

Concentrated Wealth Strategies

A quick look at strategic alternatives for managing concentrated wealth positions.



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Concentrated Wealth Strategies

An investor can find him or herself holding a concentrated equity position for any number of reasons — inheritance, a sale of a business for stock, executive compensation, or simply shrewd investing. Regardless of the source, concentrated equity positions can increase risk in an investor's portfolio by putting too many eggs in one basket. If the equity in which the investor has a concentrated position

takes a significant decline, the impact on that investor's wealth, and the financial fortunes of the investor's family, can be devastating. The recent collapse of former market stalwarts like Lehman Brothers, illustrate the danger of holding concentrated positions.

Clearly, the advantages of moving away from an over-concentration are numerous. However, individuals holding such positions face a two-fold challenge. They must diversify their portfolio while effectively managing the substantial embedded tax costs underlying that same portfolio. Balancing these two challenges in the context of each individual's unique circumstances and goals is the key to identifying the right strategy for each concentrated wealth situation.

The Potential Peril of Concentrated Positions

CITIGROUP, INC.

In 2008, as investors became uneasy about the health of financial companies, the financial sector weakened. Wall Street retreated after Fannie Mae and Freddie Mac fell to their lowest levels in nearly 20 years. From 5/30/07 (\$51.03) to 11/20/08 (\$4.71), Citigroup's stock dropped 91%. Reasons for the price decline include negative news regarding Citigroup's hedge fund problems, plans to eliminate 15% of its work force, and the deterioration in consumer credit as economies worldwide headed for recession. Citigroup shares fell nearly 83% in 2008 and continued to decline into 2009.

Citigroup's 52-week ranges ending 10/30/09 was \$0.97 - \$14.81.

GENERAL MOTORS

It's not just small companies or growth companies with crazy valuations that can suffer substantial falls. Consider the case of venerable GM, a stock very often held in concentrated positions because of its blue-chip status. From 10/12/07 to 11/19/08, the stock moved from \$41.39 to \$2.79, a drop of 93%. In the midst of a deepening global financial crisis, the big three carmakers, including GM, were in a precarious financial position.

On June 1, 2009, General Motors filed for bankruptcy protection. Existing equity investors lost any remaining value as the company restructured and exited from bankruptcy protection a mere 40 days later.

JONES APPAREL GROUP, INC

Jones Apparel is a leader in the apparel and footwear industry. Jones Apparel markets its products under a number of nationally recognized brands. As the contracting economy and stubbornly high unemployment rates squeezed consumer spending across Jones Apparel's different brands, the stock went from \$21.44 on 9/9/08 to \$2.53 on 11/20/08, a loss of 88% of its value. Jones Apparel is reworking its business to focus on core brands and improve operations as it continues to face subdued discretionary spending in the weak economy.

Jones Apparel's 52-week ranges ending 10/30/09 was \$2.34 - \$19.66.

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Understanding Goals

Aligning Strategic Alternatives with Individual Concerns

A number of techniques can mitigate the risk of a concentrated position and help to move toward a more diversified portfolio. Each of these techniques addresses certain concerns that an investor might have regarding a concentrated position and is not universally applicable. Therefore, before action can be taken to address a concentrated position, it is important to identify the investor's concerns, which might include:

- Need for liquidity or income to meet certain financial targets or obligations
- Desire to decrease portfolio risk through diversification
- Tax impacts surrounding the sale of appreciated equities
- The charitable intent of the investor and his/her family
- Emotional ties to the security

Identifying Strategies

Strategies for Managing Concentrated Positions

Usually, an investor has several of the concerns and issues previously identified and, as such, the ultimate solution often involves several different tactics. Once specific objectives and concerns have been identified, a plan can be crafted, using the strategies described below, to satisfy the investor and work toward a well diversified portfolio.

Three primary approaches can be used to address a concentrated position:

1. Sell and Diversify

This strategy seeks to liquidate the concentrated position and redeploy the assets in a broadly diversified portfolio. It addresses the issues of liquidity and portfolio risk, while taking advantage of current favorable Federal long-term capital gains rates. There are several means with which to execute this strategy, including:

- **Direct Sales Program and Strategic Sales Structures**
Investor establishes strategy for selling out of stock at given price parameters, timing intervals, or dollar targets; can include program for sale of company stock by a corporate insider
- **Variable Forward Sales**
Investor agrees to deliver shares of the subject stock at a future date and in return receives discounted proceeds currently; this structure allows capital gains deferral and possible participation in appreciation of the underlying stock

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- **10b5-1 Trading Plans**

Insiders in a publicly traded company have unique issues when it comes to concentrated wealth. Generally, an insider is a senior person inside the company and as such likely has much of his/her wealth in that company stock. Insiders are prohibited from buying or selling shares of common stock of their company while they are in possession of material non-public information about that company; usually an insider is able to sell shares in his/ her company only during limited trading windows which occur for a short period of time after the company earnings announcement. This limited ability to sell company shares makes it very difficult for an insider to implement a wealth plan that calls for a diversified investment portfolio. Rule 10b5-1 of the Securities Exchange Act of 1934, however, affords insiders a way to diversify their portfolio through regular sales, without running afoul of the insider trading rules.

