Managing the Risks of a Concentrated Position—Overview

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Concentrated Positions

What is a concentrated position?

- If you have a large portion of your investment portfolio in a single stock, you have a concentrated position
- Company founders, board members, senior management and other employees and individuals who might be compensated in part in its stock often end up with concentrated positions. Even some investors can amass shares over time or inherit a large position in a single stock
- Is it bad to hold a concentrated position? Not necessarily. A concentrated position may be responsible for significant wealth creation—but it can also be responsible for significant risk in your portfolio

What are the potential risks of holding a concentrated position?

- History shows that forces beyond management's control or foresight can sometimes cause a company—even a very well-managed one—to fail
  - A business can be vulnerable to wide-ranging forces including:
    - Changes in government policy, for example a slowdown in FDA approval patterns; changing subsidies for renewable energy; changes in interpretation of anti-trust rules; etc.
    - Fraud by employees
    - Changes in U.S. or foreign government tariff or trade policy
    - Technological innovation by competitors
    - Competition
    - Commodity price risks that can't be hedged away
- From 1980 to 2020, 42% of the Russell 3000 index experienced an absolute negative return.[1] This means you would have been better off holding a simple position in cash than holding a single concentrated position in those 1,260 stocks
    - 66% of the time, a concentrated position in a single stock would have underperformed a diversified position in the Russell 3000 Index

[1]Source: Factset, Bloomberg Finance L.P., J.P. Morgan Wealth Management. September 2020.
Past performance is no guarantee of future results. It is not possible to invest directly in an index.

Managing the Risks of a Concentrated Position

In general, you can divide the strategies to deal with a concentrated position into five main buckets:

1. Sell it
    - *An outright sale is the most direct path to mitigating the risks of a concentrated position*
2. Hedge it
    - *Hedging allows an investor to protect against downside risk in the stock without selling it*
3. Monetize it
    - *Monetization strategies allow a client to access the value of a concentrated position without necessarily selling it; they can be used to generate liquidity for diversification, charitable goals, or supplementing one's lifestyle*
4. Diversify it
    - *You can diversify either by selling your stock outright or in a more tax-efficient manner (e.g., exchange funds, charitable remainder trusts); there are benefits and risks in either case*
5. Give it away
    - *Gifting shares allows individuals to pass wealth directly to loved ones or charity while taking advantage of eligible income and transfer tax benefits*

Managing the Risks of a Concentrated Position—Outright Sales

Selling your stock eliminates your risk associated with owning a concentrated position and puts you in a position to diversify

- Capital gains tax may be payable on the sale, but its impact should not be the primary driver for your decision to sell your stock or not
- In some cases, the tax you pay will have far less impact on your investment success over time than the relative performance of the investments you choose in place of your concentrated position
- Not being invested in the concentrated stock means that you are no longer subject to movements in its price
    - If the concentrated stock increases in value more quickly than your investments, then of course (with 20-20 hindsight) you should not have sold your concentrated stock
    - If, however, the alternative increases in value more quickly (and as long as you live for some time after the transaction), in general you will be better off financially having paid the tax and converted your portfolio from the concentrated position to the alternative portfolio
- Potential benefits:
    - Immediate reduction of exposure to the single stock
    - Immediate cash inflow
- Potential drawbacks:
    - Capital gains tax (but see discussion above)
    - You may not sell at the high price of the concentrated stock

Managing the Risks of a Concentrated Position—Outright Sales

There may be reasons—for example, the stock may not trade with a lot of volume—that you can't sell your stock in a single sale

Other sale strategies include:

- ***Staged selling***
  - This strategy involves creating a plan that details the quantity of shares to sell, the timeframe, and qualifying price levels
  - Potential benefits:
    - Can help mitigate the downward pressure of selling a large position
    - Can help deal with the challenge of predicting the best time to make a sale
    - To help manage their taxable income, investors can also consider which shares will be sold and when
  - Executives and certain insiders of U.S.-listed companies can use a strategy known as a Rule 10b5-1 plan*, which provides company insiders an opportunity to buy and sell company securities without violating insider trading laws
  - Potential drawbacks:
    - Your sale prices vary with the market—both up and down
    - Capital gains taxes may be due on sale
- ***Block trades***
  - A block trade is a large transaction in a security that is typically privately negotiated and executed outside of the open market
  - Potential benefits:
    - Can be effective for investors selling very large positions or significant stakes in companies with limited trading volume
  - Potential drawbacks:
    - Since block trades are negotiated outside the open market, the trade price is often at a discount to the market price

* As a result of regulations issued by the Securities & Exchange Commission in December 2022, a 10b5-1 plan may not be a preferred solution. The Wealth Planning & Advice team and J.P. Morgan have several publications outlining the rules of 10b5-1 Plans. Connect with your J.P. Morgan Representative to learn more.

