THE BIRCH LANE PERSPECTIVE

Growth Capital, Business Exit Strategies, and Preserving and Growing Wealth
Volume 35, May 2024

"The true currency of life is time, not money, and we've all got a limited stock of that."
– Robert Harris

Tax Efficient Executive Compensation Strategy

Executive compensation can involve a complex and confusing web of issues, with different tax rules and different strategies appropriate for each type. Good financial planning considers tax efficiency, value, liquidity needs, risk management, wealth concentration, estate planning, philanthropic goals, and other factors. The right strategy is different for every person.

Here is an overview of the major types of executive compensation issues you're likely to come across:

Incentive Stock Options (ISOs) and **Non-Qualified Stock Options (NQSOs)** are two common forms of equity compensation. Each has its own tax implications and requires careful planning to maximize benefits.

- Key strategies for ISOs involve the timing of exercise within a year, planning around the alternative minimum tax (AMT), 83(b) elections, early exercise, and more. Done right, ISOs can be taxed at the relatively low long-term capital gains tax rate.

- NQSOs have less restrictions than ISOs, but are taxed as ordinary income and timing is important when considering tax bracket, value, risk, and wealth concentration.

Restricted Stock and the 83(b) Election. Restricted stock refers to shares granted to an employee that are subject to vesting. An 83(b) election allows the employee to pay taxes on the total fair market value of restricted stock at the time of granting. This can be beneficial from a tax perspective if the stock's value increases significantly over the vesting period, but subjects the employee to the risk that the stock ends up worthless or does not vest.

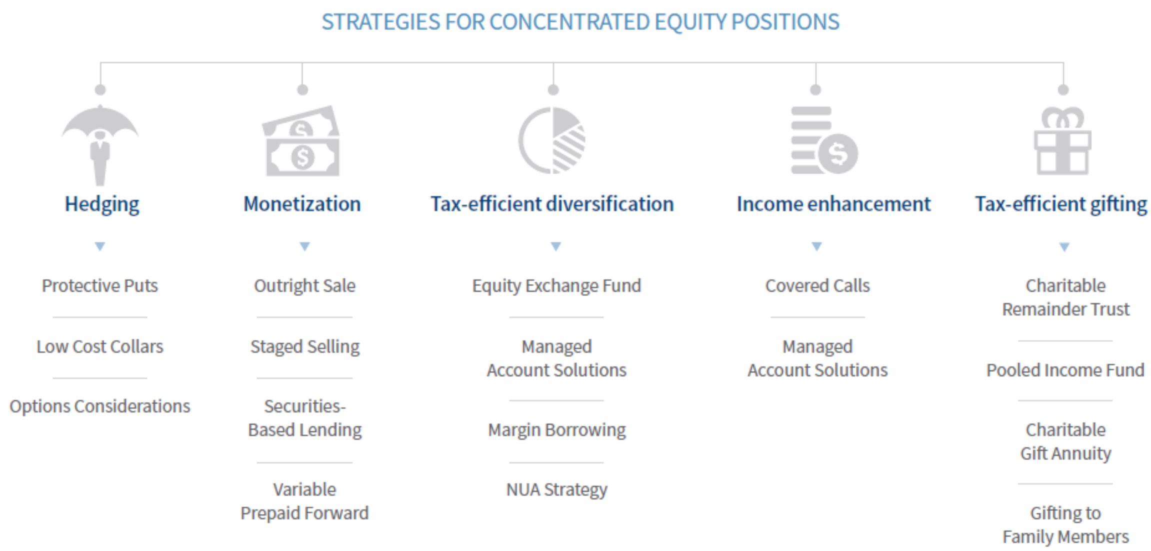
Concentrated equity strategies involve holding a significant portion of wealth in a single business or stock. To manage the risk and tax implications, several strategies can be employed:

- Using options for value protection and reducing the position.

- Structured stock selling, variable prepaid forwards (VPFs), and using a trust when selling stock.

- Equity exchange funds.

- Gifting stock to charity or family: This can reduce the size of the estate and potentially provide a tax deduction.



