HIGH EXPOSURE TO LOW-BASIS STOCK: TOO MUCH OF A GOOD THING?

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By Alan R. Feld, Managing Director, Sanford C. Bernstein & Co., Inc.

The high-flying stock market has given rise to a felicitous quandary for many investors. What if the vast bulk of their gains derives from a sizable concentration in one or two investments, acquired at a fraction of today's market value, perhaps through a shrewd investment made years ago, through executive compensation, or through the tax-free sale of a closely held business in exchange for stock in a public company? On the one hand, sitting on such a highly concentrated portfolio is very risky. On the other hand, the stock could go on to post stellar returns. And of course, if the stock is sold, the transaction will generate a hefty tax bill. (For simplicity's sake, we're assuming no restrictions on the sale of the concentrated stock. Insiders, affiliates, and owners of illiquid issues face regulatory and market-related impediments to diversification.)

How should investors evaluate these trade-offs? They can choose a prudent course of action appropriate to their circumstances, aided by a cool look at the facts.

Stars Can Fade

The first fact is that the concentrated portfolio is even riskier than most think. While single stocks can do extraordinarily well if they "win," chances are they will underperform. Even great companies may not always be great investments. For example, of the 10 companies named by Fortune magazine in 1988 as the "most admired" in the country, six lagged behind the S&P 500 over the ensuing decade to such a degree that you would have been better off paying the capital-gains tax and diversifying. The other four companies, however, did very well. But are those odds likely to give you comfort in clinging to one stock?

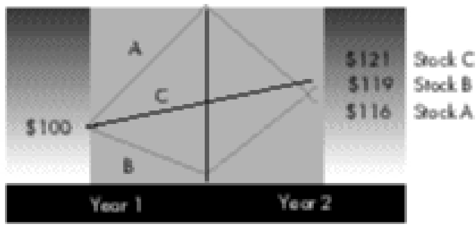
In some cases, betting on a single stock can be disastrous. Remember companies like Ames Department Stores, Circle K, Service Merchandise, Pan Am and Wang Laboratories? Since 1985, all have lost between 70 and 100% of their value. And of course, no matter how high a stock climbs initially, a 100% decline always leaves you with nothing.

Odds Against Average Stock Too

But you don't have to focus on "stars" or extreme cases to appreciate the virtue of diversification. Because the second fact is that volatility erodes any stock's compounding rate--the true measure of wealth accumulation. The dynamic is illustrated at the Table 1, which traces the performance of three different stocks over two years. Even though Stock "A" has the highest average return, it grows the slowest because it moves up and down the most. Conversely, Stock "C," with the lowest average return, grows the fastest--because it has a much steadier rise.

Stocks with higher average returns can grow more slowly if they're volatile enough...

Return	Year 1	Year 2	Arithmetic Average
Stock A	45%	(20)%	12.5%
Stock B	(12)	35	11.5
Stock C	10	10	10.0



...Indeed, the typical single stock's fluctuations have cost it dearly vs. the market

Single Stock Performance* vs. S&P 00 Index (1970-98)

	Arithmetic Average Annual Return	-	"Risk Drag"†	=	Compound Annual Return	Growth of $1 Million
Average Single Stock	15.2%	-	4.1%	=	11.1%	$21.2
S&P 500 Index	14.7%	-	1.2%	=	13.5%	39.3

** Bernstein tracked the performance of every stock in the S&P 500 index at the beginning of 1970 that was still publicly traded at the end of 1998.*
†The degree to which the compound return is reduced over time due to volatility
Source: Standard & Poor's and Bernstein

Since even a "typical" stock--a stock with an average arithmetic return close to the market's--misses out on the smoothing effect of diversification, it's likely to underperform the market as a whole. In fact (Table 1), between 1970 and the end of 1998, a $1 million investment in the average single stock was sufficiently volatile to fall $18 million short of a market portfolio over the 29-year period. Furthermore, this heightened volatility is exacerbated when the investment environment is more difficult than usual. The longer the bad patch, the more poorly the average stock is likely to perform relative to the market. In other words, diversification is prudent insurance against the extreme unpredictability of any one stock.

