illustrative purposes only and does not reflect the performance of any specific investment. The data also does not reflect any commission fees or trading costs.

## Monetization

“Monetization” is another term for liquidating stock for cash. While an immediate sale solves the over-concentration issue, there are other techniques that may be more appropriate from a tax planning perspective.

### Outright Sale

The most obvious method for reducing the risk of a concentrated position is to simply liquidate a portion of the stock and use the proceeds to invest in a more diverse range of securities. However, many investors resist this strategy because selling outright may result in significant capital gains taxes related to the low cost basis of the stock. But with today’s capital gains rate at a modest 15%, selling the shares and paying the taxes may be an acceptable and immediate solution for your lack of portfolio diversity.

There are other factors to consider before you sell all or some of a concentrated position. For instance, the actions of senior executives who own a significant portion of the firm’s equity could influence other investors, potentially impacting the stock’s market price. In some cases, restrictions on stock shares may even prevent this from happening by limiting insiders’ ability to sell.

### Variable Prepaid Forward

A variable prepaid forward (VPF) is another common technique for monetizing a large stock position, and can address some of the concerns associated with an immediate sale. A VPF provides similar protection to a collar, but with the added benefit of providing you with an immediate cash payment. A VPF is an agreement to sell a variable number of shares at a specified future date (typically one to five years) in exchange for an upfront cash payment. This cash advance is normally between 75% and 90% of the stock’s current market value and never has to be repaid.

It is important to note that VPFs protect against losses related to downside movement in the stock price (at an amount equal to the initial cash payment), but may also limit potential upside in the stock. At the contract’s expiration, you’re responsible for delivering a number of shares (or the cash equivalent) as determined by the stock price at that time. Tax on the sale of the shares is generally deferred until the contract expiration date. Seek counsel from your tax advisor about your specific situation, since tax consequences may impact this strategy.

The initial proceeds from a variable prepaid forward can be used to invest in a diversified portfolio. Meanwhile, you still maintain a limited upside in the performance of the stock, continue to receive dividends and potentially defer the capital gains taxes associated with the eventual sale.

#### SAMPLE VPF TRANSACTION

Number of shares	100,000
Current price	\$50
Total value	\$5,000,000
Put (floor) price	100% (\$50.00)
Call (ceiling) price	120% (\$60.00)
Upfront payment	85% (\$4,250,000)
Term	24 months

% Change	Stock Price	SHARE DELIVERY		Net value retained by client
		Shares Delivered	Shares Retained	
-50.00%	\$25.00	100,000	0	\$0
-25.00%	\$37.50	100,000	0	\$0
-15.00%	\$42.50	100,000	0	\$0
-10.00%	\$45.00	100,000	0	\$0
-5.00%	\$47.00	100,000	0	\$0
0.00%	\$50.00	100,000	0	\$0
5.00%	\$52.50	95,238	4,762	\$250,000
10.00%	\$55.00	90,909	9,091	\$500,000
15.00%	\$57.50	86,957	13,043	\$750,000
20.00%	\$60.00	83,333	16,667	\$1,000,000
30.00%	\$65.00	84,615	15,385	\$1,000,000
50.00%	\$75.00	86,667	13,333	\$1,000,000

This example is for illustrative purposes only and does not reflect the performance of any specific investment. The data also does not reflect any commission fees or trading costs.

Exchange funds are offered as private placements and are not registered under the Investment Company Act of 1940. Therefore, they have strict net worth requirements that must be met. Your financial advisor must be aware of your investable net worth and other important information before this strategy can be evaluated or recommended.

## Tax-Efficient Diversification

### Equity Exchange Funds

Using an exchange fund can be a viable alternative for those who wish to achieve diversification without selling shares outright. Exchange funds essentially allow for shares of the stock to be contributed to a diversified fund in exchange for a pro rata share of ownership in the resultant portfolio. A major benefit here – besides the increased diversification – is that because the stock isn't actually sold, capital gains taxes aren't incurred. However, you still face the risk of loss if the other stocks in the pool decline in value, so be aware that diversification does not ensure a profit or protect against a loss. There are other considerations regarding this technique that should be discussed with your financial advisor, including, but not limited to: your time horizon, liquidity of exchange fund shares, objectives and actual holdings within a particular fund, eligibility of particular stocks and net worth requirements.

