Prospero Wealth

Concentrated Position Playbook

WHAT IS A CONCENTRATED POSITION AND DO I HAVE ONE?

A concentrated position is any individual equity investment that gives you pause, keeps you awake at night, or that will cause additional problems (e.g. excessive capital gains) if you try to diversify it.

If you are defaulting to doing nothing with a large position solely because it has “worked for you so far,” or you hate the thought of paying taxes on the proceeds, you’ve got a concentrated position problem.

Concentrated positions are a lot like the proverbial “frog in the pot.” You feel fine as your exposure slowly grows...until you realize you’ve been cooked. You’ll know you have a concentrated stock position when the position has become golden handcuffs, something that keeps you from doing what you know you should.

Many of our clients have benefited from doing nothing with their concentrated positions over a long period of time—but approaching retirement dates, and an increase in financial demands eventually necessitates that the risk of these positions be dealt with explicitly.

There’s a Buffett quote I love (from his 2002 letter to Berkshire Hathaway Shareholders): “To make money they didn't have and didn't need, they risked what they did have and did need.”

A well implemented strategy around a concentrated position immediately protects what you have and moves you towards a more desired outcome over time.

For some additional context, our planning software defaults to saying any position above 5% is concentrated. We find that a bit “over-the-top” and typically advocate that employees have “skin in the game” with their employers. For people early in careers, in growing companies, we don’t tend to get too concerned until we see that position above 20%. The more obligations you have, the lower that number is likely to be.

It’s important to remember that your employment is already tied to your company. If you’re also holding a concentrated equity position in the same company, you’re facing “double jeopardy” if and when the company experiences headwinds. Nothing like being concerned for your job while also watching your paper value get torched.

HOW DOES PROSPERO WEALTH HELP ME DEAL WITH A CONCENTRATED POSITION?

At Prospero Wealth, we serve tech professionals at many of the leading tech companies and startups, so we see a lot of concentrated positions. As mentioned, the hard behavioral challenge at play here is that most of these clients have experienced extraordinary success precisely by doing nothing.

It's important to note that no matter how high-flying your company might be, there's always an opportunity for it to experience a "Crowdstrike moment."

Leading companies don't stay leaders forever and it's hard to pinpoint the exact right time to exit. Large market losses eventually accrue to people who do nothing with a large position (typically in an attempt to defer taxation). 50 years ago, IBM, Exxon, GM, and AT&T were in the top 10 companies by market cap. Where are they now?

You do not want to be the last person at the party. Staying at a card table (even one that has favorable odds) with larger and larger amounts of money will eventually accrue to the house.

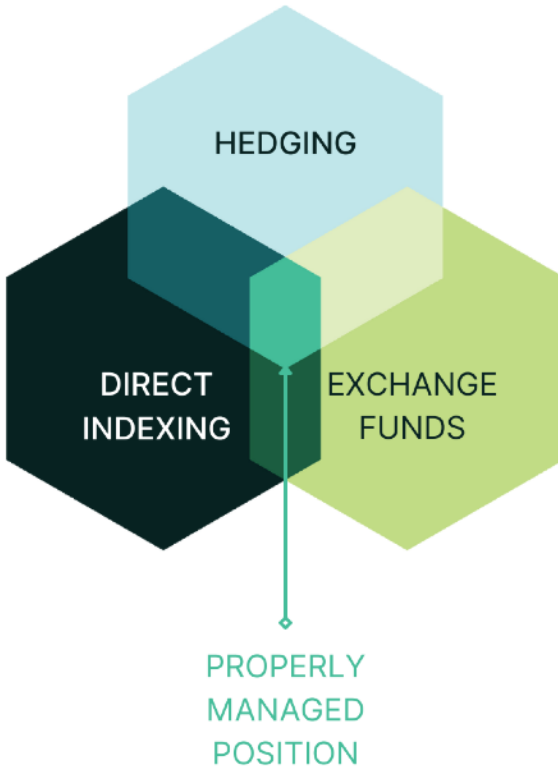
My grandfather was an amazing entrepreneur and a terrible investor. He spent his entire life building and running a successful auto parts chain in Southern California. After retirement, in a bid to cement his family legacy, he took the proceeds from the sale of that business and put most of it in a land development deal with a very successful developer. I bet you figured out where this is going.

