By **Thomas Boczar** & **Elizabeth Ostrander**

Stock Protection Trusts

Use an SPT to manage concentration risk

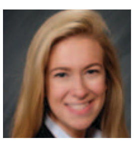
Thanks to the active support of the Federal Reserve and other global central banks, the stock market has performed impressively over the past half a decade. As a result, many investors and trusts currently own positions in publicly traded stocks that have increased dramatically in value.

However, the market is currently facing a number of serious stressors, including mounting geopolitical tension around the globe, plunging oil and commodity prices, listless economies in Europe and China and, in the United States, the threat of higher interest rates.

Unfortunately, investors can easily materially underestimate the danger of holding a single stock for a long time. "Rock Bottom" (p. 27), depicts the 50 worst performing S&P 500 stocks over the past 10 years; each of these household names experienced a catastrophic loss ranging from 78 percent to 100 percent.

Under the prudent investor rule, fiduciaries have an affirmative duty to mitigate undue stock concentration risk.[1] In addition, the current state of the law will, in many instances, require fiduciaries (and financial advisors who hold themselves out as experts) to fully understand and be able to implement single-stock risk mitigation strategies that are available in the marketplace.[2] This duty will likely require that fiduciaries consider risk reduction strategies as a possible alternative to either an outright sale or continued holding of the concentrated position.[3]

Single-stock concentration risk can be substantially mitigated through a stock protection trust (SPT). An SPT is a non-traditional equity risk management methodology that's rooted in both modern portfolio theory (MPT) and insurance. An SPT is a relatively low-cost and tax-efficient single-stock risk management solution that's simple to use, easy to understand, completely transparent and doesn't require exposure to dealer counterparty credit risk. The cost-effectiveness of an SPT empowers investors to implement a long-term, strategic approach to managing the specific company risk associated with their concentrated stock positions, while retaining full upside potential and all dividends and any other distributions paid on the stock.

Thomas Boczar is CEO, and **Elizabeth Ostrander** is a managing director, both at Intelligent Edge Advisors in New York City

Risky Business

A recent study makes the sobering observation that, since 1980, 320 stocks have been deleted from the S&P 500 for reasons of "business distress," and since 1980, 40 percent of Russell 3000 stocks have suffered a permanent decline of 70 percent or more from their peak value. The study concludes:

> No matter how well you know your industry and your company, no one is impervious to event risk and industry changes. The factors outside of management control are a formidable list, and have grown in complexity since we first drafted this report 10 years ago. This is perhaps the most important epiphany we gained from the study; that exogenous forces may overwhelm the things we can control.[4]

Yet, despite accruing huge gains in recent years, many investors remain reluctant to sell their concentrated positions for a plethora of reasons. Some believe in the continued upside potential of their particular stock. Others feel a powerful emotional attachment to it. Still others face restrictions on selling their shares