Longer Time Horizon Favors Selling

The presumption, of course, is that investors will be able to recoup the tax costs they'll incur in diversifying. Their success is primarily a function of their time horizons: The longer until they expect to pass the stock on to heirs with a step-up in basis, the greater the chance a diversified portfolio will justify paying the capital-gains tax up front. The more limited the horizon, the less attractive selling becomes.

Consider the following circumstances about an investor's portfolio:

* Market value of stock XYZ: $10 million

* Cost basis: $1 million

* XYZ percentage of stock portfolio: 100%

* XYZ percentage of total portfolio: 83%

* Projected annualized volatility of S&P 500: 18%

* Projected annualized volatility of XYZ: 30%

* Federal and state capital-gains tax rate: 26.85%

* Arithmetic annual return of 10.12% for both the S&P 500 and XYZ in average conditions; compounding rate reduced in each case by volatility projections.

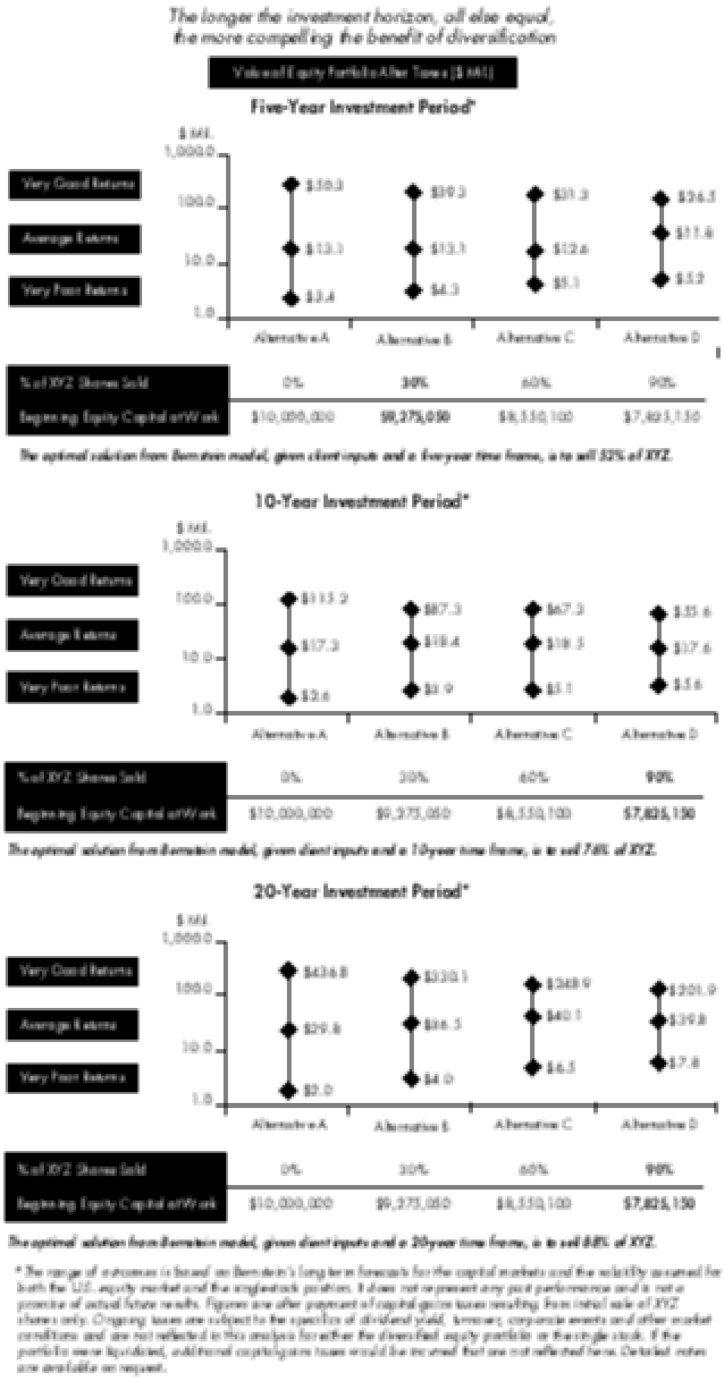
If the entire position in XYZ were sold, the investor would owe $2.42 million in gains taxes. To recoup the tax cost, the after-tax sales proceeds would need to appreciate by 31.9%; in other words, outperform XYZ by 31.9 percentage points. The critical question is, over how long a period?:

For the time frame ...	...incremental return needed to recoup the tax liability
1 year	31.9% a year
5	5.7
10	2.8
20	1.4

Earning 31.9 percentage points more in a year than you'd make from XYZ just to break even is a formidable hurdle. With a one-year time frame, it's almost always better not to sell. The more time is on your side, however, the less incremental return is needed to make divestment worthwhile. For investors with at least a 20-year horizon (which includes most people in their 60s or younger), selling most of a concentrated position up front is recommended.

How Much Should Be Sold?

We recognize that, even for investors with long time horizons, holding or selling is rarely an all-or-nothing proposition. Using the portfolio and tax assumptions described above, the Exhibit shows projections of asset growth in three different time periods--five, 10, and 20 years--for four different divestment strategies. In each case, three different investment environments are considered: average, very good, and very bad (two standard deviations above and below the average; in extraordinary settings, results can be even better, or even worse). The statistics are based on the alternatives presented, which range from retaining the entire single-stock position to divesting 90% and purchasing a market-like U.S. stock portfolio with the after-tax proceeds of the sale.



Critical in evaluating the strategic alternatives are a few principles about time horizons. As they lengthen--

* the greater the downside risk of holding the single stock. If none is sold, our model suggests that after a 10-year period of significantly below-average returns, almost three-quarters of the investment would be lost; after 20 years, fully 80%. That compares with preserving 80% in a 20-year bad stretch with a highly diversified portfolio--after paying the gains taxes on the original sale;

* the greater the upside potential of holding the single stock, as well. In good times, the higher volatility of the single stock works in its favor. Divest none of XYZ, and after five years of an unusually favorable environment, we'd expect its value to have grown to $50 million; after 20 years, to a fortune of nearly a half-billion dollars (though we'd never counsel planning based on so spectacular an outcome); and

* the better the chance that the diversified portfolio will beat the tax bogey. The volatility of the single stock puts it at an increasing disadvantage over time. After five years of an average environment, we wouldn't expect the diversified portfolio to have fully recouped the tax cost of selling the single stock, but we'd probably still recommend selling about half the position because the downside could erase millions of dollars. After 10 years, the investor would likely be better off diversified in all but the most favorable environments. At the 20-year mark, the contrast is stark; in an average environment we'd expect between $7 and 10 million of additional wealth from at least some divestment, not to mention the significant mitigation of downside losses.

And so as a general rule, the longer the time horizon, the more of the concentrated position should be divested at the outset. But "optimal solutions" reflect not facts but forecasts and trade-offs, based on each investor's asset allocation, embedded tax liability, and risk tolerance. And every solution entails giving up some good things in exchange for others.

Suppose the Investor Doesn't Want to Sell?

If it sounds as though we're stumping for selling, that's only half right. For most investors, we do believe it's a mistake to hold a highly concentrated portfolio. But there are alternatives to selling that can make sense, especially over short time horizons. Two of the most commonly used methods, equity swaps and shorting-against-the-box, were effectively eliminated by the 1997 tax law, but there are still viable strategies available. Consider the popular combination of a purchased put and a sold call (usually held open for a few years), known as a "collar."

In some ways, collars combine the best of options-based hedging strategies: Buying the put gives you downside protection, and selling the call pays for that protection while still allowing for some upside participation. For example, you might collar a $100 stock by purchasing a $90 put and selling a $125 call. You can't lose more than $10 on the stock, and you'll be eligible to pocket up to $25 of gain. Meanwhile, no capital-gains tax is incurred during the term of the collar, though the embedded liability still exists. (At press time, the U.S. Treasury had yet to issue regulations on the spread between the put and call strike prices and the length of a collar necessary to avoid constructive sales.) The terms of the collar can be customized, and you can usually borrow against the hedged position to provide a measure of diversification. Collars can be useful for buying time, but they aren't panaceas.

