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WEALTH

UNLOCKING CONCENTRATION RISK

Revised March 2025

Summary Thoughts Within This Report:

- Advisors must continually evaluate the investment landscape, position risk, opportunity cost, time horizon and taxable consequence related to concentrated holdings.
- Behavioral biases exist and one can never underestimate the power of emotion related to a concentrated investment.
- Various techniques are available to investors in order to customize an effective approach to reducing a concentrated investment.

Highlighted in This Report:

- Stock Options
- Net Unrealized Appreciation
- Outright Sale
- Protective Puts
- Buy-Writes
- Equity Collars
- Variable Prepaid Forwards
- Exchange Funds
- Charitable Remainder Trusts
- Pairs Trading
- Portfolio Management

The Mindset

Equity markets have shown resilience after making significant bottoms in 2002, 2009 and 2020. However, since the Covid pandemic low in 2020 investors have been rewarded with a sustained upward move in the equity market. Although the S&P 500 Index is down from recent highs, it is still up over 50% since the beginning of 2023. The emotional journey many have taken, but fortunately survived, gives one an opportunity to reassess their investment portfolios, general investment philosophy, and balance between risk and reward.

The favorable equity climate has led to many companies making 52-week highs and/or near all-time highs. At the time of this publication, many of the companies in our own backyard have performed well. Procter & Gamble is up over 85% since the markets March 2020 low, Cincinnati Financial is up over 119%; American Financial Group is up 311% and Cintas is up 359%. We believe it is an opportune time for investors to analyze these positions and any other equity positions in the context of their portfolio weighting.

We contend the best time to seek portfolio protection is when it's cheapest. This would be comparative to purchasing life insurance when premiums are least expensive. Similarly, one should evaluate stock concentration risk when markets are positive and sentiment is good. The intent of this report is to outline the challenges associated with concentrated holdings and to introduce potential solutions to help reduce the risks associated with such holdings.

The Approach

Experience in dealing with investors that have concentrated holdings, public equity or private equity for that matter, has taught us one important lesson; one can never underestimate the power of emotion. Investors frequently create significant wealth through concentrated equity investments. Highly appreciated stock positions are typically established through inheritance, sale of a business, executive compensation programs, stock purchase/option plans, and/or years of holding a successfully purchased investment. Sizable positions often create a feeling of loyalty or commitment to the position and thoughts or actions to reduce that position can be quite difficult.

Objectivity is paramount when making recommendations to hold, sell or hedge a highly concentrated equity position. The financial complexity for many families varies greatly and thus the need for a customized process is important.

Both qualitative and quantitative elements are incorporated as part of the analysis; however, there is no one factor which leads investors to the moment of clarity. Advisors who follow a strategy that stresses time horizon, lifestyle and discipline provide the objectivity investors need for successful outcomes.

The time horizon over which one evaluates the decision to hold, sell or hedge a concentrated position is an important one. Simply selling all or a part of a concentrated stock position usually generates a taxable event with the investor likely subject to significant capital gains tax. Some reference the lost valuation paid as tax drag. The time period that it takes to recover that lost valuation becomes increasingly more important as the investor seeks to bridge that gap.

Quantitative analysis is conducted to make long-term comparisons between the individual position and other investment alternatives. We assert that forecasting long-term price targets are difficult but still important as individuals weigh the opportunity cost of holding their position versus an alternative. Notably, analysis predicated solely on historical data may lead to specific behavioral biases that influence the investor to maintain his or her position weight. One can understand that mindset as investors tend to maintain loyalty to positions that have performed favorably in the past.

Maintaining a particular lifestyle is an important and vital part to the decision making process to hold, sell or hedge an equity position. Many investors are far more impacted by an event that reduces net worth by 50% as compared to one that increases their net-worth by 50%. Behavioral finance studies show investors generally have a stronger preference for avoiding losses than for making gains when evaluating the risks of an investment. This is a behavioral bias known as loss aversion that was introduced by psychologists Daniel Kahneman and Amos Tversky, both pioneers in behavioral finance. Because of this behavioral tendency, investors generally react more vigorously to the onset of negative events that could trigger painful losses than when faced with a similar likelihood that may lead to performance gains. The implication for investors is they should seek to construct a more diversified portfolio as individual stock concentrations can increase the magnitude of portfolio volatility.

It is not uncommon for investors to implement several diversification strategies in order to protect their portfolio. The key is to carefully review the various techniques available to investors in order to customize an effective approach to reducing a concentrated investment. This report highlights some of the techniques related to selling and hedging concentrated holdings.

The Strategy

Stock Options:

Participation in options programs through various publicly traded company compensation programs can be extremely rewarding. Clearly, stock appreciation is the driving force behind generating significant wealth through option leverage. Take a hypothetical example where an employee for XYZ Industries receives a 10-year option grant for 5,000 shares at a price of $30 per share. At the maturity of the grant, the stock is $75 per share. The gross gain, therefore, on this one grant alone, is $225,000.