Rule 10b5-1 allows an insider to create a trading plan during one of the trading windows described above. The insider would develop the trading plan to control a certain number of company shares in accordance with his or her directions, i.e., sales at certain target prices or at certain dates. She/he would then sign the plan and place it with an institution for execution. Then, if certain targets are hit as specified in the plan, shares can be sold even if the sale does not take place during a trading window. Once the insider has put the plan in place, however, she/he can have no further input as to the plan, other than the possible ability to terminate the plan.

The primary benefit of a 10b5-1 trading plan is the ability of an insider to diversify his/her portfolio in an orderly manner without taking the market risk of being confined to certain trading windows. Additionally, a trading plan can serve a public relations role. Making a trading plan public at the time of inception can inform Wall Street that future sales are part of a plan for diversification and not an indication of lack of confidence in the company.

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2. Charitable Giving

This strategy affords significant benefits in terms of deferral and avoidance of Federal capital gains taxes while also allowing a family the opportunity to pass values to future generations by building a legacy of philanthropy. The primary tactics for executing this strategy include:

- **Charitable Remainder Trusts**
Investor funds an irrevocable trust that allows donor, and possibly others, to receive annual payments with the remainder interest passing to charity
- **Private Foundations**
Investor creates a non-profit, grantmaking entity organized in furtherance of the investor's charitable philosophy and objectives
- **Donor Advised Funds**
Investor works with existing charitable entity to establish a fund similar in purpose and operation to a private foundation, but with less administrative oversight required

3. Holding a Position and Diversifying Through Borrowing or Derivatives

This strategy recognizes that factors, including emotional ties or an impending step-up in tax cost of the concentrated security, can make selling a stock undesirable. Borrowing or use of derivatives can allow the investor to retain some or all of the concentrated security while at the same time generating liquidity to diversify the portfolio or to meet other financial needs. The primary tactics for executing this strategy include:

- **Borrow and Reinvest**
Investor borrows funds that are secured by the concentrated position and reinvests those funds in a diversified portfolio
- **Protective Put Options**
Investor pays premium for right to sell security at a certain price, providing downside protection by setting a minimum security price
- **Covered Call Options**
Investor receives premium for the sale of the obligation to sell security at a fixed price, effectively increasing income from security but limiting his or her ability to participate in stock appreciation
- **Equity Collars**
Investor sells a call and uses the premium received to buy a put in order to get downside protection

Exhibit 1 on the next page summarizes how certain tactics address distinct needs or objectives that an investor might have.

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Exhibit 1

Strategic Alternatives for Managing Concentrated Wealth

PERSONAL OBJECTIVE	STRATEGIES		
	Sell and Diversify	Charitable Giving	Hold and Diversify
Liquidity	Provides liquidity	Charitable remainder trusts provide liquidity Private foundations do not provide liquidity	Borrow and reinvest strategies subject to regulatory and credit limitations Hedging related strategies provide liquidity if coupled with margin loan
Portfolio Risk	Generally reduces portfolio risk	Reduces portfolio risk	Borrow and reinvest strategies diversify specific risk, but increase interest rate risk Hedging-related strategies reduces portfolio risk
Income Needs	Increases investment income	Charitable remainder trusts increase investment income Private foundations do not increase investment income	Borrow and reinvest strategies can increase income, net of debt cost Hedging related strategies can increase income, dependent on structure
Tax Protection	Direct sales do not minimize or defer taxes Variable forward sales defer tax cost of sale	Minimizes estate and gift taxes	Generally defers tax cost of sale

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Other Alternatives

In addition to the strategies and tactics previously described, commonly used wealth transfer techniques also can be employed to address a concentrated position by moving the subject securities to other family members or family entities. These wealth transfer strategies do not, in and of themselves, provide the necessary diversification from concentrated positions. However, they do create new investment vehicles with new time horizons, risk characteristics and tax impacts. For this reason, they can be worthy of consideration in some circumstances. Some common wealth transfer techniques include:

- Grantor Retained Annuity Trusts
- Family Limited Partnerships
- Generation Skipping (Dynasty) Trusts
- Irrevocable Life Insurance Trusts

Concentrated positions in one security can build great wealth; they also carry great risk and can destroy a family's wealth without warning. A concentrated position deserves close attention and a thoughtful plan of attack. It is important to emphasize that a single solution approach to managing — or managing out of — a concentrated position is rare. The various vehicles or approaches available are simply building blocks of an overall strategy. What is most critical is to combine the practical knowledge and experience necessary regarding the financial implications of various diversification strategies with a very thorough understanding — and analysis — of the investor's complete situation. Any plan must be tailored in light of the preferences, tolerances and goals of each investor and his or her family.

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