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Concentrated Stock

A Strategy Sheet

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Concentrated Stock Positions

The ownership of large, significant stock positions tends to create singular opportunities and risks. These positions are often the hallmark of a successful corporate career, or shrewd investment decisions. Sometimes, the positions are inherited. The constant challenge, and concern, is diversifying the risk of having all, or most of, one's eggs in one basket. As the old saw goes, wealth tends to be created by concentrated positions, and preserved by diversification. The primary consideration in these situations is preserving the wealth that the position represents, while protecting the stock from a variety of risks, including the vagaries of the financial markets, the volatility of the underlying business represented by the stock and even evolving economic cycles that could impact the stock's trajectory.

Process & Outcome:

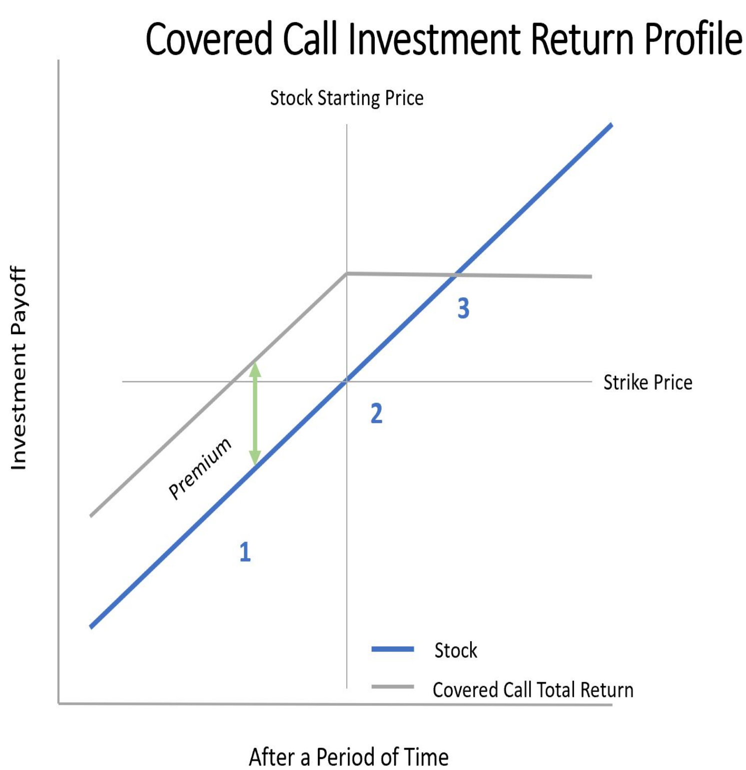
The traditional approach to concentrated stock tends to waver between doing nothing or selling chunks of the stock on some predetermined schedule. But another approach exists that can help investors get paid by the options market just for agreeing to do something that they want to do anyway - sell stock at higher prices. After determining an investor's goals, a covered-call selling program can be crafted that is designed to generate incremental income that can enhance returns.

Process and Outcome *continuation*:

The goal of the covered-call strategy is ensuring that investors are always making decisions for themselves, rather than leaving that to the stock market.

If a stock is at $50, for example, an investor could opt to sell a call option with a strike price of $60 that expires in three months. In return, the investor would collect an options premium of say $2 per share, creating a potential effective sale price of $62. If the stock price remained below the call strike price of $60, the investor would keep the options premium. Should the stock price exceed the strike price at expiration, the investor could allow the stock to be sold at $60, or perhaps buy the call back and "roll" to a higher strike price in a more distant month.

The sale of an option against a stock generates what we call a "conditional dividend" payment. What is the condition of the dividend? The investor must be willing to sell the stock at the predetermined sales price. In return for making that decision, the investor collects the amount of money that was received for selling the call. The strategy can create taxable events and it is important to consult a tax advisor.



Scenario Analysis

Changes in the stock price are represented by the blue line, which can be compared to the total return of a Covered Call Strategy.

In these scenarios, the stock begins at the same level as the option's strike price.

Scenario 1: Stock price declines, loss is less severe than the stock by the amount of the premium.

Scenario 2: Stock price remains unchanged, total return is the amount of the premium.

Scenario 3: Stock price goes up; total return will outperform the stock, but only up to the strike price plus the premium.

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