Letting Go

StockOpter software helps clients who hold options see the need for regular exercise

Gregory Taggart

Breaking up has always been hard to do, especially when it comes to clients parting ways with their stock options. Even in a buoyant stock market and when clients are sold on the importance of diversification, establishing and executing a strategy for diversifying out of employee stock options is fraught with complications. The current stock price, the strike price of the options, the value of the client's other assets, and the client's tenure with the company—past and future—all must be taken into consideration before a decision to diversify can be made. Today many employees—executives and rank and file alike—are confronted with making these tough decisions, particularly those employees who hold options issued during the early to mid-1990s that are set to expire in the next couple of years. "It's very easy to become overconcentrated in an employer's stock and vulnerable to price movements in that stock," explains David Stein, chief investment officer at Parametric Portfolio Associates, an investment firm in Seattle. "The question is how do you decide when to sell and when to hold? And the answer is very complicated."

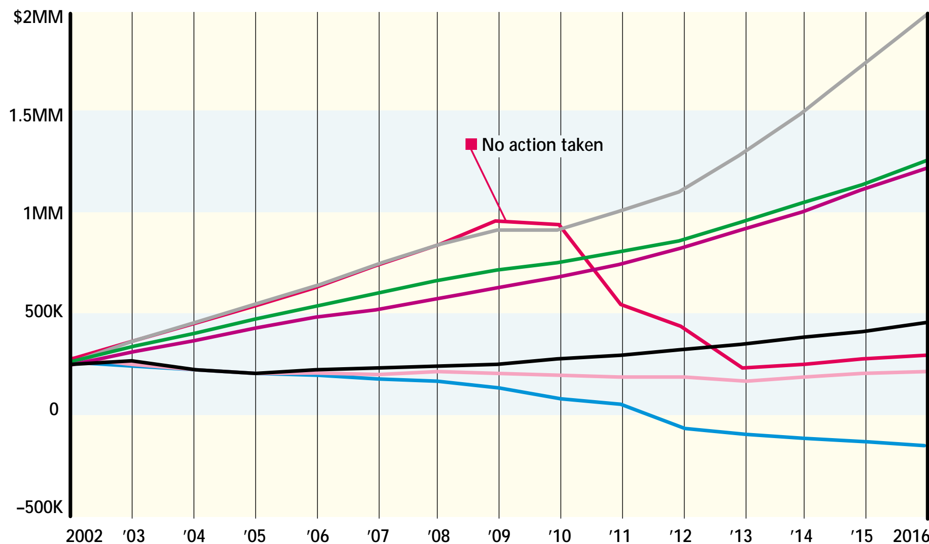
Compounding the problem, few financial advisers have the tools and knowledge to give informed advice on how best to diversify stock-option holdings. Bill Briggs, president of Net Worth Strategies, a financial-software development and training firm in Bend, Ore., puts the number at fewer than 1,000, including certified public accountants. And that figure appears especially small when one considers that, according to Stein, millions of employees with millions of dollars of unexercised options are in need of help. Of those, approximately 300,000 are highly compensated executives with multimillion-dollar stakes in their options, estimates Briggs. "The industry is not serving them well," Stein says. "We're not equipped to serve them. And truth is I don't know anybody who is."

The first challenge for an adviser is to effectively communicate to options holders the importance of having an exercise strategy in place. "That's an uphill battle because the guy probably believes in his company and wants to hold on to the shares," Stein says. Options holders need to understand the possible downside, he adds. "Too many people who received options in Internet companies thought they were going to become wealthy but didn't realize what the risks were."

