Single-stock solutions

A large holding of a single companyøs stock can pay exceptional rewards. But when the holding represents the major share of a portfolioøs value, it flouts the principle of diversification and can expose you to an unacceptable level of investment risk.

When your equity holdings are concentrated in one stockô whether acquired by investment design over a period of years or through the exercise of employer-provided stock options, inheritance, the sale of a business, or distribution of partnership interestsô diversifying can help you to sleep more soundly each night.

However, the tax cost on a sale of highly appreciated stock can be quite an effective deterrent to diversificationô no one wants to pay more tax than necessary, especially if the effect is to reduce significantly the size of the portfolio. You may wish to retain the voting rights and dividends that your stock carries. You might be constrained as well by restrictions on the sale of stock in a closely held company. And you may be concerned about the negative price impact that a large sale can have on a thinly traded stock.

Is there a way to satisfy seemingly contradictory objectives? Can you unlock the financial resources represented by the stock short of selling it?

Approaches

Here are three ideas to consider.

• *Borrowing against equities.* Using your stock as security, you may be able to borrow tax-free funds for diversification or any other purpose. You retain full voting rights and receive all dividends, and you pay interest at competitive margin loan rates. Keep in mind, however, that this use of leverage can expose you to additional market risk in the event of a downturn in the stock market.

• *Hedging with options*. Downside risk may be limited with the purchase of a protective put or, to some extent, with the sale of a covered call. Buying a put, you acquire the right to sell the specified stock to the option issuer at a specified õstrikeö price in the time frame of the option. A protective put is bought for a position that the buyer owns, providing an escape price if the stock falls. A call gives the buyer the right to buy the stock, and the seller the obligation to sell it, at the contracted price. Used in this way, options can be effective

hedging tools, whereas õnakedö puts and callsô in which the party obligated to sell does not own the underlying securityô are highly speculative and complex investments.

The aim of hedging a concentrated position is best accomplished with European-style, cash-settled options, which may be exercised only just before expiration. Both strategies may be combined in an õequity collarö at little or no cost, with the premium received for the call used to buy the put. The trade-off for downside protection is a limit on upside potential to the callø strike price.

- *Charitable remainder trusts.* Combining philanthropy with provision for a familyø financial needs, these trusts also offer a way around the problems of a large concentrated holding when your wish is to dispose of the holding. If you were to sell the stock to reinvest the proceeds in an income-producing portfolio, you would owe tax on the full capital gain, reducing the earning power of your new portfolio. Placing the stock in an irrevocable charitable remainder trust, however, you can direct an immediate tax-free sale and reinvestment to provide your family with income for a fixed term of years or for a lifetime. You get a current tax deduction, and the value of the stock is removed from your estate. At the trustø termination the principal remaining passes to the designated charity.

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