### Managed Account Solutions

Another technique for diversifying a position is to use a professional portfolio manager to execute an agreed-upon, customized strategy. The portfolio manager seeks to provide a long-term (three to five years) selling strategy to efficiently manage the tax impact of sales.

A covered call writing strategy may also be used to generate additional income during the selling period. As the position is sold over time, the proceeds can then be diversified according to your desired strategy.

### Borrowing Using Margin

A leveraging strategy addresses the risk related to concentrated positions by using the large stock position as collateral to purchase other investments. This strategy – often referred to as margining securities – may be appropriate in some cases, but it involves an incremental degree of risk that should be evaluated with your advisor.

Specifically, a decline in the stock's price can magnify the potential for loss of your equity value. A decreased value of the leveraged securities may mean you'll be required to deposit additional securities and/or cash in the related margin account. To meet a margin call, the securities in the account may be sold without notifying you. In addition, you're charged interest at rates determined by the value borrowed and prevailing market interest rates.

Margin may be an appropriate method for addressing concerns of a concentrated position if these risks are well understood; however, it may be used more effectively in combination with other techniques described in this brochure.

### Net Unrealized Appreciation Strategy for Stock Held in Qualified Plans

Because of the growth of employer savings plans to meet retirement goals, it's not uncommon for employees to have a significant amount of employer stock in their qualified retirement plans. When it comes time for employees to leave the nest, most are willing to directly roll over all qualified plan assets into a traditional IRA. However, there may be another option that should be considered – one that offers significant tax advantages.

By not including the employer stock in the traditional IRA rollover when you retire, you're exposed to income taxes immediately as a taxable distribution. However, the taxes due will be applied only to the cost basis of the stock. The remaining untaxed value, called net unrealized appreciation, is deferred until later sale — and then only at favored capital gain rates. If the cost basis of the employer stock is much lower than the current market value, exposing the stock to taxes now may be more advantageous in the long run than eventual distributions taxed at ordinary income tax rates. While this strategy does not result in immediate diversification, it can be used effectively in combination with other techniques to help you diversify your holdings.

## Tax-Efficient Gifting

Some methods for reducing concentrated equity risk can also help you leave a longstanding and meaningful legacy. Consider these ways to achieve philanthropic or generational transfer goals while lessening your tax obligation.

### Charitable Remainder Trusts

Charitable remainder trusts (CRTs), allow for the donation of an asset — in this case a portion of a concentrated stock position — to a donor-controlled trust. The owner can then sell the stock and reinvest in a diversified portfolio — and you'll continue to receive a stream of income for a set number of years or your lifetime. When this period expires, the remaining assets in the trust become the property of the chosen charity.

Because this charitable trust is itself a tax exempt entity, donating shares to a CRT helps you defer capital gains taxes upon the sale of the shares. Plus, the transaction may result in a charitable income and estate tax deduction.

### Pooled Income Funds/Charitable Gift Annuities

These programs provide the benefits of establishing a CRT without the establishment cost, ongoing management responsibilities or owner control. You deposit the stock into a charitable fund, receive an income tax deduction and get a fixed or variable stream of income over your lifetime. The principal is left to the qualifying charity of your choice.

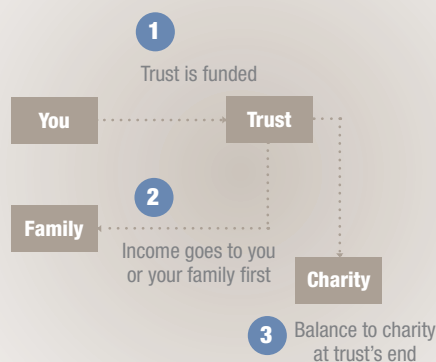
### Gifting to Family Members

Another way to manage a concentrated personal investment in a single security is to give some of the stock to family members or trusts. The annual gift exclusion rule allows a person to give up to \$12,000 per year (in 2007) per beneficiary — free of any gift or generation skipping transfer taxes.

Furthermore, the lifetime gift exclusion (roughly \$1 million) allows for even larger gifts to be made. Although the cost basis in the stock carries over to the beneficiaries, all existing and future income and appreciation occurs in their hands. This could allow for savings in income, estate, and state death taxes.

For many investors, multiple techniques may be employed in combination. For example, using the NUA strategy to remove a large position from a qualified plan can be followed by the use of an exchange fund — this immediately diversifies the position and continues to defer the capital gains.