Outright Sales—Variation

- ***Covered call options***
  - Covered call options allow you to generate income from a concentrated position by collecting an upfront premium while allowing for a sale of the stock at a higher price than the day you entered the covered call strategy
  - In a covered call strategy, you sell an “out-of-the-money” call option
    - The call option gives the buyer the right to buy your stock at a higher price than the current market price
    - The payment you receive for selling the option is called the “premium”, which you can think of as an additional return on the stock
    - If the stock price rises above the strike price (the price at which the buyer of the option can purchase your stock), your stock is likely to be sold to the person who bought the call option from you
      - This allows you to receive income (in the form of the premium) while also allowing you to sell your stock at a higher, more comfortable, price
      - If you don’t want to sell your stock, you should consider professional management for a covered call strategy
  - Potential benefits:
    - Can help generate income from a concentrated position
    - If the stock price increases, a covered call can also allow you to diversify a concentrated position at a higher price than a current sale
  - Potential drawbacks
    - Does not protect you if the stock declines in value
    - You may no longer control the timing of a sale and therefore the realization of taxable gain
- A similar strategy known as a “contingent forward sale” or “knock-in forward sale” also allows you to sell stock at a higher price than the current market but does not give you income from any option premium. If you may be interested in this strategy, please contact your J.P. Morgan representative.

Managing the Risks of a Concentrated Position—Hedging Strategies

Hedge the position

Hedging allows you to protect against downside risk in the stock without selling the position

- ***Protective puts***
    - A protective put involves purchasing a put option with a strike price equal or close to the current price of the concentrated position
    - A put option gives you the right to sell the stock at a predetermined strike price on or before the expiration date
    - The cost of this option is called a premium
    - Potential benefits
        - If the security were to drop in value below the strike price of the put, the losses below the strike price are offset by your right to sell the stock at the strike price
        - You retain all upside appreciation, dividends and voting rights
    - Potential drawbacks
        - Buying put options can be expensive
        - If the stock goes up in value, or goes down but stays above the strike price, the premium you paid will be lost
- ***Protective put spreads***
    - Protective put spreads involve the purchase of a put option combined with the sale of a lower strike put option
    - Selling a put at a lower strike price can somewhat offset the cost of the protective put, but you are at risk of loss if the stock price falls below the strike price of the put you've sold—in short, you've reduced your risk, but not as much as if you just buy a put or sell the stock outright

Managing the Risks of a Concentrated Position—Hedging Strategies

- ***Cashless collars***
  - A cashless collar protects a concentrated equity position at little or no initial out-of-pocket expense
  - In a collar, the investor purchases a protective put and sells a covered call
  - The put you buy comes at a cost (the premium); you try to offset the cost of the put with the premium you earn by selling the call
  - The combined position reduces downside exposure and upside appreciation, thus narrowing the range of potential outcomes while the collar is place
    - You limit the amount of money you can lose if the concentrated position declines in value
    - You limit the amount of money you can make if the concentrated position increases in value
  - No tax is paid until the transaction closes, which can be years from now; tax is only due if you unwind the transaction early or if the stock ends up at a price below your floor or above your ceiling
  - Since your stock is now effectively hedged (its value can move only within the band between the floor and the ceiling), you may be able to borrow more against your hedged position than you could against the concentrated single stock
  - Potential benefits:
    - Protects against a decline in the value of stock below the put strike price
    - Strike prices and maturities can be customized
    - You retain ownership of the stock, dividends and voting rights
    - The ability to borrow using the underlying stock as collateral is enhanced
    - Although often cashless, collars can be created involving a credit or debit (these transactions are not ***costless***; rather, they can be structured to be ***cashless****)*
  - Potential drawbacks
    - Creation of a collar is a potentially disclosable event and may be prohibited for insiders by the company's insider trading policy
    - You give up any upside above the call strike
    - Margin or underlying shares must be posted as collateral

Managing the Risks of a Concentrated Position—Hedging Strategies

- ***Proxy hedges***
    - If you are unable to hedge your position directly (for example, many corporate insider trading policies prohibit hedging by executives and board members), you could consider a proxy hedge
    - A proxy hedge uses a stock or a basket of stocks that share a similar risk profile to that of your concentrated stock—one that is said to be highly correlated to your stock
        - Assets with high correlation to each other will tend to move in similar directions to a similar degree under similar circumstances
        - Buying a put on a correlated asset or basket of assets can provide some protection to the extent that the price of the proxy asset(s) moves similarly to the price of your concentrated position
    - A proxy hedge will never perfectly eliminate risk since the proxy asset may not trade exactly the same as your concentrated stock

Managing the Risks of a Concentrated Position—Monetization Strategies

Monetize the position

Selling a position is the most straightforward way to monetize it. There are additional strategies that allow you to access the value of a concentrated position without necessarily selling it.