Historically, many employees assumed the best course of action relative to exercising an option was to exercise just prior to the option's maturity date. This was the case for those with one option grant or multiple option grants with various maturity dates. This can be a risky strategy, as stocks with significant embedded gain may prove compelling for exercise well in advance of the option grant's maturity date. Today we advise employees to evaluate their options in conjunction with their other holdings in advance of expiration. This assessment includes the investor's tax situation, option leverage and value at risk.

Highly appreciated option grants must be monitored closely and carefully. Options that are highly appreciated, also known as deep-in-the-money, lose their embedded leverage. Ownership in such an option is more like owning stock outright. As a result, the value at risk has increased significantly and situational tax strategies come into play regarding the timeliness of exercising the option. Investors who decide against an exercise should then consider selling other shares held outright.

Stock options are, unfortunately, not considered collateral for purposes of hedging. Therefore, the holder of an incentive based stock option cannot sell a call option against his or her option position in an attempt to offset some risk and potentially generate some income. On occasion, we have recommended implementing a synthetic buy-write (see definition below) strategy where other investment assets were used as collateral for the calls that were sold.

Net Unrealized Appreciation (NUA):

Frequently, executives participate in stock reward programs through company matching or profit sharing plans in addition to their stock option compensation. Company profit sharing may be paid in the form of company stock. Although these programs can be quite generous, they do add further concentration risk. One approach to help reduce concentration risk and leverage an individual's tax situation is to execute a net unrealized appreciation strategy (NUA). NUA's allow

individuals to convert company shares held in retirement accounts to taxable investment accounts. The NUA strategy allows investors to pull low basis, highly appreciated stock out of the corporate retirement account and pay ordinary income tax on the basis only. Since the stock is outside of the qualified account, the net unrealized appreciation, the difference between the basis and current stock price, is taxed at sale as long-term capital gain. Generally, capital gains rates are lower for most high-net worth individuals versus ordinary income tax rates. The tax implications for NUA's can greatly favor certain investors. NUA's also offer flexibility for hedging and for balancing taxable investment accounts in relation to nontaxable investment accounts.

Outright Sale:

An outright sale of stock is often the best and most simplistic means for reducing a concentrated stock position. A mental hurdle associated with this strategy is one will pay long-term capital gains rates on the gain, but at a multigenerational low of 15%, this tax is by no means egregious. In fact, the probability that capital gains rates will move higher in the coming years has increased. Spreading sales over multiple years can help offset too much gain in any one calendar year and the strategy of selling a call option to help set a future sale price can be compelling. Generally, it is wise to use higher basis positions for outright sales. Deferring the lower basis shares allows for better compounding of investment dollars and these shares can be used for future gifting and charitable intent for those so inclined. When structuring sales, incorporating a minimum sale amount and minimum target date is important to following a constructive plan.

Protective Put:

A protective put provides the holder of a stock position the opportunity to purchase downside protection. A purchased put is the equivalent of buying insurance against the risk of loss. The stock maintains the potential for unlimited upside price appreciation, however there is a cost to purchase that protection, also known as the premium. It is important to note that put premiums are more expensive in higher volatility environments and with stocks that pay healthy dividends. Investors considering a borrowing strategy utilizing individual stock positions generally can purchase put options to increase borrowing limits.

Equity Collar:

Collars combine the purchase of put options and sale of call options at different strike prices with like expiration dates. Collars enable an investor to protect the value of an equity position while maintaining some price appreciation potential. The purchase of a put option provides downside protection below the put's strike price. The call option creates a cap on price appreciation to a level equal to the call's strike price. Frequently, investors execute collars on a cashless basis where the premium generated from the sale of a call option is equal to the purchase price of the put option.

Executing a traditional equity collar with favorable metrics related to downside protection and potentially meaningful upside participation is difficult into today's option market environment.

Puts have become increasingly expensive as market volatility has increased and interest rates have dropped. Hedging a stock position using a collar strategy is more difficult in situations where the stock pays a dividend, as the time value of money negatively impacts the put option price relative to a healthy dividend. With 1-year interest rates at virtually zero, money has limited time value and stock dividends become far more attractive than 1-year treasury bills.

Variable Prepaid Forward:
A variable prepaid forward (VPF) sale operates similarly to a collar but adds the element of liquidity. Some may compare the VPF to executing a collar with a corresponding loan agreement. This strategy creates a floor of downside protection while allowing for upside appreciation to a cap. The floor of protection provides the investor with the ability to receive an upfront payment against a guaranteed stock value. The upfront premium, also known as advance rate, generally ranges from 75-85% of the position value. The current nature of the transaction defers tax consequences until the maturity date of the contract, typically 2-4 years. At such time, the owner of the stock and VPF contract must make a decision about the best strategy to pay-off the advanced funds. This may come in the form of a cash payment or in the form of delivery of the underlying stock. Settlement is the most complicated aspect to the transaction and entails strategic thought and sensitivities to tax implications. It should be noted that the IRS is frequently reviewing the tax nature related to this type of transaction.