Briggs, for one, thinks his firm has the tool to make those risks clear and to help you determine the best exercise strategy for a given client. His firm markets StockOpter, an Excel-based software program that allows advisers to quickly illustrate a multitude of option-exercise scenarios by simply changing one or more variables. The program takes into account how many options the client holds, when they vest and expire, and whether they're incentive stock options (ISOs) or nonqualified stock options (NQSOs) or restricted-stock grants. It then figures the tax and cash-flow consequences of each exercise strategy. The program compares the results in an easy-to-read line graph, so the client can see which road is paved with gold and which is strewn with land mines. One user, Ella Kaplan, a financial adviser with Strategies for Wealth

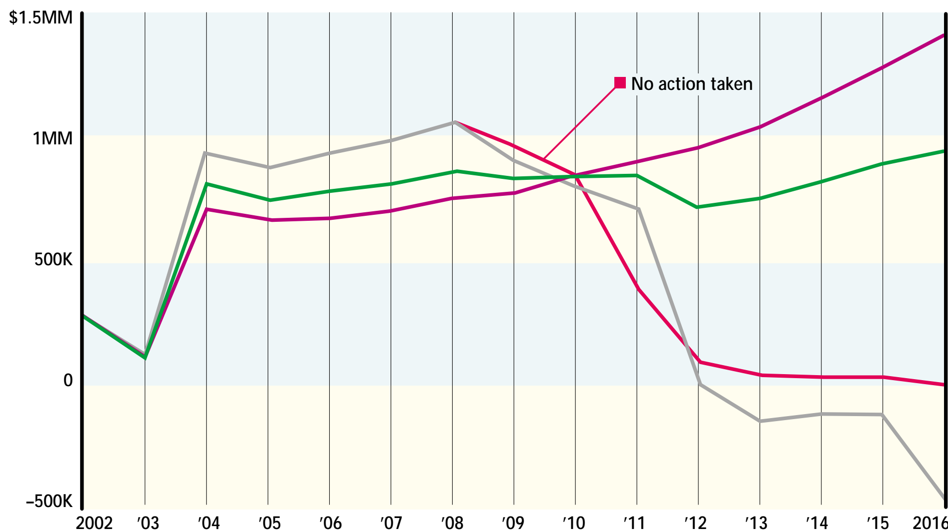
Illustrations by Calvin Rambler

EXERCISING FOR FINANCIAL FITNESS



StockOpter can show the projected outcome of given option-exercise strategies under differing market conditions. The chart above shows the results of three strategies each under two sets of market conditions for a client who holds four grants of nonqualified stock options totaling 12,640 Philip Morris shares. Exercise prices range from $21.34 to $49.04 and issue dates are between June 29, 1999, and June 30, 2002. The client also holds 880 shares from a restricted-stock grant that is now unrestricted. The scenarios are as follows:

- Exercise as late as possible with 10% annual growth
- 15% annual diversification with 10% annual growth
- 30% annual diversification with 10% annual growth
- Exercise as late as possible with –5% annual growth
- 15% annual diversification with –5% annual growth
- 30% annual diversification with –5% annual growth



The bottom chart shows projected outcomes for the same client as in the example above but instead of using a fixed growth rate, it uses the pattern of returns of US Airways stock from 1981 to 1995—a period of turbulence and ultimately dismal performance. The strategies are as follows:

- Exercise as late as possible
- 15% annual diversification
- 30% annual diversification

SOURCE: StockOpter

Creation & Protection in New York, loves the robust program. "It addresses all the issues, including a lot of the tax issues that are hard to work around with ISOs."

For example, Kaplan used the software to help a client who at year-end 2001 had four different grants of NQSOs in Philip Morris totaling 12,640 shares with exercise prices varying from $21.34 to $49.04 and issue dates ranging from June 29, 1999, to June 30, 2002. All but 2,780 options are vested. But the client also holds 880 shares from a restricted-stock grant that is now unrestricted. At the end of December 2001, the stock was trading at $43.85. Assuming 10 percent annual appreciation, the stock will be trading for just over $100 when the client's first option grant is set to expire. Under these conditions, conventional wisdom says the client should exercise each grant "as late as possible," or just before it expires. And conventional wisdom would be right—if a steady 10 percent appreciation were a certainty. But that's the problem: as the recent market turmoil demonstrates, even a great stock won't appreciate steadily. So Kaplan used the software to show her client the potential outcomes of three strategies—exercising the options as late as possible, exercising 15 percent of the options annually and diversifying, and exercising 30 percent of the options annually and diversifying. She determined the client's total

portfolio value for each strategy with the stock appreciating 10 percent annually and with the stock losing 5 percent of its value each year. (See "Exercising for Financial Fitness," top chart, opposite page.) "I showed my client that the more we diversified out, the greater the downside risk he gave up, and the less of the upside he sacrificed," says Kaplan.