- ***Variable prepaid forward contract (PRiSM)***
    - **Principal goal:** Generate a substantial upfront payment while providing downside protection and potential deferral of capital gains taxes
    - A **variable prepaid forward contract** limits your downside exposure to declines in your company's stock price but caps your upside—effectively, you will have exposure to movement in the stock price within a certain range and will not participate above or below the ceiling and floor of that range, respectively
    - A PRiSM is similar to a collar in the limitation on your economic exposure to movements in the company's stock price
    - Because the underlying structures are different, the amount you can receive as the up-front payment from a PRiSM is usually larger than the amount you can receive from a loan against a collared position
        - Additionally, the PRiSM payment is not a loan
    - A PRiSM can be used to monetize a concentrated position, defer tax, and, depending on whether you choose to reinvest the up-front proceeds, and in what, potentially to generate cash flow (dividends, interest, or both)
    - Potential benefits:
        - Sale provides downside protection on value of underlying shares to the extent of the upfront payment
        - Investor realizes upfront proceeds without investment restrictions
        - Capital gains tax payment may be deferred until physical settlement (that is, until you deliver your shares at the end of the contract)
    - Potential drawbacks:
        - You give up any price appreciation above cap level
        - Underlying shares must be posted as collateral
        - Sale is a potentially disclosable event with trading regulations for affiliates and insiders
        - Capital gains tax is due at the end of the contract—regardless of what you've done with the upfront cash payment

Managing the Risks of a Concentrated Position—Monetization Strategies

- ***Hedge and borrow***
  - **Principal goal:** Provide a loan against a hedged equity position
  - Potential benefits:
    - Since the collateral is hedged a lender may offer higher loan amounts and lower costs than a traditional security-based line of credit
    - May have the added benefit of mitigating the risk of having to sell shares to meet collateral requirements
    - Flexible liquidity—the amount and timing of the loan are based on your ongoing needs
    - Funds are available without a taxable event
  - Potential drawbacks:
    - Interest is charged on the borrowed funds
- ***Charitable remainder trusts ("CRTs")***
  - **Principal goal:** Tax-deferred diversification that also creates an income stream. Can be utilized to fulfill charitable goals
  - You contribute your concentrated stock to a properly drafted charitable remainder trust
  - The trust can then sell the stock and invest in a diversified portfolio
  - The trust pays you an income stream that are determined upon trust creation
  - When the trust ends any remaining assets pass to one or more charities of your choice
  - Potential benefits:
    - Capital gains on the sale of the concentrated stock can be spread out over a substantial period
    - The charitable beneficiary can be another entity (such as a donor-advised fund or Private Foundation) that you create and control
  - Potential drawbacks:
    - You lose access to the principal you contribute to the trust; you only receive the income stream
    - CRTs are subject to complex rules and regulations; noncompliance can lead to penalties. It's important to consult with your individual attorney to help draft your CRT and navigate these rules and regulations

Managing the Risks of a Concentrated Position—Monetization Strategies

- ***Security-based lines of credit***
  - **Principal goal:** You use your concentrated position as collateral for a line of credit
  - Potential benefits:
    - You can gain access to capital without selling shares
  - Potential drawbacks:
    - Could increase the risk of the portfolio and create situations where you are forced to sell shares to meet collateral requirements

Managing the Risks of a Concentrated Position—Diversification Strategies

Diversification Strategies

Any monetization strategy can also be used to diversify. If you are interested in diversifying a concentrated position without a sale and without using derivative contracts, an Exchange Fund can provide diversification with no immediate tax consequences

- ***Exchange Funds*[1]**
    - An exchange fund is an investment vehicle that accepts the physical delivery of shares in return for an interest in a diversified portfolio, while avoiding tax recognition
    - **Principal Goal:** Provide diversification and defer capital gains tax indefinitely
    - How it works:
        - You transfer your appreciated shares to the exchange fund. In exchange, you receive an interest in the fund's diversified portfolio
        - No capital gain is recognized on this exchange
        - The fund invests approximately 20% of its assets in "qualifying assets" (usually real estate interests) and the balance in a diversified portfolio, most frequently a U.S. large-cap stock portfolio or a U.S. multi-cap stock portfolio
        - After seven years, you can withdraw from the fund and receive a portfolio of stocks chosen by the fund manager (those stocks will have your original basis)
            - If you withdraw before seven years, you receive some or all of your original shares, still with your original basis
        - An exchange fund is a private placement vehicle; in order to be able to purchase it you must be both an "accredited investor" and a "qualified purchaser"[1]
    - Potential advantages:
        - No capital gains tax contribution of appreciated stock
        - You achieve diversification without selling stock or paying capital gains tax
        - Fund shares are generally redeemable daily
        - Redemptions generally are met by distributing securities and therefore do not trigger tax liability
    - Potential drawbacks
        - You are unable to control or vote shares
        - Future performance is subject to the performance of the fund
        - Participation is a reportable event for insiders
        - You will pay an annual fee for participating in the fund

