FIELDPOINT PRIVATE®
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WHEN THE MARKETS OR A COMPANY'S FORTUNES HEAD SOUTH, HOLDERS OF HIGHLY CONCENTRATED SINGLE-STOCK POSITIONS CAN BE DECIMATED. HISTORICALLY, THE TOOLS TO HEDGE THIS RISK HAVE BEEN EITHER EXPENSIVE, SHORT-LIVED, COMPLICATED OR DISTASTEFUL. OR ALL OF THE ABOVE. TODAY, A NEW RISK MANAGEMENT STRATEGY IS AVAILABLE – ONE THAT OFFERS IMPROVEMENTS IN SIMPLICITY, TRANSPARENCY, AFFORDABILITY AND TAX EFFICIENCY.

Bear Cage

A new strategy could be a game changer for holders of concentrated public stock positions

BY WILLIAM KENNEDY, *CFA, Chief Investment Officer*

Circuit City. General Motors. Sprint. Citigroup.

If there was a Hall of Fame for life lessons in the dangers of concentrated equity positions, these names would be in it — along with Clear Channel, RadioShack, Peabody Energy and others that lost nearly all of their value over the last decade.

Over long periods of time this kind of tail risk is less rare than you might suspect. According to J.P. Morgan Asset Management, since 1980 320 stocks have been removed from the S&P 500 due to "business distress" – and 40% of Russell 3000 stocks suffered a permanent decline of 70% or more from peak value.

If you hold large, concentrated equity positions and — thanks to restrictions, loyalty, tax considerations or your own well-reasoned confidence — you expect to continue to hold your position, you know the queasy sensation that comes from these exposures.

TRADITIONAL DOWNSIDE PROTECTIONS

Traditional downside protection strategies for highly concentrated positions are well known:

- Outright sale
- Exchange funds
- Put options
- Equity collars
- Prepaid variable forwards
- Stop-loss orders
- Securities-backed loans

However, as laid out in the table on the next page, each of these has significant limitations that few of us would tolerate in other investment tactics. These include short terms, high fees, high taxes, the appearance of disloyalty, mind-boggling complexity, and, at times, special attention from the IRS.

If your shares are restricted by employer agreements or vesting periods, your options are even more limited. It can feel as you have half your wealth tied behind your back.

Traditional solutions

NAME	HOW IT WORKS	CONSIDERATIONS
Sell & diversify	Sell shares, pay capital gains tax, reinvest remainder.	Cap gains taxes (30%)[1]. Forego subsequent appreciation. SEC filing; reputation/optics risk for insiders. Employment contracts may disallow. Not available for restricted/unvested shares.
Exchange fund	Exchanges your position for diversified portfolio of positions contributed by others. Min. 7-year holding period; tax deferral.	SEC filing; reputation/optics risk for insiders. Lock-up/illiquidity. Most funds continually adding other stocks people want to hedge. Expensive.
Put options (AKA “protective put”)	Purchase “put option” with strike price below current market, sets a floor for the stock.	Option premiums can be very expensive. Employment contracts may disallow. No role for restricted/unvested shares. Tax on gains and dividends; losses not deductible. Counterparty risk. SEC filing; reputation/optics risk for insiders.
Equity collar	Purchase a put and sell a call on the stock at negotiated strike prices.	Forfeit significant upside potential. Employer contracts may disallow. Does not work for restricted/unvested shares. Tax on gains and dividends; losses not deductible. Counterparty risk. SEC filing; reputation/optics risk for insiders.
Prepaid variable forward	Contract to sell shares in the future in exchange for cash today (~70-90% of current value). Protection floor; cap gains deferral.	Expensive. Must forfeit significant upside. Employment contracts may disallow. Not available for restricted/unvested shares. SEC filing; reputation/optics risk for insiders.
Stop-loss order	Place stop-loss order at below current market, protecting further downside by triggering sale.	Ineffective for very large blocks. Simple volatility can trigger sale. Employer contracts may disallow. Stop-loss order may fail in times of market stress.
Securities-backed loan	Securities-backed loan with stock pledged as collateral; proceeds used to buy portfolio of stocks.	Potential margin calls. No floor on downside of pledged stock or securities purchased. Lock-up on pledged shares. Employment contracts may disallow.

STOCK PROTECTION FUND

In 2016 a new strategy became available, known as the Stock Protection Fund (SPF). An SPF mutualizes the downside risk of your concentrated holding across a group of diversified investors, creating a pool of liquidity to compensate for losses. It does so without touching a single share of the concentrated position – there are no stock sales required; no encumbrances or lock-ups, no SEC filings or employer restrictions. While the downside is hedged you can continue to participate 100% in the stock’s upside and any dividends. Or, if you wish, you can sell outright.

The secret of the strategy is nothing more complex than U.S. government bonds and the principal of mutualization.

How it works

The SPF consists of 20 investors who participate in a limited offering with a pre-set closing. Each is protecting a different stock in a different industry, for diversification purposes. They contribute cash (not shares) into the fund, equal to 10% of the value of the shares they wish to protect. The fund is then invested in U.S. Treasurys for a term of five years.

When the bonds mature the fund is terminated and the cash gets distributed back to the participants. If the fund exceeds the total of the declines, those with declines are made whole, and any remainder is returned equally to the others.