Rock Bottom

The 50 worst performing S&P 500 stocks from 2004 to 2014

	Company Name	% Decline	Time Period		Company Name	% Decline	Time Period
1.	Circuit City Stores Inc.	-100	2005-2010	26.	Sovereign Bancorp Inc.	-88	2004-2009
2.	Lehman Brothers Holdings Inc.	-100	2005-2010	27.	Countrywide Financial Corp.	-88	2006-2011
3.	Washington Mutual Inc.	-100	2005-2010	28.	SuperValu Inc.	-87	2007-2012
4.	Ambac Financial Group Inc.	-100	2005-2010	29.	Wachovia Corp.	-87	2005-2010
5.	Visteon Corp.	-100	2004-2009	30.	Sprint Nextel Corp.	-87	2006-2011
6.	Delphi Corp.	-100	2004-2009	31.	Liz Claiborne Inc.	-86	2004-2009
7.	Freddie Mac	-99	2005-2010	32.	Merrill Lynch & Co Inc.	-84	2006-2011
8.	Fannie Mae	-99	2005-2010	33.	Synovus Financial Corp.	-83	2004-2009
9.	General Motors	-99	2004-2009	34.	Monster Worldwide Inc.	-83	2006-2011
10.	RadioShack Corp.	-98	2009-2014	35.	Centex Corp.	-83	2005-2010
11.	American International Group	-97	2004-2009	36.	Cliffs Natural Resources Inc.	-82	2009-2014
12.	Eastman Kodak Co.	-97	2007-2012	37.	Marshall & Ilsley Corp.	-82	2004-2009
13.	E*Trade Financial Corp.	-96	2006-2011	38.	KB Home	-82	2006-2011
14.	MEMC Electronic Materials	-96	2007-2012	39.	Peabody Energy Corp.	-82	2009-2014
15.	Office Depot Inc.	-94	2006-2011	40.	Regions Financial Corp.	-81	2006-2011
16.	National City Corp.	-94	2004-2009	41.	Huntington Bancshares	-81	2004-2009
17.	Bear Stearns Companies Inc.	-93	2006-2011	42.	Sears Holdings Corp.	-81	2006-2011
18.	MBIA Inc.	-93	2004-2009	43.	Bank of America Corp.	-81	2006-2011
19.	MGIC Investment Corp.	-93	2006-2011	44.	PulteGroup Inc.	-80	2005-2010
20.	Dynegy Inc.	-92	2006-2011	45.	KeyCorp	-80	2004-2009
21.	Caesars Entertainment Corp.	-92	2007-2012	46.	Terex Corp.	-79	2006-2011
22.	Citigroup Inc.	-92	2004-2009	47.	Zions Bancorporation	-79	2004-2009
23.	Clear Channel	-90	2007-2012	48.	Genworth Financial Inc.	-79	2006-2011
24.	Santander Holdings USA Inc.	-89	2006-2011	49.	United States Steel Corp.	-78	2007-2012
25.	OfficeMax Inc.	-89	2006-2011	50.	Sanmina-SCI Corp.	-78	2004-2009

— *Standard & Poor's Total Shareholder Return Data*

imposed by regulatory/securities law, contractual provisions (that is, post-initial public offering lock-up or merger agreement) or company policy. In addition, with the federal capital gains tax rate having increased almost 60 percent from its recent low and many states increasing their tax rates as well, most investors and advisors suffer "sticker shock" when they take into account the all-in tax expense of disposing of an appreciated stock position.

Outright Sale Considerations

For tax purposes, a capital gain is the increase in the value of an investment asset (that is, shares of publicly traded stock) above its tax cost basis. The tax cost basis is the amount that was paid to acquire the stock (which will be adjusted on the occurrence of certain events), and it serves as the foundation for calculating the capital gain (or loss), which is the selling price less the tax cost basis.

Concentrated single-stock positions were often acquired years ago and, typically, have a tax cost basis that's very different from its current market value. If the shares have risen significantly in value since their acquisition, the tax cost basis may be well below the current market value of the shares, resulting in a potentially significant embedded tax liability if the shares were sold outright today.

Given the recent changes to our Tax Code, owners of concentrated stock positions often don't realize the magnitude of the tax bill they would face should the position be sold outright.

The capital gains tax rate depends on how long

The harsh reality is that owners of concentrated stock positions are currently subject to a significant combined federal and state tax on their realized LTCGs.

the shares have been held; shares held for longer than one year qualify for long-term capital gain (LTCG) treatment. Currently, LTCGs resulting from the sale of stock are taxed at a federal rate of 20 percent and are generally subject to the 3.8 percent federal Medicare surtax. That's an increase in the federal rate of almost 60 percent from the previous 15 percent rate. In addition, according to The Tax Foundation, 41 of 50 states impose a state-level tax on capital gains. The average rate is 5.1 percent, but it can range as high as 13.3 percent.

Therefore, the average combined tax rate on the sale of shares is currently about 29 percent (that is, 20 percent federal rate plus 3.8 percent Medicare surtax plus average 5.1 percent state tax).

The highest combined tax rate on the sale of shares is over 37 percent and falls on California residents (that is, 20 percent federal rate plus 3.8 percent Medicare surtax plus 13.3 percent California tax).

The lowest tax rate on the sale of shares is 23.8 percent and falls on residents in the nine states that don't tax LTCGs (that is, 20 percent federal rate plus 3.8 percent Medicare surtax).

