

Strategies For Hedging Concentrated Stock Positions (Part 1) mso+

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You own 10,000 shares of stock in your company. You also have what accountants call a very low cost basis in the stock, with a split-adjusted price of \$1 per share from option exercises, restricted stock grants, and founders stock. Now your shares are worth \$100 each. So the \$10,000 (10,000 shares at \$1 per share) is now worth \$1 million (before taxes).

You should be happy. But money worries keep nagging you. Your company stock represents a large, concentrated portion of your wealth, making you nervous in these days of volatile stock prices, with no guarantees of share price rises every year. You want to protect your gains. You'd also like to get your hands on some money.

So What Are Your Choices?

1. You can simply hold the stock and hope it continues to climb -- or at least does not fall.
2. You can sell it and pay a long-term capital gains tax of 15%. Since you have capital gains of \$990,000, that would be \$148,500.
3. You can also choose to protect your gains with hedges (and defer taxes).

Before you even think about hedging, you need to know whether your company prohibits this.

What Are The Restrictions?

Before you think about any hedging and risk reduction strategies, you need to know whether your company prohibits them. Many companies ban them both for philosophical reasons and to prevent accidental insider trading violations.

In addition, the SEC places restrictions on the transactions that senior executives, directors, and large block shareholders can undertake. So any hedging transaction needs the active involvement of your own advisors and possibly company legal counsel.

Puts: The Simplest Hedge

The simplest hedge is the purchase of a put. A put is an option that gives its holder the right to sell the underlying security at a given price (i.e., the strike price) for a specified length of time. For example, let's assume the company you work for is a fictitious one called CaliforniaSolar, and its stock is trading at \$100 per share. An at-the-money put on CaliforniaSolar would give you the right to sell it at \$100 per share.

At the same time, you don't have to sell. That's the great thing about buying puts: Your potential for future profit on the underlying stock is unlimited. CaliforniaSolar could go to \$1,000 per share, and you wouldn't have to sell it. (Of course, if the stock went to \$1,000 per share, the put would expire worthless.)

Buying Puts Is Too Costly

Puts are an expensive form of insurance against a drop in your company's stock price. At-the-money put options typically cost as much as 10%-20% of the value of the underlying stock -- annually. So if you just buy puts, you could spend as much as \$200,000 to hedge the CaliforniaSolar stock for just one year.

Some experts believe that calls work best when they are used in conjunction with puts.

Selling Calls Offers No Real Protection

A call is the opposite of a put. It gives its owner the right to buy your stock at the strike price. So if you sell a call on your stock, the purchaser acquires the right to buy (or call) the underlying stock at the strike price. Selling calls

generates revenue. This revenue could cushion you from the full impact of downside drops on your stock price. Better yet, you could use this revenue to offset the cost of a put -- and then some.

A one-year call struck at a stock's current market price should sell for about 15%-25% of the market price of the stock. So if you sell calls on 10,000 CaliforniaSolar shares with a strike price of \$100 per share, that sale should bring in \$150,000-\$250,000 each year. If the stock drops to \$90 per share, then you will lose \$100,000 on your stock holding (\$10 per share). But that's still less than you made by selling the calls.

On the other hand, if CaliforniaSolar falls drastically, then your loss on the stock will exceed the money you made by selling the call. For this reason, our company, Twenty-First Securities, believes that calls work best when they are used in conjunction with puts. If a call is properly structured in conjunction with a put, the main drawback is that you risk losing profit on the stock when it rises above the call strike price.

Collars Basics

A collar involves buying a put and simultaneously selling a call on the same stock.

With CaliforniaSolar, you could create a collar by buying puts on the stock struck at \$90 per share, and selling calls struck at \$130 per share. If the stock goes below \$90 per share, you can sell it at \$90; conversely, if it goes above \$130 per share, you'll have to hand it over at that price. You've created a floor and a cap around the stock price.

Two types of collars that financial advisors recommend are zero-premium (zero-cost) collars and income-producing collars.

Limits On Collars

Before you decide on the parameters of your collar, you should be aware of the constructive sale rules. Under Section 1259 of the Internal Revenue Code, investors will be treated as having constructively sold an appreciated stock position when they have hedged away too much possible risk and reward. Based on a review of legislative history, we believe that a collar with a price band of at least 15% and a term of up to five years generally should not create a constructive sale under current law.

You should also be aware that most options-based hedges (such as the purchase of a put or the sale of a call) will stop the capital gains holding period clock on a stock. As a result, they may delay the date when you can sell your stock and have it receive long-term treatment. Long-term capital gains rates are much lower than short-term capital gains rates. However, for many investors, the ability to protect a holding in rocky market conditions could more than compensate for the postponement of long-term capital treatment.

Zero-Premium Collars

Zero-premium (or zero-cost) collars are the best strategy for bullish investors. With these collars, the strike price of the call is set to generate exactly enough cash to pay for the put. So, the investor hedges for free. At the same time, zero-premium collars allow room for substantial profit. This is the feature that makes them most suitable for optimistic investors.

For example, you could buy CaliforniaSolar puts struck at \$100 for \$100,000, and simultaneously sell calls struck at \$150 for \$100,000. With this hedge, if the sale price of CaliforniaSolar was under \$100, you'd have no gain or loss on the stock. If CaliforniaSolar went over \$100 per share, you'd have an additional profit of \$10,000 for every \$1 of value the stock gained, up to a maximum of \$150 per share. If CaliforniaSolar went over \$150 per share, your maximum profit (before taxes) would level off at \$1,490,000 (\$1,500,000 minus the \$10,000 acquisition price). Remember, the hedge itself would be costless.

