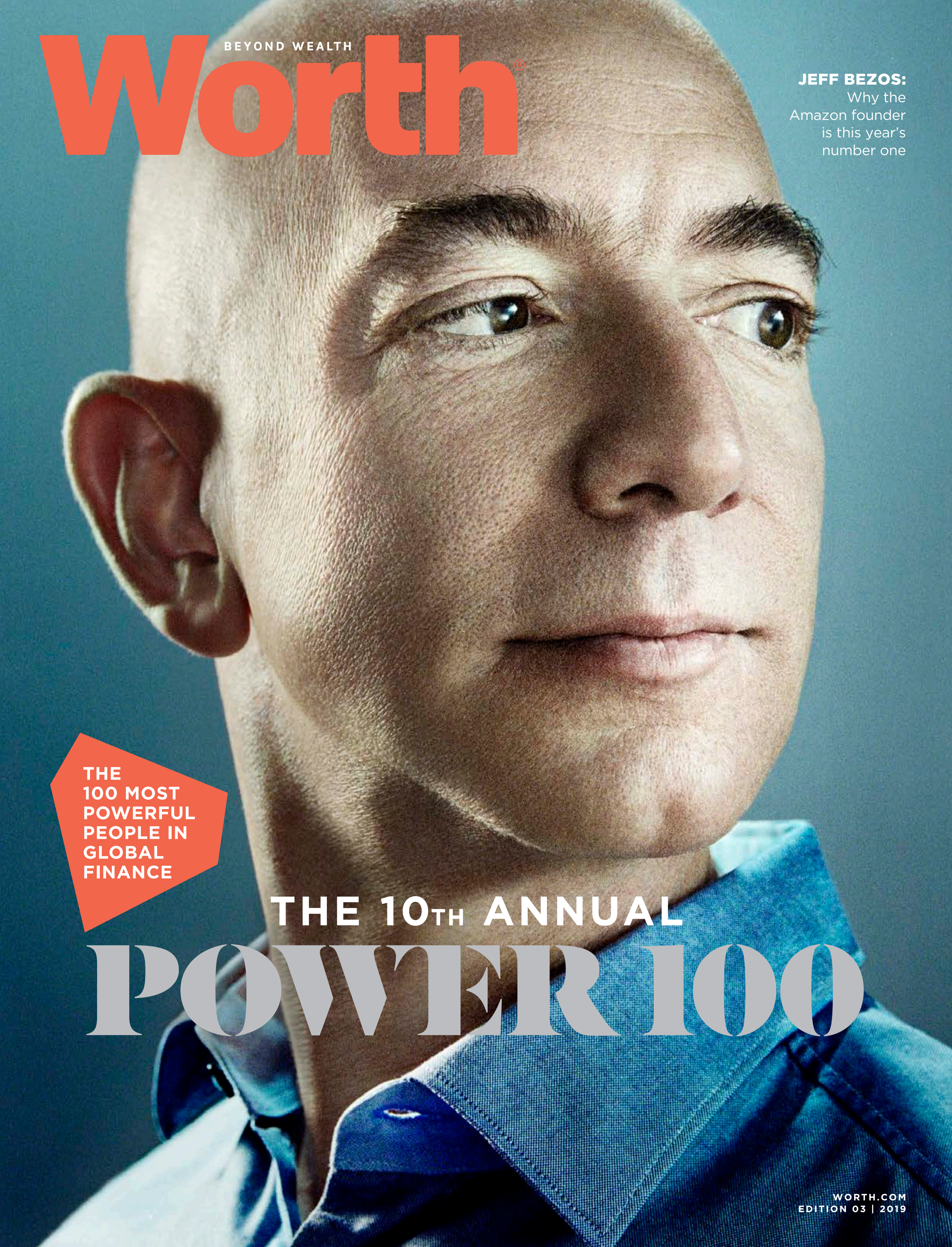

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Q:

How should you manage a concentrated position in one stock?