Employee Stock Ownership Plans (ESOPs)

ESOPs are a type of employee benefit plan where employees have an ownership interest in the company. ESOPs can be a tax-efficient exit strategy for business owners. Here are some tax-efficient strategies related to ESOPs:

- **Deferral of Capital Gains Taxes**: Owners of privately held businesses can sell a portion or all of their shares to the ESOP and defer or, with proper planning, permanently avoid paying capital gains taxes on the sale.

- **Tax Deductible Contributions**: For companies, contributions made to the ESOP are tax-deductible, providing financial relief and incentivizing the adoption of the ESOP model.

- **Estate Planning Techniques**: With appropriate planning, an ESOP transaction presents significant opportunities to minimize estate, gift, and generation-skipping taxes through the use of techniques such as charitable remainder trusts, grantor retained annuity trusts, and irrevocable trusts.

Net Unrealized Appreciation (NUA) is a tax strategy for company stock held in a 401(k). It allows you to pay long-term capital gains tax rates on the appreciation, which can be significantly lower than ordinary income tax rates.

Rule 10b5-1 Trading Plans allow insiders to sell company stock without violating insider trading laws. These plans must be set up when the executive is not in possession of material non-public information.

Investment Management is crucial for executives who often have little time to manage their investments and create the most value for themselves by focusing on their own business. Investment management involves making strategic decisions about investment mix and policy, asset allocation, and balancing risk against performance. Tax-efficient strategies include prioritizing long-term capital gains, tax loss harvesting, choosing tax-efficient bonds, and using tax-advantaged accounts.

Estate and Trust Services involve managing and distributing a person's assets after their death. Tax-efficient strategies include utilizing annual exclusions, making tax-free gifts, and employing trusts to transfer assets efficiently.

Cash Management and Lending Solutions can provide liquidity when needed, without disrupting your long-term investment strategy or realizing gains before you're ready to sell.

Finally, **Philanthropic Strategies** involve making charitable contributions. Tax-efficient strategies include donating appreciated assets, opening a donor-advised fund, and making qualified charitable distributions.

Each of these topics go much deeper and a lot depends on the nuances of the situation. We are happy to have a conversation to help you optimize the benefits for your specific needs.

Planning Ahead

We can help you raise growth capital, prepare to sell your business, efficiently manage executive compensation, improve tax efficiency, and organize your finances for a comfortable, confident, and stress-free retirement. If you would like to learn more, please visit my calendar online at Calendly or email me at Randall.Watsek@RaymondJames.com for a free consultation. The earlier you start planning, the better prepared you'll be.

Key Wealth Principles

- A foundation of good habits is more important than fancy techniques
- Invest in quality businesses at an attractive price
- Build a portfolio of good businesses in different industries
- Maintain appropriate reserves and income sources
- Consider your financial circumstances, liquidity needs, goals, tax, and risk exposure

Last Month's Winners and Losers

Winners	**Losers**
Size	Risk
Value	Crypto
Profitability	Theme stocks
Momentum	Long-term bonds
Chinese stocks	Crude oil

April was a bad month for most things risky, whether stocks, long-term-bonds, or crypto. Perhaps the exception was Chinese stocks, which have been beaten up over the last few years, but did well last month. Relatively speaking, larger companies, value-oriented companies, and profitable companies held up better.

Stocks

	S&P 500	**Dow Jones U.S. Select Dividend**	**Russell 2000**	**Bloomberg US Long Treasury**
1mo Return	-4.1%	-3.1%	-7.0%	-6.1%
YTD Return	6.0%	2.8%	-2.2%	-9.1%
10yr Return	12.4%	8.9%	7.2%	0.4%
20yr Return	10.0%	8.4%	7.9%	3.6%
30yr Return	10.5%	10.9%	8.6%	5.3%

Source: FactSet as of 5/4/2024. We use the S&P 500 index as an illustration of the performance of large cap stocks, the Dow Jones U.S. Select Dividend index as an illustration of the performance of high dividend stocks, the Russell 2000 index as an illustration of the performance of small cap stocks, and the Bloomberg US Long Treasury index to illustrate the performance of treasury bonds with maturities greater than 10 years out.