The harsh reality is that owners of concentrated stock positions are currently subject to a significant combined federal and state tax on their realized LTCGs. Given that many individuals and families have accumulated the wealth represented by their concentrated stock positions through many years of hard work and calculated business and investment risks, the fact that an outright sale of those shares would result in an immediate tax expense of this size is sometimes not psychologically palatable.

Furthermore, in certain situations, the original tax cost basis of an investor's stock positions will be adjusted in their favor on the occurrence of certain events. In many situations, the shares received by the investor's estate or a beneficiary will receive an adjusted tax cost basis equal to the fair market value (FMV) (that is, market price) of the shares on the investor's date of death. This step-up in tax cost basis to FMV gives investors both an opportunity and incentive to permanently avoid the capital gains tax on their unrealized gains.

Indeed, investors are increasingly evaluating whether it might make sense to continue owning their shares until death, thereby not only deferring, but completely eliminating, the capital gains tax via the step-up. With the estate tax exemption of $5.43 million per individual in 2015, married couples get the benefit of two individual exemptions, so in 2015, the total exemption per couple is nearly $11 million. Investors are correct in asking, "Does it make sense to sell now and pay a substantial capital gains tax if I can wait until death and avoid paying both the capital gains tax and the estate tax?"

Three Goals

In any event, for whatever reason an investor decides to continue holding his highly appreciated stock position, ideally, the investor would like to achieve three goals:

1. Protect unrealized gains by mitigating downside price risk,
2. Avoid triggering a taxable event and other adverse tax outcomes, and
3. Retain all appreciation in value and all dividend income and other distributions.

However, finding a long-term equity risk

management solution that fulfills these objectives in a cost-effective and tax-efficient manner has proven elusive for investors.

Traditional Approaches

The availability of liquid public capital markets makes it possible for investors who hold highly appreciated positions in publicly traded stock to use equity-based derivatives to help manage the risk of their positions. For decades, investors have used (and continue to use) equity derivatives (for example, puts and collars) to manage single-stock risk. Investors can use puts and collars to implement both strategic and tactical hedging programs.

Buying put options. Strategic hedging involves having the single-stock position continuously hedged and entails regularly buying put options to protect it. However, put options can be quite expensive, and very few investors employ this strategy long-term; most conclude it isn't cost-effective.

Tactical hedging, on the other hand, involves opportunistically purchasing put options to hedge the single-stock position when it's perceived that the stock price is in danger of dropping precipitously. Tactical hedging with put options can be cost-effective, but only if the investor is able to properly time his entry (buying puts) and exit (selling puts) of the hedge; it's not at all surprising that, in practice, many investment professionals find this extremely difficult to accomplish.

Equity collars. Having concluded that the cost drag of regularly purchasing put options to protect a single-stock position over a longer term period of time, even in a period of upward price momentum, can be too expensive and that the tactical use of put options is very difficult to properly time, what's an investor to do?

To lessen the upfront cost of purchasing puts, some investors consider selling call options (with a strike price above the market price of the stock) to partially or fully finance the purchase of the puts (with a strike price at or more typically below the market price of the stock). The combination of long puts and short calls to hedge a single stock position is commonly known as an "equity collar."

Unfortunately, as is the case with puts, most investors who evaluate long-term, strategic hedging with collars conclude that collars can be very costly (involving the forfeiture of a portion of the upside potential associated with regularly selling call options over a long-term period of time), and most investors who consider tactical hedging with collars conclude that, in practice, timing the entry and exit of the collar is much easier said than done.

Other traditional single stock protection strategies. A prepaid variable forward (PVF) can be used to hedge (and also monetize if that's desired) an appreciated stock position; however, an investor using a PVF faces the same challenges as described above for collars.

An exchange fund could be used, but an exchange fund isn't a hedge; rather, it's a tax-deferred exchange of a single stock for an interest in a fund (20 percent leveraged with debt) comprised of a diversified portfolio of stocks (contributed by investors who wish to dispose of their stocks) and commercial real estate. Therefore, this approach appeals to investors who wish to eliminate their single-stock exposure.