#### HOW A CHARITABLE REMAINDER TRUST WORKS



A professional financial advisor can provide you with access to ongoing research that examines individual companies; this research can then be evaluated when making decisions.

## The Value of Professional Advice

While concentration in a large, low-cost-basis stock position is one of those “good problems to have,” over-concentration must be addressed if you wish to avoid significant risk to the future financial security of your family. A professional financial advisor understands this risk and can assist you in making decisions regarding what is likely your family’s largest asset.

If reducing the risk exposure of a single stock is so important, why don’t people take action? Here are the three reasons most often cited:

**Taxes** | The outright sale of a low cost basis position can lead to a large tax liability. However, taxes are only one consideration when making a financial decision, and should be weighed alongside the risk of volatility and significant losses in the stock. Investors should not “let the tax tail wag the investment dog.” You should consult with your tax advisor when considering changes in strategy.

**Emotional attachment to the company** | Owners of single stock positions often let emotions overcome rational investment discipline. The stock position is often the main reason families have achieved significant wealth, and owners tend to believe their stock will continue to perform as it has in the past. However, to not consider the potential for significant loss in a stock could erode accumulated wealth much more quickly than it took to amass it. Some of the techniques described in this brochure allow for continued ownership of the shares while managing this risk.

**Dividend income** | When the dividends from a large stock position provide a significant source of income for a family, it can be difficult to look past that fact and consider selling the stock. The dividend yield on a stock, however, is only one component of its total return and risk profile; a few days of negative performance in the stock price can lose much more value for the holder than an entire year’s worth of dividend payments. Your portfolio may be repositioned to provide the same level of income for your family, without taking on the significant risk associated with the volatility of a single stock.

Objections like these are difficult for people to overcome. That’s why the perspective of a professional financial advisor is so valuable. Informed, objective counsel can help clarify potential choices and propose more suitable solutions.

### SELECTED U.S. COMPANIES DECLARING BANKRUPTCY: 1987-2005

Texaco	Financial Corp. of America
Eastern Airlines	Texas American Bancshares
Federated Dept. Stores	Drexel Burnham Lambert
National Gypsum	Bank of New England
Columbia Gas Systems	Charter Medical
Wang Laboratories	Rockefeller Center Properties
Montgomery Ward	Boston Chicken
Fruit of the Loom	Armstrong World Industries
Bethlehem Steel	Burlington Industries
Enron	Pacific Gas & Electric
Polaroid	Sunbeam
Adelphia Communication	Conseco
Global Crossing	Highland Insurance
Kaiser Aluminum	Kmart
Peregrine Systems	UAL (United Airlines)
WorldCom	Loral Space
Magellan Health Services	Spiegel
Delphi Corporation	Delta Airlines
Refco Inc.	Winn-Dixie Stores

Source: [www.bankruptcydata.com](http://www.bankruptcydata.com)



# Customized Solutions

Due to the complexities involved in the strategies covered in this brochure, it is important that you work with your financial advisor and tax professional to determine that the technique you employ is suited for your long-term objectives and risk tolerance.

Keep in mind that these strategies are not an “all-or-nothing” decision. In other words, either

a single technique or a combination of strategies may be used for some or all of your concentrated holdings. Your financial advisor and a team of supporting specialists at Raymond James stand ready to assist you in evaluating your choices and creating a customized solution. Turn the page for some questions to review with your financial advisor to get the process started.



## Next Steps

Here are some questions to explore with your financial advisor to help determine which solutions may be most appropriate for your situation. These questions are a general guide and don't represent all the factors that should be considered before making a decision to use the strategies described in this brochure. Your advisor can help you consider the individual risk factors of each strategy in the context of your specific financial situation.

- 1 What is the objective for this stock position in the context of your long-term wealth management plan?
- 2 In what stock(s) do you own a concentrated position? Is the stock held individually, jointly with your spouse, in a retirement plan, in a trust or some other entity? How many shares do you own and what is the cost basis?
- 3 Based on the size of your position, the company's market capitalization, any restrictions on the shares and your net worth, which strategies in this document would be available to you?
- 4 What is your outlook on the stock's future performance? What does available research indicate?
- 5 Do you have immediate liquidity needs for the value in the stock position?
- 6 Are you willing to pay upfront costs to provide for downside protection against price declines?
- 7 To what extent do you rely upon dividend income from the position for current cash flow?
- 8 Are you charitably inclined? If so, how can you use the stock position to achieve charitable objectives while managing your risks of concentration?

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