BY TIMOTHY E. FLATLEY

Timothy E. Flatley, ChFC®, President, CEO

STERLING INVESTMENT ADVISORS, LTD.

When working with entrepreneurs, Sterling frequently meets individuals who have a large concentration in one stock. This may happen after they sell their company in exchange for stock as the result of their company going public, or if they have been making private equity investments that are acquired or go public.

After one of the aforementioned events, the investor is left with a sizable stock position that often represents more than half their portfolio. This situation can create considerable volatility tied to the fortunes of that one company. The investor would have likely made out incredibly well if their concentrated position was in Amazon over the last five years. However, someone highly concentrated in General Electric would have been staring at a monumental loss.

Most investment advisors would counsel against allowing one position to have so much influence within a portfolio. Typically, there are two reasons why people maintain a concentrated position. The first is that they have great confidence in the company, generally accompanied by a keen understanding of the business, and feel the stock has strong growth prospects. The second, and potentially more significant, reason is that they have a low tax basis and are reluctant to pay the capital gains tax.

To determine the probability of the stock performing well in the future, thorough research has to be undertaken. This includes examining the company's financials, current news and competitive positioning. We also overlay a technical analysis, which involves a study of the stock's previous price movements. Support floors and resistance met at certain ceilings can help identify a trading range. Granted, it is nearly impossible to determine the exact best price at which to sell. But a plan for selling the stock over a period of time and at a number of different prices can be developed.

Overriding factors in the sale decision often involve the risk tolerance of the investor and how vital the stock is for their financial security. In addition to those factors, the constantly evolving rhetoric from Washington concerning tax legislation will help steer the pace of stock sales. The current 20 percent long-term capital gains tax rate may be attractive relative to what future tax rates will become.

We also employ a "collar" stock options strategy. This entails selling a call option against the stock while simultaneously purchasing a put option that protects the stock dollar for dollar should the price decline. The collar allows you to buy insurance in the form of the put option, with the money earned from the call option. This strategy was popularized by Mark Cuban, who sold his company broadcast.com to Yahoo. In 1999, he received Yahoo stock valued at $95 per share. His collar had a strike price of $85. Initially, this looked like a bad trade as Yahoo zoomed higher. However, the dot-com bubble eventually burst and Yahoo plummeted to $13, while Cuban locked in his floor at $85.

Other tactics include donating low basis stock to fulfill charitable commitments, and gifting to relatives who are in a lower tax bracket. Utilizing exchange funds is another tactic. Exchange funds are private partnerships that allow the owner of a concentrated position to contribute their stock to a pool of investments from persons in similar situations. Such funds have complex rules and require large contributions, but they can provide diversification in conjunction with tax deferral opportunities.

Special consideration should be paid when the investor with a concentrated position is either elderly or in poor health. When a person dies, their assets receive a "step-up" in basis. This means that when the designated beneficiaries sell any of the stock, they will only have to pay taxes on gains accumulated since the date of death, potentially creating a substantial savings.

If you are fortunate enough to have

> "Special consideration should be paid when the investor with a concentrated position is elderly."

an investment outcome resulting in a large amount of a single stock, it is best to manage it as unemotionally as possible. A trained investment professional can assist you in devising a strategy to mitigate your risk and manage the tax impact while maintaining your ability to participate in future growth. ●

ABOUT STERLING INVESTMENT ADVISORS, LTD.

Sterling Investment Advisors recognizes that every situation—educating children, building retirement wealth, insuring against loss, reducing taxes, planning estates, setting up trusts and the like—brings its own complexities. The objective of the firm's team concept is to help clients develop a support group of professionals to whom the management of these issues can be delegated. Sterling Investment Advisors, an independent wealth management firm, was named three times to the Philadelphia 100, honoring "the fastest-growing privately held entrepreneurial companies in the Philadelphia region." The firm has 30 years of investment experience with an independent orientation and utilizes proprietary trading strategies, with assets held at Charles Schwab.

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