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Seven Ways to Diversify Your Concentrated Stock Position

And Why You Should

Too much wealth is never a problem. Too much wealth in one asset could be.

Having a concentrated stock holding in a single company may create significant risk. The investor is exposed: Not only are there dangers in relying on the performance of one company to grow their wealth, but there can also be tax issues and liquidity problems along the way.

For example, should the investor want to sell their entire position, they could be hit with a steep capital gains tax. These risks can be reduced if their wealth was diversified across multiple assets.

Concentrated stock positions could come from one of the following scenarios:

- Holding an appreciated stock for a long period of time.
- Incentive equity from an employer.
- A large inheritance that is primarily in a single security.
- Shares of a publicly traded company following the sale or merger of a business.

There is *no reason why the wealth created in any of these scenarios should remain in one security*. With the right strategies, you can get closer to realizing your personal investment goals while at the same time potentially lower your tax burden and overall risk.

Here are seven strategies to help break up your concentrated position and diversify your wealth to ideally grow more.

Covered Call Writing*



In this scenario, within a certain time window you sell a call option (the right to purchase a stock) you already own within a specific time period. One benefit is that you generate income because you receive a cash premium immediately, and still participate if the stock price rises past the strike price. No matter what happens, you keep the cash premium, and you partially hedge your position if the stock declines in value. Think of covered call writing as a way to hold the stock, receive some income, and reduce some of the downside on the stock.

Equity Collars*



Collars are used to manage risk in a single stock position. An equity collar is created by selling an equal number of call options and buying the same number of put options on a long stock position. This option strategy effectively "collars" the stock. Buying the puts establishes a floor for the stock which reduces the downside. To pay for the purchase of the puts, the investor sells calls, and the premium received covers the cost. As a result, the client gives up some of the upside, to pay for the insurance on the downside. This is considered a bearish-to-neutral strategy designed to protect profits rather than increase returns.

Variable Prepaid Forward (VPF)



A VPF represents an agreement to sell shares at a specified date in the future (up to three years) in exchange for an immediate cash payment. Oftentimes, the cash advance is between 70%-90% of the stock's value and is determined by size, interest rates, duration, and more. A VPF also allows the investor to defer capital gains until the stock is sold. Since the stock sale is not finalized, this may be an option for holders of stock options with an exercise date in the future. This strategy is typically employed when an investor has single stock exposure and wants to raise cash while postponing taxes.

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Tax Managed Portfolios



Many investors have existing portfolios that they have held for a long time. As a result, they have some positions which have low-cost basis and large unrealized gains. It would be inefficient to simply sell those positions and incur the tax. In a tax-managed portfolio, taxes do not drive investment decisions, but they are factored into the trading strategies. Techniques like tax loss harvesting, gain realization deferral, wash sale avoidance, and tax lot optimization are few of the ways to increase an investor's after-tax returns.

Exchange Funds



An Exchange Fund is a vehicle that allows different investors with different low-cost basis stock to "exchange" their shares into a diversified portfolio.

A remarkably simple example is you and two friends have very low-cost basis stock and you want diversification, but you do not want to have to pay the tax. You have 100 shares of Apple, your friend has 100 shares of Netflix and a third friend has 100 shares of Exxon Mobil. Together you contribute your shares to the fund and "swap" with each other. You now have 33 shares of Apple, 33 shares of Netflix and 33 shares of Exxon Mobil. In this way you've increased diversification by contributing shares of your existing stock into a broadly diversified fund in exchange for a pro-rata share of ownership.

Now you're diversified because you own a share of a fund that consists of different stocks. Because this isn't an outright sale, you are not exposed to capital gains taxes.

Charitable Giving



Many investors are charitably inclined. In addition to being altruistic, there are tax advantages to donating low-cost basis stock to charities. There are simple and complex planning techniques that can be used to minimize capital gains. These ideas range from donating low-cost basis stock to a Donor Advised Fund, or for larger portfolios, creating a Family Foundation. Charitable Remainder Trusts (CRT) are irrevocable trusts that allow an investor to donate appreciated stock to the CRT and potentially receive an income tax deduction in that tax year. By diversifying the asset inside of the CRT, the donor can receive income from the portfolio for their lifetime, and then the remaining assets go to the charity. As part of the planning process, investors should understand the potential benefits of charitable donations.

Advanced Estate Planning



Gifting stock to family members is a popular estate planning strategy that can also have significant tax benefits. Thanks to the gift tax exclusion rule in 2021, you and a spouse can gift up to $15,000 every year and avoid transfer taxes. Often an heir will be in a lower tax bracket and can sell the position and capital gains taxes may be lower or even eliminated. A more complex option could be using a trust for investors in high-tax states. Funding a trust with low-basis stock and using a situs in a low tax state can reduce capital gains taxes when selling securities. Federal taxes are generally not affected by the trust situs, but savings on state taxes can still be significant.

Let Cerity Partners Help

Cerity Partners are experts at creating holistic wealth management strategies that incorporate all of the above and more. Knowing which option is best for you in protecting your assets is critical to making an informed decision. Cerity Partners offers a full suite of services including tax planning and preparation, financial planning, investment management, and more, which means we will work with you to develop a strategy that helps you diversify your position while considering all potential tax liabilities.

Knowledgeable and helpful, the team at Cerity Partners will help manage risk and any potential exposure of your current position. Contact us today!

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*Options strategies are typically used to generate income and/or manage risk. Trading options involves risk and is not suitable for all investors. It is important that investors considering options trading read the Characteristics and Risks of Standardized Options before engaging in options trading. There are many factors that an investor should be aware of when trading options including interest rates, volatility, stock splits, stock dividends, stock distributions, currency exchange rates, etc. Investors should only engage in options trading that is best suited to their financial condition and option experience and which considers current market conditions.

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