That project went bust and my grandfather spent the rest of his life feeling guilty about not leaving things the way he wanted to leave them for his heirs. He was retired and out of moves. I never want this to happen to anyone, especially one of our clients.

Being highly concentrated can make you rich. Being appropriately diversified is what keeps you rich.

The goal of any concentrated position strategy should be to manage risk while diversifying the position as tax efficiently as possible.

We use three basic strategies (tailored to each client's unique needs and profile) to manage concentrated positions:



1. **Hedging (derivative overlays)** - immediately reduce the risk of the position without a tax bill through use of derivatives (puts, collars, and/or covered calls). Basically, we use options to provide insurance on the position while employing the additional strategies below.

2. **Direct (Custom) Indexing** - using technology, we can create a custom list of equities closely tracking a diversified benchmark while also creating some additional tax benefits through automated tax loss harvesting. These tax losses create a bank that can be used to chip away at the concentrated position or for use against other capital gains.

3. **Exchange Funds** - instantly diversify your most highly appreciated shares while tracking a benchmark like the Nasdaq 100 or the S&P 500. NOTE: Requires 7 years for full tax benefits to be portable.

CAN I "DIY" THIS WITHOUT PROSPERO WEALTH?

Our clients tend to be successful, highly educated, technology professionals, so the answer is "yes, you could probably figure out how to do some (or maybe even all) of this yourself" and save yourself asset management fees. The problem, of course, lies in the risk of getting these pieces wrong and not managing them correctly over time. **These are not "set it and forget it" types of strategies. They require frequent re-alignment and re-allocation (this is what the management part of professional money management includes). Implementation and operations here can be advanced and can easily cost you more on the performance side than the fee side.**

Where most people injure themselves implementing hedging on their own, for example, is letting their position get called away. Not fully understanding the math behind early calls means you can wake up and find large chunks of your position called, all while triggering a large tax bill—the opposite of the outcome we are seeking.

These things are specialized enough that we (Prospero Wealth) don't do this all on our own. We work with service and technology leaders in each of these strategies. We have identified what we feel are the best partners in each category, many of which are solely available to institutional investors[1].

CAN YOU HELP ME UNDERSTAND A BIT MORE ABOUT HOW THIS ACTUALLY GETS IMPLEMENTED?

Let's use a common example and assume you have a concentrated position in shares you acquired from your employer over a sustained period of time where the market price has generally gone "up and to the right." Your accumulated position will probably look a bit like a ladder.

As you can see, we will generally start to apply direct indexing on the lowest appreciated shares, using any tax losses that are harvested to offset gains from your concentrated position. Any gains we make on the hedging side can also be utilized to add your direct indexing account to chip away at your concentrated position.

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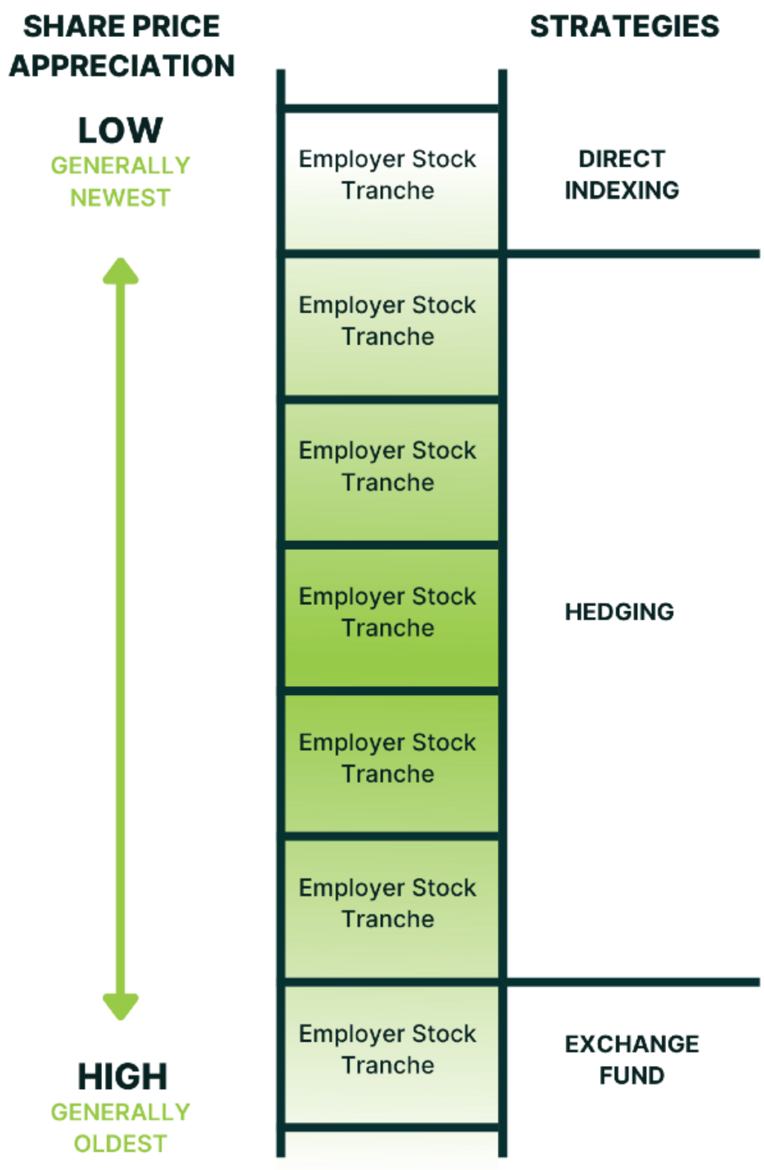
[1] The exchange funds we use are available to retail clients. The one we use most frequently, however, offers wholesale discounts to clients coming through an advisor.