A stock protection trust can best be conceptualized as the inverse of an exchange fund.

Challenges With Traditional Approaches

Traditional approaches are not only expensive, but also, investors find it difficult to make regular and consistent use of the traditional tools and strategies due to a number of other factors.

Using equity derivatives to manage single-stock risk is inherently tax-inefficient in that, generally, gains are taxed as short-term capital gains, losses aren't currently deductible and any dividends received while a stock is hedged are taxed as ordinary income instead of LTCGs.[5]

The shares being hedged must be pledged to, and held in custody with, the derivative dealer, and, therefore, the owner can't sell the shares until the hedge matures or is otherwise terminated. The investor is exposed to the credit risk of the dealer counterparty.

Derivatives are complex financial instruments with many moving parts and can sometimes be difficult to understand, even for professional investors and advisors.

The pricing of over-the-counter derivatives (as opposed to exchange-traded derivatives), which are often used by investors to enhance tax efficiency and achieve greater customization, is inherently not a fully transparent process.

A Non-Traditional Approach

The convergence of asset management, risk pooling and insurance is catalyzing the creation of non-traditional solutions to financial challenges that have long perplexed financial advisors and investors, including single-stock concentration risk management.

Along these lines, a non-traditional approach has been developed that allows investors to mitigate their specific company risk over a longer time period (that is, five years or more) and in a more cost-effective and tax-efficient manner than the traditional tools. Investors can continue to own their single-stock positions to benefit from continued price appreciation and dividend growth yet, at the same time, obtain the benefit of diversification and reduction of downside risk similar to that achieved through a mutual fund or exchange-traded fund.

SPT

This technique can, perhaps, best be conceptualized as the inverse of an exchange fund; that is, investors who use this technique want to continue to own (and not dispose of) their stock positions. Participating investors, who each own a different stock in a different industry, contribute a modest amount of cash or "premium" into an SPT (for example, a Delaware statutory trust) that's conservatively invested and used to reimburse the participants in the event of a large decrease in the value of their stock after a period of years.

The SPT methodology is rooted in the principles of MPT, risk pooling and insurance, and enables investors to diversify or mutualize—and therefore substantially reduce—a stock's downside risk, while retaining its full upside potential and all dividend income.[6]

MPT informs us that, with respect to portfolio construction, as securities are added to the portfolio, the average covariance of the portfolio declines. An important question is: How many securities must be included to arrive at a completely diversified portfolio? Much research has been done to answer this question.[7]

To achieve diversification, about 20 equal-sized and well-diversified stocks are necessary, and further increases in the number of holdings don't produce any significant additional risk reduction.[8]

Over time there will be a substantial dispersion in individual stock performance. Some stocks in the portfolio will outperform achieving large gains, most will perform in line with the market and some will underperform, losing substantial value. After a period of years, the dispersion of the total return of a diversified 20-stock portfolio will have some resemblance to a normal curve, with the big winners reflected on the right tail, the in-line performers in the middle of the curve and the big losers on the left tail. An SPT combines these key elements of MPT with the concept of a risk sharing pool to truncate left tail risk.

"The Mechanics," p. 31, depicts the mechanics and economics of how SPTs work. In this example, 20 investors, each owning a different stock in a different industry, contribute cash (not their shares) equal to 10 percent of protected value into an SPT, which will terminate in five years. The cash is invested in U.S. government and high-grade corporate bonds that mature on the date the SPT terminates. On termination, the cash is distributed to those investors whose stock lost value on a total return basis. Losses are paid until the cash is depleted. If, as in our example, the cash exceeds the total of all losses, all losses will have been eliminated, and the excess cash is returned equally to the investors. If the total of all stock losses exceeds the cash, large losses are dramatically or substantially reduced.

More specifically, on termination of the SPT, the largest loss incurred among the group of 20 investors' individual stocks is first identified. Using funds in the cash pool, this loss is reduced (that is, reimbursed) to the level of the second largest loss incurred among the other 19 stocks. Next, these two losses are reduced to the level of the third largest loss among the other 18 stocks, and so on. This process continues until either all losses have been reimbursed or the cash pool has been depleted. The largest remaining loss at this point defines the "maximum stock loss" for all investors incurring losses (stated as a percentage of the amount of protected value).