Worried that your clients might still be unconvinced? To help them grasp the risk of holding stock options too long, you can also input some real-world performance numbers into the analysis. For example, what if Kaplan calculated the outcomes of the same scenarios for her client but substituted the steady annual growth with the actual performance of, say, US Airways from 1981 to 1995, when the airline had erratic returns? Under that assumption, the client can see that by waiting until the last possible moment to exercise his options, they'll be so far underwater, he'll need a submarine to check their value. (See "Exercising for Financial Fitness," bottom chart, opposite page.) But if he diversifies 15 to 30 percent of his vested grants each year, the value of his diversified portfolio grows from $258,131 to as much as $1,402,821 even as his stock bores into the ground. "He gives up a lot of potential loss on the downside, and he'll probably sleep a lot better," Kaplan continues. StockOpter incorporates charts on a number of other stocks—Apple Computer, Halliburton Co., Xerox Corp., and everybody's favorite, Enron Corp.—as well as various indexes, that you can run for clients to show the dangers of overconcentration.

Exercising options as late as possible generally

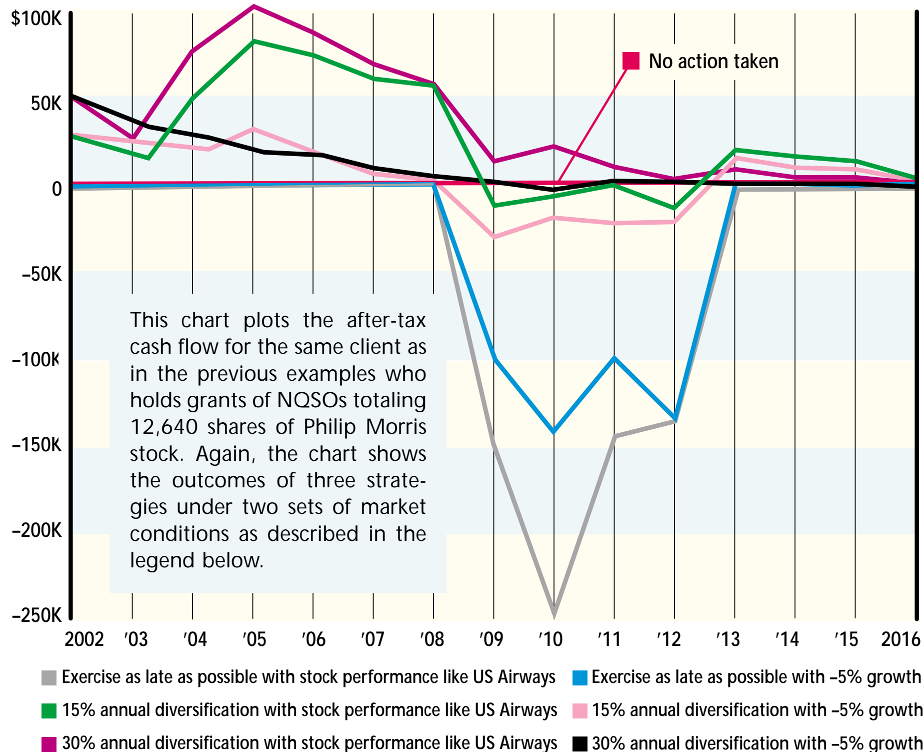
is best only if the stock's price and the market are rising steadily

According to Kaplan, the StockOpter's Total Portfolio Value line graph is all her firm needs to convince its clients that they must at least consider diversification. Based on assumptions the client and adviser develop together, each line illustrates what is often hard for option holders to understand: diversification takes most, if not all, of the risk out of holding unexercised options, and exercising as late as possible generally is best only if the stock's price and the market rise steadily. "Everything else being constant, I'd say you want to let the option to run some more," Stein says. "But everything else is never constant."