Stocks took a moderate hit in April. Valuations are still stretched in anything related to artificial intelligence and there may mini-bubble in that and related sectors. However, outside of those sectors, I believe that there are many quality companies trading at reasonable valuation multiples. For example, it's not hard to find quality dividend stocks or small cap stocks trading at a 6% earnings yield, which is well in line with historical averages.

	Large Cap Stocks	**Dividend Stocks**	**Small Cap Stocks**
Dividend Yield	1.4%	3.4%	1.6%
Earnings Yield *	5.2%	6.3%	6.4%
Earnings Growth	11.4%	8.2%	16.7%
Return on Equity	17.1%	12.0%	10.6%
% Losing Money	6.2%	7.9%	39.2%

Source: FactSet as of 5/4/2024. Dividend Yield is an estimate based on the weighted average of all companies in the category (by market cap). Earnings Yield, Earnings Growth, and Return on Equity are estimates based on the median profitable company. The % Losing Money statistic represents the percent of stocks with negative earnings in the preceding 12-month period. Large Cap stocks are defined here as the stocks in the

S&P 500, according to FactSet. Dividend Stocks are defined here as the stocks within the S&P 500 that pay an above-median dividend yield, according to FactSet. Small Cap stocks are defined here as U.S. stocks ranked 1,001 to 3,000 in market capitalization, according to FactSet.

** "Earnings yield" is an investor's share of earnings for every dollar invested (i.e., earnings per share / price per share). It's the same as the more famous Price / Earnings (P/E) ratio, but expressed as a yield rather than as a multiple. I use it to compare stocks more clearly with bonds and other asset classes. "Equity Risk Premium" equals the Earnings Yield minus the 10-year Treasury Inflation Protected Securities yield.*

Artwork

"Sri Shanmukaha Subramania Swami" by Raja Ravi Varma (c. 1900-15). Source: WikiArt.org.

Income Investing

Interest Rates	
1yr Treasuries	5.2%
10yr Treasuries	4.7%
10yr TIPS	2.2%
Municipal Bonds (5yr AAA)	2.8%
Corporate Bonds (5yr A)	5.2%
30yr Fixed Rate Mortgages	7.6%

Dividend Yields	
Common Stocks	1.4%
—Top 25%	4.3%
—Next 25%	2.5%
Preferred Stocks	6.0%
Utilities	3.7%
Real Estate (REITs)	4.0%

Source: Interest rates from Raymond James' Weekly Interest Rate Monitor as of 4/29/2023 and The Wall Street Journal as of 5/5/2024. Source for the Dividend Yields is from FactSet as of 5/4/2024. Common Stocks uses the estimated weighted average dividend yield for the S&P 500. The top 25% yield is the median yield of the top quartile of dividend-paying stocks out of the largest 1,000 stocks. The next 25% yield is the median of the second quartile. Preferred Stocks is the median dividend yield of the 100 largest traded preferred stocks (by dollar volume, per FactSet). REIT and Utilities dividend yields are the median of those sector stocks included in the 1,000 largest common stocks.