Income-Producing Collars

Income-producing collars work best for investors who are less bullish -- or for investors who wish to borrow money (there's more about this in Part 2). With these collars, the call strike price is set quite close to the price of the

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Suppose you're fairly worried about CaliforniaSolar. You buy a put on the stock with a strike price of \$90. This costs you only \$70,000. Simultaneously, you sell a call struck at \$105. Since many investors believe that CaliforniaSolar could go that high or higher, that call brings in \$120,000. (Although these hypothetical numbers are based on classic pricing models, the "real world" prices could vary depending on market conditions.)

With this low strike price, you've given away most of the potential for profit on the stock -- but who cares? You doubt this stock is going up, and you're making money on the collar -- \$50,000 (\$120,000 call revenue minus \$70,000 put cost). You've traded a bird in the bush for a bird in the hand.

With this hedge, if the price of the stock goes down, the most you can lose is \$5 per share, after considering that the money you netted on the collar cushions the stock fall. Using an extreme example, should the stock decline all the way to zero, you would lose \$1 million on the CaliforniaSolar holdings. However, you could exercise the put and receive \$900,000. You would have already received \$50,000 on the collar. So your net loss would be only \$50,000 (thus only a \$5 loss per share on the 10,000 shares).

If the stock sells for a price between \$90 and \$105, your revenue will increase by \$10,000 for each dollar that the stock gains above \$90. The maximum profit that you can obtain is \$100,000. You will make \$100,000 if the stock sells for a price of \$105 or more (\$50,000 on net collar revenues and \$50,000 on the stock).

Hedges Affect Dividend Taxes

You should consider how your hedging strategy will affect the tax rate on any dividends that are paid. Under the 2003 tax cut, "qualified" dividends are taxed at a top rate of 15%. Nonqualified dividends are taxed at a maximum of 35%. For a dividend to be qualified, you must hold the stock for at least 61 days. During this 61-day holding period the only derivative security you can use to hedge the stock is a qualified covered call (QCC).

The tax cut did not change the rules of QCCs. These rules are complex, but a call generally constitutes a QCC if it meets three basic conditions:

1. When the investor enters into the call, the call must have more than 30 days left before expiration but not more than 33 months.
2. Options in the underlying stock must be listed on an options exchange.
3. The call must be out of the money.

Twenty-First Securities maintains an interactive program to help you determine whether a call on your equity position is a QCC. Most other hedges, including collars, will suspend the holding period clock. When the hedge comes off, the clock will restart where it left off. A separate 61-day holding period must be met for each dividend. The 61 days must be achieved during the period that begins 60 days before the ex-dividend date and ends 60 days after the ex-dividend date.

The Straddle Rules: Tax Impact Of Collar

If you acquired CaliforniaSolar after 1983 and you hedge it with a collar, the collar is subject to the straddle rules. Under these rules, you cannot deduct the losses realized on any part (leg) of a collar until all positions are closed. An options position is closed out when it expires, is exercised, is bought out (in the case of a call), or is sold out (in the case of a put). However, when your unused call expires, you must pay short-term capital gains tax on the money you received for selling it, plus tax on any gains recognized on the puts. This double whammy is called "the whipsaw effect."

Suppose that CaliforniaSolar is selling at \$100 per share. You construct a three-year zero-premium collar on the stock, buying \$90 puts at \$14 each, and selling calls at \$160 for \$14. If the collar expires with the stock price between \$90 and \$160, you will face a tax of \$4.90, or 35% (the highest tax bracket) of \$14, on each expired call.

At the same time, however, you cannot currently deduct the "wasted" \$14 cost of the puts. You have created economic

protection and some potential for profit, but the after-tax cost was almost \$5 per share.

A New, Improved Zero-Premium Collar

Now imagine the same zero-premium collar we just described -- only with the put and call combined into one contract. With this approach, you could create the same economic profile -- i.e., effectively buying puts at \$90 and selling calls at \$160. But, if the put and call are combined, the price of the contract would be zero. (Remember, it's a "zero-premium" collar.)

If a one-contract collar expires with the stock price anywhere between \$90 and \$160, the expiration will not create any taxable income or loss. You will have created the same level of economic protection and potential for profit but without incurring any additional tax burden.

You can create one-contract collars using either options or variable forwards. If you use options, you will need to negotiate the contracts privately in the over-the-counter (OTC) market, instead of just buying or selling the options on one of the options exchanges. Puts and calls that trade on the exchanges are traded as separate entities, so there's no way that you can combine them into one instrument.

In contrast, when puts and calls are traded in the over-the-counter market, they can be combined into one instrument, if both parties agree. When a collar is structured this way, the value of the call sold is automatically netted against the cost of the put.

To help investors gain an overview of the possible hedges available for low-cost securities, Twenty-First Securities maintains an interactive low-basis stock decision tree at www.twenty-first.com.

What's Next?

In future articles we will discuss restricted stock and the relative advantages of variable forwards and options-based collars. We will also examine how monetization fits in with the various types of hedges.

In subsequent pieces we will describe strategies for protecting employee options and stock acquired through the exercise of these options. We hope that these articles together will provide a general overview of the choices that are appropriate for different holders of concentrated stock positions.





Nothing in this article constitutes investment or tax advice or a solicitation to engage in a transaction.

Editor's Note: Options involve risk and are not suitable for all investors. Before engaging in an options transaction, you must review the options disclosure document [Characteristics And Risks Of Standardized Options](#).

Regardless of the type of hedge, many companies prohibit executives and employees from using them because they eliminate the full downside risks and upside potential of stock ownership. You no longer feel the same impact as public shareholders do from drops in your company's stock price and no longer experience the financial motivations to drive the stock price as high as possible.

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