StockOpter can also be used to determine the best set strategy for a client who wants to take advantage of Securities and Exchange Commission Rule 10b5-1 for insiders, says David Williams, an options planner with Morgan Keegan in Memphis. Under that rule, as long as the executive adopts a diversification plan prior to having material inside information and the plan specifies a formula that determines the number of shares, price, and date of sale, he can diversify out of his options regularly without worrying about blackout periods—the period of time immediately before and after the release of material information when insiders are prohibited from selling their shares. (For more on 10b5-1 plans, see "Options for Insiders," June 2001.) For example, a client could set up a 10b5-1 plan to exercise 25 percent of his vested options every quarter "or something like that," Williams says. "The transaction is on autopilot. The insider is not acting on inside information."

As Kaplan mentioned, you can also use StockOpter to help clients with the complicated tax issues involved in exercising ISOs. For example, holders of ISOs pay no ordinary income tax on the date of the grant or on the day they exercise their options; they pay tax only at the time the shares are sold. However, once they exercise, if they hold the underlying stock for at least a year and a day and at least two years from the date of grant, they get favorable capital-gains treatment on the sale of the stock. But because they

PAIN WITHOUT GAIN?



SOURCE: StockOpter

have to wait to sell the stock, they must come up with the exercise price out of another pocket. "And the issue is whether the client wants to deploy his other assets that way," Williams says. "Can he even afford the negative cash flow?" StockOpter helps sort out these questions.

StockOpter also helps untangle the alternative-minimum-tax (AMT) complications that can arise because the Internal Revenue Service treats the bargain element—that is, the difference between the strike price and the exercise price—as a tax preference item. At the end of the year, if your client's alternative minimum tax is greater than her regular tax, she pays the higher amount. Now there's an opportunity and a risk here. The opportunity is that if, near the end of your client's tax year, there is a significant gap between her potential income-tax and the alternative minimum-tax liabilities, she can exercise many or most of her incentive stock options without fear of triggering the alternative minimum tax. StockOpter keeps track of that gap based on your client's tax assumptions. Armed with that information, one way clients can avoid triggering AMT "is to exercise and sell NQSOs to boost their ordinary income and give them a bigger gap between regular income tax and AMT," says Briggs. "Then they can exercise and hold more ISOs, recognizing, of course, that they need to manage their cash flow."

Oh yes, the cash flow. Virtually all the horror stories you heard about employees exercising their stock options and losing their shirts were the result of people exercising their ISOs and holding the stock, thinking mistakenly that the deal was tax-free. Often they would take out a margin loan or a mortgage loan to pay the exercise price. Then the end of the year rolled around, and they found themselves staring at a $250,000 tax bill because the ISO exercise resulted in AMT. "In the meantime, the company's stock had dropped from $100 to $20 and the margin loan was being called," Briggs says. "About the only thing you can do at that time is to bargain with the IRS." Briggs tells this story because StockOpter also helps advisers and clients manage their option cash flow.

Still, taxes are only one element to consider in options planning. As Neile Wolfe, senior vice president of investments at Prudential Securities in Austin, Tex., says, "I would have no problem doing a disqualifying disposition [that is, selling ISOs before the end of the required holding period, and therefore triggering ordinary income tax] on an incentive stock option if the stock had run up tremendously and economically it looked like a wise decision. If executing a disqualifying disposition is a good economic decision, then the tax consequences are what the tax consequences are." (For a look at how taxes can affect an options strategy, see "Pain Without Gain?" chart above.)

In short, typically, diversifying out of employer stock options is a good economic decision. Tax-efficient diversification can be an even better decision. But to help clients make the decision, the well-advised adviser needs to bone up on options and arm himself with the proper tools. "Then imagine you're a doctor," Stein says, "and your client is smoking like a chimney. It's your job to advise him to straighten up, right? I look at financial advisers and say, 'That's your job too.' "

Gregory Taggart, a lawyer who has worked in insurance and financial planning, teaches writing at Brigham Young University.

INVESTOR'S CAPITAL MANAGEMENT CAN ANALYZE YOUR OPTIONS WITH STOCKOPTER.