Collars Aren't Costless. Because the call premium offsets the cost of the put, collars are often misunderstood as costless. While they may be structured as cashless--no money changes hands between investor and options dealer during the term of the collar--they must cost something, or there'd be no incentive for the dealers to do them.

A number of factors relating to both the options and the underlying stock go into pricing a cashless collar, but the key is that the sold call is usually worth more than the purchased put. And so by equilibrating the call and put premiums, dealers are expecting to realize a profit on the collar. Typically, this implicit cost is in the range of 1% per year on the initial value of the stock, which investors may well consider reasonable. Regardless, collars aren't free for the asking.

Collars Raise the Specter of Straddle Taxation. Probably the biggest drawback of collars is that most tax practitioners agree they're generally subject to tax-straddle rules. In other words, losses are treated as long-term and may not be deductible until the underlying stock is sold, while gains are considered short-term and taxed as soon as the collar expires. Of course, for investors this is the worst combination.

Table 2 explains how this can play out in extreme circumstances. We're again assuming a $100 stock ($0 cost basis), with a strike price of $125 on the call and $90 on the put and, for ease of arithmetic, gains tax rates of 40% short-term and 20% long-term. After two years, the stock ends up far above the protective band--say at $400. If you want to settle in cash, you'll have to pay the counterparty $275 per share. There are two problems here: If the stock represents most of your net worth, you probably don't have $275 a share in cash to pay out. Even if you do, you may not be able to deduct the loss (at unfavorable long-term rates, to boot) until you sell the underlying stock and pay any gains taxes that may be due. So chances are you'll settle physically by unwinding the straddle and effectively selling your stock to the dealer at the $125 call strike price, leaving you with a portfolio worth $100 a share after taxes.

Suppose, on the other hand, the stock ends up far below the protective band, at $25. If you settle in cash and collect the $65 per share on your put, you're subject to "negative conversion": paying short-term tax rates on what would otherwise be a long-term capital gain, doubling your tax bill. Once again, you'd probably opt to unwind the straddle and settle physically. That way, you'd sell the stock back to the dealer for $90, pay $18 in long-term gains tax, and net $72.

In both scenarios, the collar didn't save you from paying the taxes you were hoping to avoid. The alternative of selling two years earlier and reinvesting the $80 proceeds (the $100 market value minus the $20 in gains taxes) looks quite attractive now.

A Word About Other Tactics

Space limitations prohibit a detailed analysis of the two other major alternatives to outright sale: exchange funds, where groups of shareholders contribute appreciated stock to a limited partnership; and charitable remainder trusts (CRTs), tax-advantaged vehicles for divesting appreciated stock through a trust (with a remainder earmarked for charity) that generates regular income. CRTs can be useful for many investors, assuming at least a modest donative intent; though like all strategies, they have their pros and cons. For one thing, transferring a stock to a CRT is irrevocable; the stock is no longer yours and cannot be passed on to heirs.

Like CRTs, exchange funds can provide diversification and permanent gains deferral, as well as a vehicle for estate-planning. But typically they are illiquid, provide limited or no current income, carry high fees, and give the investor little control over the aggregate asset pool. In addition, they're stringently regulated (indeed, at press time Congress was considering their elimination).

Helping Clients Through the Maze

In sum, diversification strategies are complex and full of uncertainties. But the fact remains that for most investors, it's unwise to concentrate wealth in a few large investments--or in employee options on one stock, where additional complications require rigorous analysis. Deciding how to fix the problem, with one or a variety of approaches, is an area where tax, legal, and investment advisors can work together efficaciously in the client's best interest. *

Alan R. Feld, CPA, is managing director of the Sanford C. Bernstein & Co., Inc.'s Family Wealth Group, dedicated to helping high-net-worth private clients solve complex investment-planning issues.