To illustrate, if the maximum stock loss was 15 percent, an investor whose stock lost 80 percent of its value would receive reimbursement from the cash pool reducing his loss from 80 percent to 15 percent. If the maximum stock loss were 0 percent, the investor's stock loss of 80 percent would be fully

reimbursed by the cash pool. In our example, the maximum stock loss is zero.

Backtesting of Methodology

"Backtesting of 5-Year SPTs," p. 32, depicts the results of extensive historical backtesting of the SPT methodology. The assumptions used were:

- Twenty S&P 500 stocks are associated with each SPT;
- The stocks are randomly selected;
- Each of the 20 stocks is in a different industry;
- The amount of protected stock value is the same for each investor;
- The SPT's term is five years;
- An up-front cash contribution equal to 10 percent (2 percent per annum) of protected value is made;
- The period tested is 1972 to 2014;
- Based on 7.6 million data points: 380,000 random computer simulations using 1972 to 2014 S&P 500 database; and
- Ten thousand simulations per 5-year period and 20 stocks per simulation.

For stocks held during a 5-year period, the use of an SPT reduced the average stock loss from 35 percent to 6 percent, more than an 80 percent reduction in downside risk. The risk of a catastrophic stock loss greater than 60 percent was virtually eliminated, from a

The **Mechanics**

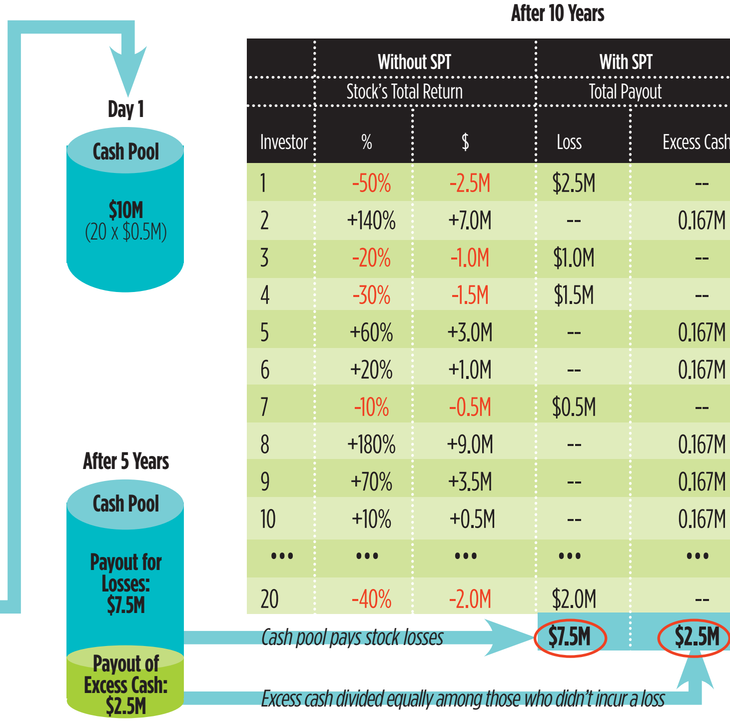
How SPTs work

A one-time cash contribution of $0.5 million from 20 investors, each protecting a $5 million stock position for 5 years, results in a maximum stock loss of 0% (that is, all losses are fully reimbursed by the cash pool).

Initially (Day 1)

20 Investors With 20 Different Stocks		
Investor	Stock Protected	10% Cash Contribution
1	$5M	$0.5M
2	$5M	$0.5M
3	$5M	$0.5M
4	$5M	$0.5M
5	$5M	$0.5M
6	$5M	$0.5M
7	$5M	$0.5M
8	$5M	$0.5M
9	$5M	$0.5M
10	$5M	$0.5M
•••	•••	•••
20	$5M	$0.5M
TOTAL	$100M	$10M

Note: Assumes the annual cost of operating the stock protection trust (SPT) is fully covered (that is, paid) by the interest income generated by the cash pool