[1] See important information at the end of this presentation)

Managing the Risks of a Concentrated Position—Diversification Strategies

- ***Charitable remainder trusts ("CRTs")***
    - **Principal goal:** Tax-deferred diversification that also creates an income stream. Can be utilized to fulfill charitable goals
    - You contribute your concentrated stock to a properly drafted charitable remainder trust
    - The trust can then sell the stock and invest in a diversified portfolio
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    - Potential benefits:
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Managing the Risks of a Concentrated Position—Gifting

Give it away

Gifting shares allows you to pass wealth directly to loved ones or charities while taking advantage of eligible income and transfer tax benefits

- ***Direct gifts to family and friends***
  - Gifting directly to family and friends is a great way to share financial success with loved ones
  - You give both the current value of the asset and also any future appreciation, which will grow outside of your taxable estate and will ultimately escape estate taxes. Gifting to individuals—often children—who are at a lower income tax rate may allow them to sell the position with less income tax impact
- ***Grantor retained annuity trusts ("GRATs")***
  - GRATs allow you to keep the current value of an asset and only transfer future growth to your loved ones
  - A GRAT is an irrevocable trust you create that consists of two stages:
    - (1) the GRAT or annuity term—a term of years selected by you as the grantor when the trust is created (minimum 2 years); and (2) the remainder—the period after the GRAT or annuity term
  - Once you contribute assets to the GRAT, it will pay you an annuity during the GRAT term
    - The annuity and implied interest rate (the "hurdle rate") are calculated by the Internal Revenue Service every month
    - If the assets in the GRAT grow at a higher rate than the hurdle rate, that growth will pass to the GRAT beneficiaries gift-tax-free
  - When the GRAT term expires, the remaining assets (if any) will be distributed to the remainder beneficiaries of your choosing either outright or in trust

Managing the Risks of a Concentrated Position—Gifting

- ***Charitable contributions***
  - Charitable contributions made with an appreciated stock may allow you to maximize the tax benefits of your charitable giving
  - If you contribute appreciated stock to a charity, you could receive two benefits:
    1. A charitable deduction for the full fair-market value of the stock you contribute (as long as you properly itemize your deductions)
    2. Avoid paying capital gains tax on the appreciation
  - Methods of charitable giving
    - Donor-advised Fund (DAFs)
    - Private Foundations
    - Charitable remainder trusts (CRTs)
    - Charitable lead trusts (CLTs)

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There is no guarantee that at the end of the fund's life cycle it will have outperformed the single stock originally contributed by an investor. These funds are relatively illiquid and require a long-term hold in order to achieve their tax benefits. It is important to note that an exchange fund is a tax- deferral mechanism, not a tax elimination mechanism.

Exchange funds are "private placements" and are not suitable for all investors. In order to purchase an interest in an exchange fund you must be a "qualified purchaser" as defined under the Investment Company Act of 1940. A qualified purchaser is: (a) an individual with not less than $5 million in investments; (b) a family-owned company with not less than $5 million in investments; (c) a trust, not formed in order to make the investment, with not less than $5 million in investments; (d) an investment manager with not less than $25 million under management; or (e) a company with not less than $25 million of investments. Other entities (such as a Qualified Institutional Buyer) may also be a qualified purchaser.

An accredited investor, in the context of a natural person, includes anyone who:

- earned income that exceeded $200,000 (or $300,000 together with a spouse) in each of the prior two years, and reasonably expects the same for the current year, OR
- has a net worth over $1 million, either alone or together with a spouse (excluding the value of the person's primary residence).

On the income test, the person must satisfy the thresholds for the three years consistently either alone or with a spouse, and cannot, for example, satisfy one year based on individual income and the next two years based on joint income with a spouse. The only exception is if a person is married within this period, in which case the person may satisfy the threshold on the basis of joint income for the years during which the person was married and on the basis of individual income for the other years.

In addition, entities such as banks, partnerships, corporations, nonprofits and trusts may be accredited investors. Of the entities that would be considered accredited investors and depending on your circumstances, the following may be relevant to you:

- any trust, with total assets in excess of $5 million, not formed to specifically purchase the subject securities, whose purchase is directed by a sophisticated person, or
- any entity in which all of the equity owners are accredited investors.

In this context, a sophisticated person means the person must have, or the company or private fund offering the securities reasonably believes that this person has, sufficient knowledge and experience in financial and business matters to evaluate the merits and risks of the prospective investment.

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