For the highly appreciated shares on the other end of the ladder, the more appropriate tool is an exchange fund. On day 1 of your participation in an exchange fund, your contributed shares are exchanged for shares in the exchange fund, which will track a more diversified portfolio (e.g. the Nasdaq 100 or the S&P 500). At the end of 7 years, you can receive those diversified shares back into your brokerage account at your original cost basis. Voila. Diversification without taxation.

Everything not contributed initially into a direct indexing strategy or exchange fund, is hedged using derivatives. Typically, this is the majority of the assets at the outset.

HOW CAN I ACCESS THE VALUE OF MY POSITION WITHOUT TAKING A LARGE TAX HIT?

Most of the management we do is about reducing the risk of your large position as tax efficiently (and fee efficiently) as possible. We do, however, sometimes see a need to access the equity from a large position without taking the tax hit associated with selling it. In those cases, we work with providers of **Variable Pre-Paid Forwards.**

A Variable Pre-Paid Forward is a custom financial contract that allows a shareholder to defer the sale of stock and the associated capital gains tax. The shareholder enters into a contract to receive a payment upfront (typically 75 -90% of the contracted shares value) based on the price of the stock (without actually selling the stock). The shareholder agrees to deliver shares at a future date. The exact number of shares that will need to be delivered is variable based on the price at that time (typically dictated by a collar outlined in the contract). Since the shareholder has not sold the stock at the time of entering the contract, they defer capital gains. They may even retain upside if its value increases. The collar can also be used to protect downside risk.

HOW MUCH CAN I EXPECT TO PAY FOR THESE SERVICES?[2]

The amount you end up paying for these services is highly dependent on your specific planning needs and the proportion of the services being utilized. Broadly speaking, however, Prospero Wealth charges our standard asset management fees on the hedging and direct indexing. We charge asset advising fees on the exchange fund. Our partners in these areas charge their own fees, just as any mutual fund or ETF would.

[2] All fees are subject to change and will be assessed and communicated based on your own circumstances and current pricing available at time of offer.

SUMMARY OF CONCENTRATED POSITION STRATEGIES

	Goals					
Strategy	Reduce idiosyncratic risk	Diversification	Provide Cash Liquidity	Improve Cost Basis	Reduce Portfolio Risk	Liquid
Hedging Overlay	X			X	X	X
Exchange Fund	X	X				
Variable Pre-Paid Forward	X		X	X	X	
Direct Indexing				X		X

WHY SHOULD I WORK WITH PROSPERO WEALTH?

- The techniques outlined in this document are specialized and not something that every advisory knows how to provide.
- Prospero Wealth is not a standard advisory. Our lead advisors come from multi-decade careers as tech professionals prior to becoming advisors.
- We do this because we love it, not because we have to, and we are fully dedicated to helping tech professionals get the most out of the unique opportunities and challenges their careers represent.

HOW DO I GET STARTED?

Visit our site at prosperowealth.com and click the “Schedule a Consultation” button. In a brief introduction video chat, we can help you figure out if we can help with what you have going on.