After 10 Years

	Without SPT		With SPT		
	Stock's Total Return		Total Payout		
Investor	%	$	Loss	Excess Cash	Total Payout + Stock Value
1	-50%	-2.5M	$2.5M	--	$5M
2	+140%	+7.0M	--	0.167M	$12.167M
3	-20%	-1.0M	$1.0M	--	$5M
4	-30%	-1.5M	$1.5M	--	$5M
5	+60%	+3.0M	--	0.167M	$8.167M
6	+20%	+1.0M	--	0.167M	$6.167M
7	-10%	-0.5M	$0.5M	--	$5M
8	+180%	+9.0M	--	0.167M	$14.167M
9	+70%	+3.5M	--	0.167M	$8.667M
10	+10%	+0.5M	--	0.167M	$5.667M
•••	•••	•••	•••	•••	•••
20	-40%	-2.0M	$2.0M	--	$5M
			$7.5M	$2.5M	

—Intelligent Edge Advisors, LLC

Backtesting of 5-Year SPTs

The use of stock protection trusts reduced the average stock loss by more than 80 percent

	Percentage of Investors Losing 60% or More		Percentage of Investors Losing 30% or More		Average Size of Investor's Loss (%)	
5-Yr Period	**Without SPT**	**With SPT***	**Without SPT**	**With SPT***	**Without SPT**	**With SPT***
1972 - 1977	5.8	0	21.5	1.0	-36	-11
1973 - 1978	2.4	0	7.4	0.0	-28	-1
1974 - 1979	0.2	0	1.1	0	-19	0
1975 - 1980	0.2	0	3.3	0	-22	0
1976 - 1981	2.1	0	6.8	0.0	-27	-1
1977 - 1982	1.0	0	2.6	0.0	-29	0
1978 - 1983	0.4	0	1.7	0	-26	0
1979 - 1984	1.7	0	5.3	0.0	-32	0
1980 - 1985	3.3	0	8.2	0.1	-35	-2
1981 - 1986	3.9	0	7.9	0.2	-40	-2
1982 - 1987	3.3	0	6.7	0.0	-35	-2
1983 - 1988	3.8	0	8.2	0.2	-36	-3
1984 - 1989	3.7	0	7.6	0.1	-42	-2
1985 - 1990	6.7	0	13.9	1.2	-42	-9
1986 - 1991	5.0	0.0	10.5	0.3	-37	-4
1987 - 1992	4.7	0	9.7	0.2	-40	-3
1988 - 1993	4.3	0	8.0	0.1	-40	-2
1989 - 1994	4.1	0	8.9	0.2	-32	-3
1990 - 1995	1.3	0	5.3	0.0	-30	0
1991 - 1996	2.1	0	6.5	0.0	-33	-1
1992 - 1997	1.9	0	4.6	0.0	-32	-1
1993 - 1998	1.7	0	6.8	0.0	-34	-1
1994 - 1999	2.4	0	7.6	0.0	-37	-2
1995 - 2000	6.9	0	13.1	1.0	-43	-7
1996 - 2001	4.9	0	13.8	0.8	-37	-7
1997 - 2002	10.1	0.0	23.5	7.0	-38	-17
1998 - 2003	8.5	0.0	17.7	3.2	-41	-12
1999 - 2004	10.8	0	20.5	4.8	-43	-15
2000 - 2005	9.2	0.0	19.3	4.2	-42	-14
2001 - 2006	5.1	0	12.1	0.3	-36	-5
2002 - 2007	1.3	0	6.2	0.0	-30	-1
2003 - 2008	16.4	0.1	33.8	21.8	-47	-27
2004 - 2009	10.6	0.0	21.1	5.8	-39	-16
2005 - 2010	8.8	0	18.6	2.8	-38	-12
2006 - 2011	5.8	0	21.7	1.0	-36	-11
2007 - 2012	9.2	0	24.7	5.6	-39	-16
2008 - 2013	0.0	0	1.7	0	-22	0
2009 - 2014	1.8	0	3.7	0.0	-37	0
Average of All 5-yr Periods	**4.6**	**0.0**	**11.1**	**1.6**	**-35**	**-6**

* 0.0 indicates a value that rounds to less than 0.1. Performance is gross of fees and expenses.