1. *Long-term capital gains taxes: 20% federal rate + 3.8% Obamacare surtax + 6.1% average state LTCG tax. (California is nation’s highest combined, at 37%)*

STOCK PROTECTION FUND

• A diverse group of investors with concentrated stock positions each contribute a cash “premium” in exchange for an ownership interest in the fund.

• The cash pool is managed conservatively for the term of the fund, after which time it is used to reimburse investors whose positions have incurred losses (on a total return basis).

• Excess cash is distributed equally among those investors who have not incurred any losses.

If, on the other hand, declines exceed the value of the fund, the decliners may not be made 100% whole but their losses can be substantially reduced.

During the term of the SPF, you are free to sell, gift, leverage or do whatever you wish with your shares. When the term concludes, you can renew your protection with a new fund if you like.

Costs

The cash contribution can be thought of as an insurance premium, with a maximum potential cost of 2% of the value of the protected shares per year (2% x 5 years = the 10% cash contribution), contributed up front. If funds remain after covering losses, they are redistributed to those who did not experience a loss, potentially reducing the net cost of the protection to zero.

Additionally, there is one-time placement fee of 2%.

RESTRICTED STOCK AND STOCK OPTIONS

If you hold restricted stock or shares that are subject to a vesting schedule, your options for putting a floor under your downside risk are likely limited by your employment agreement or the terms of your share grants. If you hold stock options instead of actual shares, your choices are more limited still.

You could find and then short an ETF that represents a basket of stocks in your industry. But that only hedges your industry, not your company, and if your industry does well, you will be holding an expensive hedge.

Alternatively, you could purchase a “put option” on such an ETF. This may well be less expensive than a short sale that goes against you, but it’s still hedging an industry, not your firm.

With the Stock Protection Fund, you contribute cash. Because the strategy doesn’t require you to sell, pledge, exchange or otherwise encumber the holding you are trying to protect, your restrictions (including the fact that you might not even own your shares) effectively disappear.

WEALTH TRANSFER

Many of our clients hold significant net worth in highly appreciated stock of firms they once helped lead or from which they profited as investors. To these clients, these are not assets that will be sold and relied upon for lifestyle – which is a good thing, because the tax bill on a sale might give them a heart attack.

Instead, they intend to continue to hold the stock in their later years and to pass it on at death to their heirs, in part because this will trigger a "step up" in the asset's cost basis for tax purposes, resetting it at the market price at the time of the inheritance and eliminating the taxable gain.

Often there is an emotional tie to the stock, as it represents a life's achievement or a cornerstone in the family's identity. From a purely practical standpoint, a sale could give the misleading appearance that a former leader has lost confidence in his or her firm.

As understandable as all of this may be, it ties the hands of the share owner, potentially for years or decades, exposing the stock to market downdrafts that could dwarf the damage a big tax bill would have inflicted.

The Stock Protection Fund makes it easier to continue to hold the stock, whatever the motivation, until the step-up can occur.

Fieldpoint Private believes that the chief market threat to wealth is the destructive force of rare, historic tail-risk events, and that over time, effective risk mitigation can prove to be the most important source of investment outperformance, or alpha. Perhaps no one is more susceptible to such risk than the investor whose wealth is concentrated in a single stock. Without mitigation that risk could drive emotional, uneconomic decision making – a tail risk in and of itself.

The Stock Protection Fund is a simple, transparent, and repeatable strategy for mitigating this risk, without incurring excessive expenses or tax. Your Fieldpoint Private advisor would be pleased to discuss it with you in more detail.

ACTUAL SPF DEPLOYED THROUGH THE FINANCIAL CRISIS, 2006-2011

		Stock's Total Return %		
Investor	**Stock Protected**	**Without SPF**	**With SPF**	**Loss Elimination with SPF**
1	Best Buy Co., Inc.	-36.7	0	36.7
2	General Electric Co.	-32.1	0	32.1
3	Toyota Motor Corp.	-24.2	0	24.2
4	Harley-Davidson, Inc.	-18.2	0	18.2
5	Amgen, Inc.	-12.5	0	12.5
6	Eli Lily & Co.	-7.7	0	7.7
7	Goldman Sachs Group, Inc.	-5.3	0	5.3
8	People's United Financial, Inc.	-1.1	0	1.1
9	Boeing Co.	3.3	3.3	N/A
10	Time Warner, Inc.	9.5	9.5	N/A
11	MDU Resources Group, Inc.	11.4	11.4	N/A
12	Microsoft Corp.	18.9	18.9	N/A
13	3M Co.	25.5	25.5	N/A
14	EnCana Corp.	25.6	25.6	N/A
15	UIL Holdings Corp.	31.7	31.7	N/A
16	Procter & Gamble Co.	40.2	40.2	N/A
17	E.I. du Pont de Nemours & Co.	49.4	49.4	N/A
18	RLI Corp.	55.8	55.8	N/A
19	Humana, Inc.	56.5	55.8	N/A
20	Dow Jones & Co., Inc	100.4	100.4	N/A

Stock Protection Fund formed 6/1/2006, with 10% cash contributions, terminating 6/1/2011. Eight of the ten stocks lost money during the term, with a maximum of -36.7%. With the SPF in place, the investors experienced $0 in losses. Source: *Intelligent Edge Advisors.*

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