Taxable Concentrated Risk

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Concentrated Risk Problems

- **Create difficult decisions.**
  - Emotional and business ties.
  - Complex analysis required.
  - Some otherwise obvious remedies fall under tax authority “constructive sale” rules.

Concentrated Risk Problems

- **May be dealt with by:**
  - Hedging, usually with a “collar” in some form to avoid a cash outlay.
  - Borrowing on margin and diversifying with the proceeds.
  - Pooling risks, as in an exchange fund.
- **Or…**

Concentrated Risk Problems

- **May be dealt with more simply by:**
  - Diversifying concentrated risk better in the rest of the portfolio (complementary fund).
  - Selling much of the position and paying the taxes.
  - Doing nothing – the lifetime horizon is short and we need the money that would go to taxes.

Collar Hedging

- **Finance the purchase of a put hedge through the sale of a call.**
  - Custom fees can be high and puts generally cost more than symmetric out-of-the-money calls.
  - Asymmetric tax law can trigger short-term gain treatment but any losses are long-term and unavailable until end of multi-year contract.
- **Prepaid Variable Forward Wrapper**
  - Can skirt margin limitations.
  - Can trigger constructive sale if too little risk

Using Borrowed Funds

- **One method:**
  - Borrow on margin but offset much of the risk through a short-sale on a market index.
  - Buy portfolio suitable for tax loss harvesting
  - Sell off loss positions in new portfolio
    - To offset taxes on coordinated partial sales of concentrated position.

- **Considerations:**
  - Leverage has involved a financing decision.
  - Unfavorable tax treatment on short sales.

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Risk Pooling

- **Exchange Funds**
  - Investors with similar problems pool funds.
  - Cleanest way to get diversification.
  - But government rules require an additional activity
    - borrowing to buy real estate is typical.
- **Charitable Remainder Trusts**
  - Charity can diversify without tax
  - But makes sense only if charity attractive otherwise.

The Simple Alternatives

- **Complementary funds**
  - Constrained mean-variance optimization.
- **Sell partial position and pay tax**
  - Good solution with long lifetime and low tax rate.
  - But tax payment may be large enough relative to discretionary wealth to justify financing analysis.
- **Do nothing.**
  - Best if funds will be gifted or receive step-up in cost basis…
  - within a period too short to recover tax payment through reduced risk or added return.

Concentrated Wealth Example

BASIC PROBLEM INPUTS	
Concentrated Stock	$ 1,000,000
Residual Assets	$ 1,000,000
Pres Value C Tax Liability	$ 103,962
Other Liabilities	$ 1,500,000
Initial Discretionary Wealth	$ 396,038
Initial Disc Wlth %	19.80%

Press to find best current plan for concentrated stock.

EXPANDED PROBLEM INPUTS	
Tax Liab. Discnt Rate	6.00%
Conc Stk Cost Basis	$ 125,000
Unrealized Gain %	87.50%
Current Gains Tax	15.00%
Future Gains Tax	15.00%
Years to Liquidation	4
Future Tax Liability	$ 131,250

	Concentrated Stock	Replacement Stocks	Replacement Bonds	Residual Assets
Initial Weights	50.0%	0.0%	0.0%	50.0%
Ideal Weights	1.4%	43.5%	5.1%	50.0%
Difference	-48.6%	43.5%	5.1%	0.0%
Trading Cost	0.80%	0.20%	0.10%	0.25%
Mean Pre-Tax Return	15.0%	10.0%	5.0%	8.0%
Std Dev Pre-tax Rtn	40.0%	15.0%	6.0%	12.0%
EffectiveTax-Rate	14%	14%	35%	25%
Return Correlations				
Concentrated Stock	1.00	0.60	0.00	0.50
Replacement Stocks	0.60	1.00	0.00	0.60
Replacement Bonds	0.00	0.00	1.00	0.40
Residual Assets	0.50	0.60	0.40	1.00
				0
Maximum Weight	50.00%	50.00%	50.00%	50.00%
Minimum Weight	0.00%	0.00%	0.00%	50.00%

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Concentrated Wealth Example -- II

INTERMEDIATE CALCULATIONS

					0	
Concentrated Stock	$	27,376	Total Weights		100.0%	
Total Assets	$	1,862,411				
Pres Value C Tax Liability	$	2,650	Disc Wlth %		19.32%	
Other Liabilities	$	1,500,000	Leverage		5.18	
Discretionary Wealth	$	359,761				

	Concentrated Stock	Replacement Stocks	Replacement Bonds	Residual Assets
after-tax rate	86%	86%	65%	75%
after-tax mean	12.90%	8.60%	3.25%	6.00%
Mean Contributions	0.18%	3.74%	0.17%	3.00%
after-tax risk	34.40%	12.90%	3.90%	9.00%
after-tax risk matrix	0.3440	0.0000	0.0000	0.0000
	0.0000	0.1290	0.0000	0.0000
	0.0000	0.0000	0.0390	0.0000
	0.0000	0.0000	0.0000	0.0900
Covariance matrix	0.118336	0.0266256	0	0.01548
	0.0266256	0.016641	0	0.006966
	0	0	0.001521	0.001404
	0.01548	0.006966	0.001404	0.0081

Concentrated Wealth Example -- III

RESULTS

Portfolio Mean Return	0.0709	**Port Mean Return**	**7.09%**
Portfolio Variance	0.0088	**Portfolio Risk**	**9.40%**
Disc Wealth Mean	0.3668		
Disc Wealth Variance	0.2368		
Expected Subsequent Growth Rate of Discretionary Wealth			**24.84%**
Current % Loss of Discretionary Wealth			9.16%
Growth Adjustment for Initial Loss			**-2.40%**
Expected Growth Rate of Discretionary Wealth			**22.44%**

Useful Tools for Analysis

- **Effective Tax Rates:**
  - Short-term gain treatment (highest)
  - Dividends
  - Effective long-term gain
  - Heirs step-up in basis and gift exclusions (lowest)
- **Mean-variance optimization, embedded within…**
- **Discretionary wealth financing paradigm.**
  - Financing objective: $LE - L^2V/2$.

A question for discussion…

A new client holds $30 million dollars in low cost basis Microsoft stock, and $5 million in other financial assets, plus a magnificent house overlooking the water.

What do you ask them?

What do you tell them?