— Intelligent Edge Advisors, LLC

frequency of 4.6 percent to 0 percent. And, the risk of a loss greater than 30 percent was reduced from a frequency of 11.1 percent to just 1.6 percent, a reduction of 85 percent.

Additional backtesting was performed with all assumptions held constant, except that the term of the SPT was 10 years, and the results were virtually identical.

"Risk Transformation," this page, is a graphic depiction of the results of the backtesting both with and without the use of an SPT.

These test results validate the risk mitigation efficacy of an SPT in that both the frequency and amount of losses are greatly reduced, or stated another way, left tail risk is substantially truncated.

Performance Results

On June 1, 2006, an SPT was formed with a 10 percent cash contribution and 5-year term, protecting 20 investors who owned stock positions in 20 different industries. On June 1, 2006, the Dow Jones Industrial Average (DJIA) was 11,260 and the S&P 500 was 1,286. On June 1, 2011, at the SPT's termination date, the DJIA was 12,290 and the S&P 500 was 1,315. Therefore, an SPT was deployed throughout the entire financial crisis.

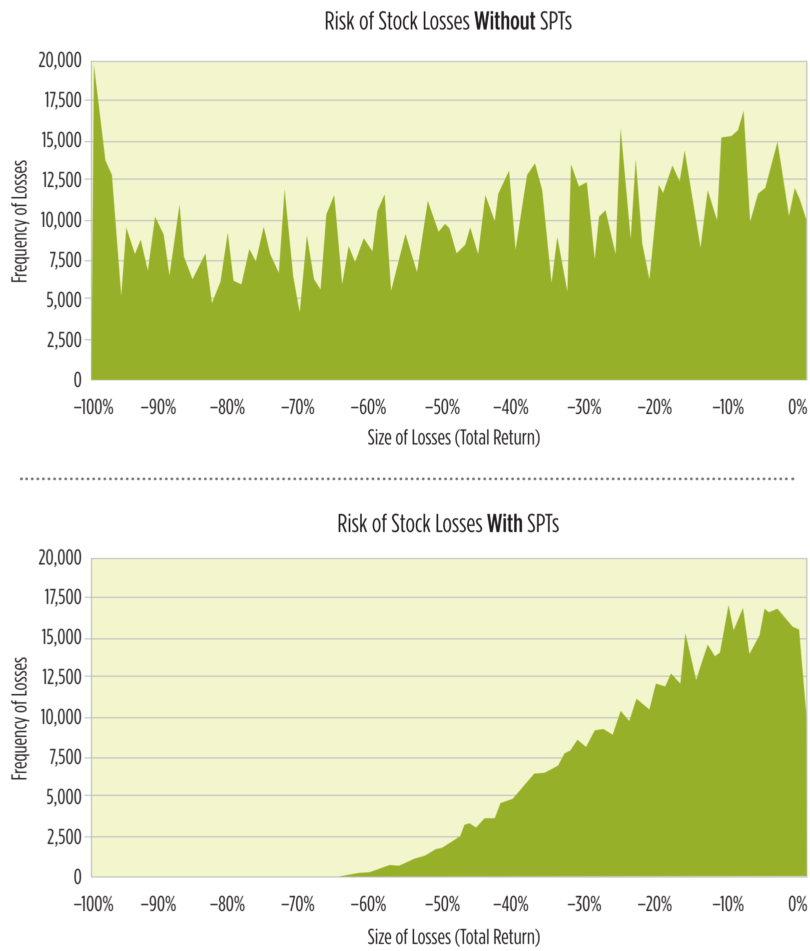
See "Actual Performance Results: 5-Year SPT," p. 34, which compares the stocks' total return with and without an SPT. The maximum stock loss was 0 percent, meaning that the cash pool eliminated all stock losses. Of the original total cash contribution or premium, 31 percent was returned to the investors (after eliminating all stock losses). Therefore, the "all-in" cost of the protection (based on the original amount of protected stock value) was 6.9 percent, or 1.38 percent per annum, when amortized over the 5-year period. When compared to the backtesting results summarized above, the SPT performed as expected in the real world and delivered effective and cost-efficient protection throughout the financial crisis.