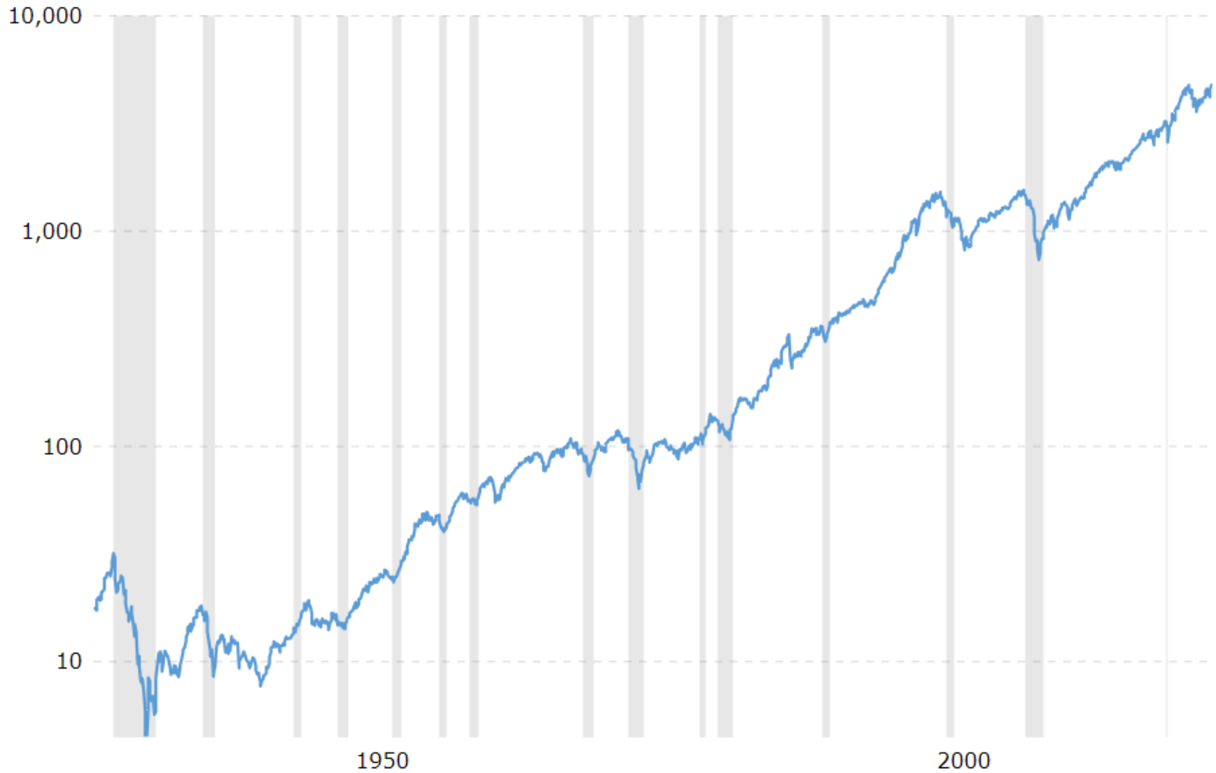
Long-term bonds went down significantly last month as interest rates rose. Although rates may be appealing to some people, I still view long-term bonds as subject to significant risks given persistent inflation and extremely high ongoing government deficits. Structural pressures will be ongoing with an aging population and increasing Social Security and Medicare payments. Meanwhile, the government continues to spend aggressively on other items.

Given those risks, I continue to believe that long-term interest rates are still not particularly attractive. I am keeping my eye on short term instruments of less than one year maturity and dividend stocks that have the potential to increase dividends faster than inflation over time. Although commodities may offer a hedge, I prefer assets that produce independent sources of value such as earnings, dividends, and interest, rather than betting on a particular economic outcome.

** Implied inflation expectations are derived from taking the 10-Year Treasury rate and subtracting the 10-Year Treasury Inflation Protected Securities (TIPS) rate. For example, if the yield on 10-year treasuries is 4.3% and the yield on 10-year TIPS is 1.9%, they are roughly equivalent investments if inflation comes in at the difference (2.8% - 0.4% = 2.4%).*