Importantly, advisors must ask one extremely important question when entering into a dialogue about VPF's. In which direction do we anticipate the stock price to move over the term of the VPF contract? The estimates for future stock price can quickly assist in deciding if a VPF is warranted. If the decisionmaker concludes the stock is either overvalued or range-bound, consideration for the VPF should be abandoned. The success of a prepaid forward is predicated on stock appreciation. The level of appreciation does not need to be overwhelming, but positive enough to offset the discounted proceeds advanced to the stock holder. Historically, a VPF might be judged a success when annual returns fall between 2-7%, depending on the stock and specific contract terms.

The variable prepaid forward sale is more complex than most and entails thoughtful analysis related to stock price, time horizon, stock basis and potential tax implications.

Exchange Fund:
Exchange funds permit qualifying investors to contribute highly appreciated stock positions into a limited partnership in exchange for shares of a diversified fund. Contributions of appreciated stock to a properly structured exchange fund are not taxable under current federal tax law. This is a passive approach to diversifying one's concentrated stock position while creating immediate and tax efficient diversification. We associate this strategy as swapping concentrated stock exposure for index exposure such as the S&P 500 Index.

As opposed to a variable prepaid forward sale, exchange funds are not overly complex. An exchange fund strategy has simple terms that are outlined before entering the transaction. In order to qualify as a partnership, exchange funds must own at least 20% of their value in a "qualifying asset." This asset tends to be real estate. Also, investors must be qualified purchasers to participate.

Ownership interest in exchange funds can be interesting in the context of portfolio construction as many investors reduce concentrated risk for U.S. stock market index risk. This passive, traditional and broad index exposure provides investment managers some flexibility to add value thorough other asset classes such as foreign stock and alternatives.

Charitable Remainder Trust:
Investors with the means and intent to gift charitably during their lifetime may consider charitable remainder trusts (CRT) as a strategic way to reduce portfolio concentrations, tax-efficiently maximize charitable intentions and provide lifetime income. An investor may gift a highly appreciated position, or multiple positions, to a trust and receive a charitable deduction at the time of the grant. Assets held within the trust may be sold without taxable consequence. The trust has predetermined terms, which allow for annual income to be dispersed to the donor often in the 3-6% range.

As with every strategy, CRT's have nuances that are very important and can impact a donor's ultimate decision. Gifts made to the trust are irrevocable and donors must evaluate a great deal regarding their personal financial position before committing to a CRT strategy.

Pairs Trading:
A less frequently used hedging strategy includes pairs trading. A pairs trading strategy takes like securities and trades them in a long-short format. The long stock position, for our sake the concentrated stock position, is offset by a short position in another like security. The intent of the trade position is to reduce position risk, dollar exposure risk or beta (volatility).

A pairs trading strategy calls for thoughtful position sizing and good decision-making when implementing the transaction. There are no guarantees that a pairs trade will prove effective in hedging a concentrated stock position. The desired price action could drift in opposite directions.

Portfolio Management:
If an investor with a stock concentration desires to retain the position in its entirety, a portfolio can be constructed that factors in the concentration. It certainly adds layers of restriction but requires investment managers to think differently about capital allocation. In this regard, advisors must go through a customized process that evaluates all of the portfolio components.

The Reminder

We are reminded of some powerful names of yesterday that experienced significant losses or were forced into bankruptcy: Kodak, Wachovia, Bear Stearns, GM, Conseco, Chrysler, Texaco, Enron, Washington Mutual, CIT Group, Pacific Gas and Electric Company, IndyMac Bancorp, General Growth Properties, WorldCom, American Airlines, Delta Airlines and Lehman Brothers just to name a few.

Understandably, an investor holding a concentrated stock position has a sense of loyalty to the company that rewarded its owner. However, we note that investors reserve the right on a daily basis to assess their market exposures and protect themselves from the unpleasant experience of those who owned stock in the companies aforementioned. We are not implying that in all instances we recommend diminishing a concentrated position but rather, we emphasize constructing a long-term plan that embarks on a path for diversification. Advisors should continue to engage investors in a dialogue about strategic ways to unlock the greatest value regarding their concentrated holdings. Good starter questions include: If the concentrated position were to decline substantially, how would my lifestyle be at risk? At what (opportunity) cost do I maintain my position loyalty? What is the appropriate position amount to divest? When do I execute? Thoughtful planning focused on time horizon, lifestyle goals, and discipline are a sure way to build a foundation for a successful investment portfolio.

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