

The Hedging Product of Choice

Do you go simple with a put or complex with a variable forward? The decision may be critical in your efforts to protect clients' gains.

By Robert N. Gordon

Every wealth manager must have a hedging tool for clients who have large, unrealized gains. Ideally, an investor holding a concentrated position in an appreciated stock would like to achieve the following:

1) Hedge. Hedge against a decrease in the value of the stock.

2) Defer and eliminate any capital gains tax. Avoid triggering a current taxable event and still qualify for a step-up in basis at death.

3) Gain liquidity. Monetize the position—e.g., currently receive in cash a substantial portion of the market value of the stock—so the client can diversify into other investments.

Since Congress passed the constructive sale rules in 1997, Wall Street has had to offer hedging strategies with options that allow the client to either make or lose money after the hedge has been put on. How much upside and downside is necessary has yet to be written, but even in the absence of regulations, there are some tea leaves to go on.

Taking the Simplest Route

The simplest hedging strategy involves buying a put. A put gives the investor the right to sell a stock at a given price. For example, an at-the-money put provides the client with the right to sell the stock at its current market price. The effect is to create a floor at that price. At the same time, the investor's potential upside for future profit on the stock is unlimited. Unfortunately, as of this writing, at-the-money put options



ILLUSTRATION: SCOTT BALDWIN

Although it has found favor on Wall Street, the prepaid variable delivery forward isn't always the best way to go.

typically cost 8% to 10% per year. This makes them prohibitively expensive as a long-term hedging strategy.

The Collar Approach

Collars are a more cost-effective way to protect stock gains. An options-based collar involves buying a put and simultaneously selling a call. (A call is the opposite of a put. It gives the call buyer the right to purchase a given stock at a given price.) The put creates a floor under the current price of the stock. The call creates a cap over the current price.

Investors commonly use zero-cost (or cashless) collars and income-producing collars. Zero-cost collars are the best strategy for a bullish investor who believes that the underlying stock will continue to gain value. These collars involve the purchase of a put and the sale of a call, with the strike price of the call set to generate exactly enough cash to pay for the put. The strategy allows the investor to hedge cost-effectively while maintaining the potential for profit in the position.

A zero-cost collar would have a wide band for potential profit or loss. A tighter band for the opportunity of gain or loss could add income. To avoid a constructive sale, an income-producing collar's band should be no tighter than 15% around the stock's current price. For instance, if a stock is currently trading at \$100 per share, an investor might buy protection below \$95 and sell off all upside potential above \$110.

The only guidance is that the collar cannot be abusive. The Senate Finance Committee Report and the House Ways

and Means Committee Report, with respect to the constructive sale rules, both highlight an example of an average collar: a 95% to 110% equity collar. We assume that what was called average cannot later be deemed abusive. So we recommend collar bands no tighter than 15%—although a very short-term collar might allow such a tight band.

Monetization Can Work, Too

An investor with a substantial holding in one position can often monetize—or borrow against—the position to raise capital. One advantage of monetization over an outright sale is that monetization does not produce a capital gains tax. Monetization does, however, create interest expense.

It is possible for investors with zero-cost collars to monetize against their underlying positions. But the combination of the two strategies is relatively expensive, because the zero-cost collar produces no income to compensate for the monetization interest expense. For this reason, investors shouldn't adopt this approach unless they're extremely bullish about the future of the underlying security or the use of the borrowed funds.

The combination of monetization and an income-producing collar represents a more appealing approach, because the income-producing collar produces cash to help offset the monetization interest expense. So while monetization with a zero-cost collar may demand an extremely bullish stance, the combination of monetization and an income-producing collar

may well represent the most cautious approach to the management of low-basis positions.

To that end, Wall Street invented the prepaid variable delivery forward sale, a hedging tool that has many acronyms on the Street, including PPVF. The PPVF is a put, a call and a borrowing all pushed together into one contract. It has become the hedging product of choice.

Trouble Ahead?

On Jan. 27, the Internal Revenue Service released a troublesome Technical Advice Memorandum dealing with variable forwards. The memo finds that when an investor lends his shares in connection with a prepaid variable forward, that arrangement (as well as other contract indicia) creates a common-law sale. And share lending is not uncommon.

Twenty-First Securities does not agree with the agency's conclusions but has long alerted investors to the risk in loaning hedged shares to the counterparty. We continue to recommend caution and believe it would be prudent—until further clarity emerges—to operate as if the ruling were law. For this reason, we advise investors who hedge with prepaid variable forwards not to lend the hedged stock to the counterparty.



Robert N. Gordon is the president of Twenty-First Securities Corp., a brokerage and financial services firm he founded in 1983.