The Long View

S&P 500, Jan. 1928 to Dec. 2023



Source: MacroTrends.net

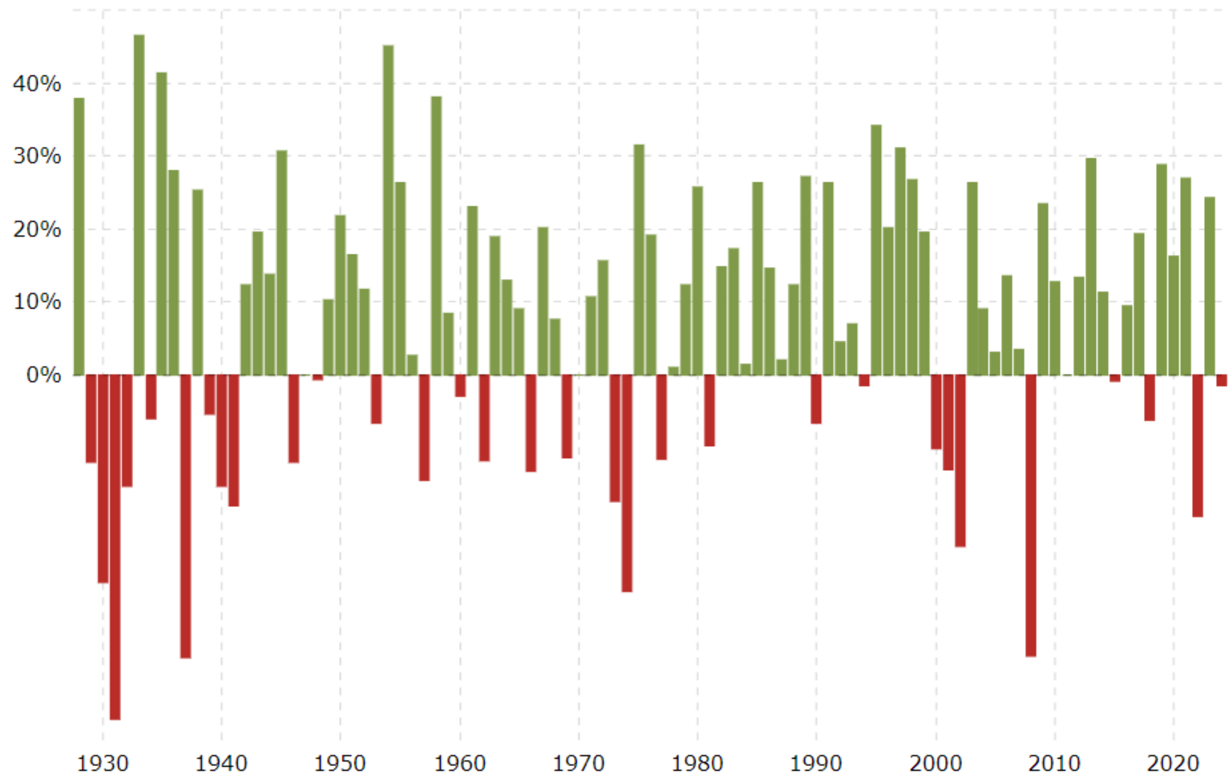
For the last 20, 30, and 100 years, stocks have averaged around an 8-10% return, driven by dividend yield, reinvestment of earnings, and earnings growth. Long-term bonds have yielded about 5% on average over the last century while inflation has been about 3%.

Throughout this period, there have been major upheavals, such as the Great Depression, World War II, The Korean War, The Vietnam War, dropping the gold standard, 1970s high inflation, 1987's Black Monday Crash, the Dot.com bust, the 9/11 terror attacks, the Global Financial Crisis, and the Covid Crash, among others.

These events led to severe market downturns about once every decade, with a median price decline of 33% and a median time to recover back to the previous high of 3.5 years. If we were to include dividends, the recovery to previous highs is actually a little faster. *

Meanwhile, a 3% inflation rate results in a 59% decline in the value of a dollar over 30 years. Meaning that people who retire at 60 years old on a fixed income face a high risk of a lower quality of life as they get further into retirement. *

The Price of Market Returns: Significant Volatility



S&P 500 Yearly Returns, 1928 to 2024. Source: MacroTrends.net

** Source: Morningstar Direct via cfainstitute.org, FactSet. Past performance is not necessarily indicative of future performance. Depreciation of the dollar: $1 / (1 + 3%)^30 = $0.41 real value 30 years later.*

Market Outlook

Now I'll put on my "Nostradamus Hat" and make some predictions, for whatever they're worth:

- Inflation will average 2-5% over the next 10 years.
- Interest rates will fall in the 3-6% range for 10yr Treasuries over the next several years, in line with inflation and historical experience.
- The economy will grow 2-3% in real terms over the next several years.
- Stocks will average an 8-10% return over the next 10+ years. After subtracting inflation, this will translate into about a 5% real return, in line with the estimated earnings yield on the S&P 500. There is likely to be at least one big decline every decade or so.

