

# Concentrated Wealth Strategies

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



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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 enron experience, and more recent falls from grace of former market darlings, 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.

## Former Market Darlings

### NEW CENTURY FINANCIAL CORP.

This sub-prime mortgage lender dropped precipitously when its funding from Wall Street was pulled as the housing market boom passed and delinquencies increased. From 2/7/07 (\$30.16) to 3/14/07 (\$1.66), the stock dropped 95%. The company revealed an SEC inquiry on 3/13/07 and it was delisted from the NYSE on 3/14/07. Its most recent 52-week high was \$51.97 on 5/1/06.

### GENERAL MOTORS

It's not just small companies or growth companies with crazy valuations that can suffer substantial falls. Venerable GM (very often held in concentrated positions because of its blue-chip status) fell by more than 50% in 2005, going from \$37.52 on 7/28/05 to \$18.61 on 12/28/05. If you stretch the time horizon out to five years, the picture is even worse: from 5/10/02 to 12/28/05, the stock moved from \$66.20 to \$18.61, a drop of nearly 72%. Even though it was over a span of time, a concentrated position that loses 72% of its value can be devastating to an investment portfolio; consider that over the same period, the S&P 500 -- reflective of a fully diversified portfolio--increased by 20%.

### YAHOO!

Yahoo! Inc., is a well known company and widely held stock. However, due to high investor expectations for growth, as competitive pressures increased last year, the stock went from \$43.42 on 1/9/06 to \$23.14 on 10/19/06, a loss of 53% of its value. While this was across a fairly long time span, consider a shorter time period too: in two days from 7/18/06 to 7/20/06, the stock lost 22% of its value, falling from \$32.24 to \$25.27.

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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 identified above 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:

#### 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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## 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. It addresses 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:

- 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

## Holding a Position and Diversifying Through Borrowing or Derivatives

This strategy recognizes that certain situations, either 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

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

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## Strategic Alternatives for Managing Concentrated Wealth

	SELL AND DIVERSIFY	PHILANTHROPIC STRATEGIES	HOLD AND DIVERSIFY	WEALTH PROTECTION AND TRANSFER
<b>LIQUIDITY</b>	Provides liquidity	Charitable remainder trusts provide liquidity  Private foundations do not provide liquidity	Borrow and reinvest strategy subject to regulatory and credit limitations  Hedging-related strategies provide liquidity if coupled with margin loan	N/A
<b>PORTFOLIO RISK</b>	Reduces portfolio risk <i>variable forward sales need upside participation to offset embedded cost of carry</i>	Reduces portfolio risk	Borrow and reinvest strategy diversifies specific risk, but increases interest rate risk  Hedging-related strategy reduces portfolio risk	N/A
<b>INCOME NEEDS</b>	Increases investment income	Charitable remainder trusts increase investment income  Private foundations do not increase investment income	Borrow and reinvest strategy can increase income, net of debt cost  Hedging-related strategy can increase income, dependent on structure	N/A
<b>TAX PROTECTION</b>	Direct sales do not minimize or defer taxes  Variable forward sales defer tax cost of sale	Minimizes estate and gift taxes	Defers tax cost of sale <i>potential straddle issues for hedges</i>	Minimizes estate and gift taxes

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## OTHER ALTERNATIVES

In addition to the strategies and tactics described above, 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.

## About the Author

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Peter Eberhart is a senior director of wealth management. He works with individuals and families to ensure that their wealth management and estate planning strategies are met. Additionally, he works with portfolio managers to address the specific estate planning needs of their clients while overseeing the administration of trusts and estates for BNY Mellon Wealth Management clients.

Prior to joining the firm in 2003, Peter worked as an attorney with a large national law firm where he advised wealthy families on estate planning, philanthropy, and business succession planning. His practice also focused on tax-exempt organizations, which included serving as advisor to large private foundations and to planned giving programs. Prior to graduate school, Peter served as an officer in the U. S. Navy.

Peter earned a BA from the University of Pennsylvania and a JD and MBA in finance from Emory University. He is a Certified Financial Planner Professional® and a member of the Pennsylvania Bar Association, the National Committee on Planned Giving, and the Council on Foundations' Philanthropic Advisor Network.

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