From the standpoint of where you and your family will be in 30 years, none of this matters. What matters is finding good quality investments that are likely to grow over the decades. For this reason, I largely ignore my own general market forecast and invest whenever I find a business that I am confident in and that trades at an attractive valuation.

Help Secure Your Golden Years

I first began managing money in the late 1990s, right when the Dot.com boom was taking off. People who didn't know anything about business were making money buying whatever stock was being hyped on TV. Wall Street firms were overflowing with profits by selling stocks to the public they knew were worthless. One notorious analyst earned $12 million a year, while privately putting down the stocks he was promoting.

Then it all came crashing down.

Most of the Internet stocks of that era went bankrupt or lost most of their value. The market went down for three straight years from 2000 to 2002. Millions of investors lost a huge chunk of their retirement savings.

Did people learn the right lessons? Only a few years later, we had the Great Financial Crisis from 2007 to 2009. Again, Wall Street was selling worthless financial instruments. This time it took down the real estate market too. Again, millions of investors lost a large portion of their retirement savings.

We want our clients to hold positions of real value, so we **personally research** all the positions in my strategies and review them regularly.

While it may surprise you, we believe this commitment to personal research and investment management sets us apart from other advisors. The vast majority of advisors outsource research to fund managers or their firm's cookie cutter options.

Instead, we personally research each position to develop the confidence that it is right for you. This commitment to research develops the trust, for us, that all the strategies we recommend are the right ones for our clients, in line with their risk tolerance, time horizon, and future goals. **Your finances are too important for a cookie cutter solution.**

At The Birch Lane Group of Raymond James, we work as a team to provide our clients with personal service, custom financial planning, and investment management tailored to your needs. I specialize in retirement planning, executive compensation and equity interests, attorney practices, and investment management. Donna Colucci also does extensive financial planning, with expertise in life transitions, divorce planning, estate planning, and long-term care insurance. Tricia Jones works tirelessly on client service, trading, and account management.

We are dedicated to helping you achieve financial independence and a comfortable, stress-free retirement.

What Can a Financial Plan Do for You?

Having a well-designed financial plan and investment strategy is important for your financial future. It can help improve your security, confidence, and comfort. It can answer questions like:

- How much will you need to be financially independent?
- What are the odds that you will run out of money?
- How will you handle unique circumstances, such as executive compensation, kids' college education, elderly parents, special needs children, and other elements of life?
- Should you change any savings or investing habits?
- Could you improve any of your current investment choices?

If you have never had a financial plan run for you or have not reviewed yours recently, we would be happy to create a complimentary financial plan and investment strategy for you.

To set up a time, please visit my calendar online at Calendly or email me at Randall.Watsek@RaymondJames.com.

Sincerely,
Randy Watsek

P.S. If you know anyone who might benefit from the information in this letter, please pass it along.

Also, I am also available to speak on educational topics such as retirement planning at events and lunch-and-learns you are holding, whether in person around the New York City area or by video anywhere in the country.

Biography

Randall Watsek and the Birch Lane Group currently maintain or advise on over $200 million in client assets. He has managed money for over 25 years, first as a credit portfolio manager at City National Bank and then as an equity research analyst, sector portfolio manager, and quantitative researcher at DGHM, a quality value boutique. He leveraged this experience to start an investment advisory practice at Raymond James.

Watsek earned an MBA from the University of Chicago in Analytical Finance and Accounting, and a BA from Claremont McKenna College in Economics and History. He also earned the CHARTERED FINANCIAL ANALYST (CFA®) and CERTIFIED FINANCIAL PLANNER (CFP®) designations.

Watsek has been quoted in a variety of publications on investing and personal finance topics, including *MarketWatch*, the *Wall Street Journal*, *Investor's Business Daily*, *Money Magazine*, the *Arizona Republic*, *ThinkAdvisor*, *The Business Journals*, and *ReThinking65*.

Watsek is the father of two young children and lives in Westchester County, New York.

The Birch Lane Group of Raymond James

The Birch Lane Group advises clients collectively holding over $250 million in assets. The team consists of:

Donna Colucci, CFP®, Associate Vice President
Tricia Jones, Registered Client Service Associate
Randall Watsek, CFA®, CFP®, Financial Advisor