Flexibility in Structuring an SPT

An SPT can be tailored to satisfy the specific needs of its participants. Depending on the level of protection

Risk Transformation

With versus without stock protection trusts



— Intelligent Edge Advisors, LLC

Actual Performance Results: 5-Year SPT

Maximum stock loss: 0 percent; all losses were reimbursed

	Stock's Total Return		
Protected Stock	Without SPT	With SPT	Loss Elimination With SPT
Best Buy Co., Inc.	-36.7	0	36.7
General Electric Co.	-32.1	0	32.1
Toyota Motor Corp.	-24.2	0	24.2
Harley-Davidson, Inc.	-18.2	0	18.2
Amgen, Inc.	-12.5	0	12.5
Eli Lilly & Co.	-7.7	0	7.7
Goldman Sachs Group, Inc.	-5.3	0	5.3
People's United Financial, Inc.	-1.1	0	1.1
Boeing Co.	3.3	3.3	N/A
Time Warner, Inc.	9.5	9.5	N/A
MDU Resources Group, Inc.	11.4	11.4	N/A
Microsoft Corp.	18.9	18.9	N/A
3M Co.	25.5	25.5	N/A
EnCana Corp.	25.6	25.6	N/A
UIL Holdings Corp.	31.7	31.7	N/A
Procter & Gamble Co.	40.2	40.2	N/A
E. I. du Pont de Nemours & Co.	49.4	49.4	N/A
RLI Corp.	55.8	55.8	N/A
Humana, Inc.	56.5	56.5	N/A
Dow Jones & Co., Inc.	100.4	100.4	N/A

— Intelligent Edge Advisors, LLC

desired, the cash contribution might be as low as 5 percent to guard against catastrophic stock losses caused by low frequency/high severity events. In such a case, an SPT might be structured to reimburse participants for losses on their stock that exceed a certain threshold, such as 50 percent. On the other hand, the cash contribution could be up to 10 percent, which, as both the backtesting and actual performance of an SPT throughout the financial crisis show, provides more robust protection against losses.

An SPT can also be any term that's five years or longer; a minimum term of five years is necessary to permit the dispersion of total returns among the 20 stocks protected by the SPT.

As "Comparison Matrix," p. 35, depicts, an SPT compares favorably to the traditional hedging tools.

Cost Effectiveness

The cost of an SPT is significantly less than the cost of protection for a similar term using the traditional tools, and investors don't need to forfeit any portion of the upside potential of their stocks, including dividends. From a practical perspective, the affordability of an SPT enables investors holding concentrated stock positions to embrace a long-term, strategic approach to continuously mitigate their stock's risks while retaining 100 percent upside appreciation and all dividends.

Tax Efficiency

An SPT is a tax-efficient way to protect a stock position in that it doesn't cause a constructive sale, the straddle rules don't apply, dividends received remain qualified for LTCGs treatment and the termination of the trust will result in either LTCGs or currently deductible capital loss.

The use of an SPT won't cause a statutory constructive sale under Internal Revenue Code Section 1259 because the participants retain all upside potential with respect to their underlying stock positions, including all appreciation, dividends and any other distributions.[9] The use of an SPT won't cause a common law constructive sale because the investors retain all incidents of ownership with respect to their stock positions; that is, each participant retains all appreciation of his shares, keeps all dividends and any other distributions paid on his stock, retains full voting votes and—because an SPT doesn't require that a pledge, lien or encumbrance of any kind be placed on the shares—can sell or otherwise dispose of his shares at any time during the term of the SPT.

The combination of an investor's stock and his interest in an SPT isn't a straddle because the value of the stock and the interest in the SPT won't vary inversely.[10] Rather, the value of an investor's interest in an SPT depends mainly on: (1) the change in value of that investor's stock position, (2) the change in value of the other 19 investors' stock positions, and, to a much lesser extent, (3) the change in value of the cash pool. Put another way, an investment in an SPT is economically

Comparison Matrix

An SPT compares favorably to the traditional hedging tools

	Low Cost	Keep 100% of Stock's Upside	Low Complexity	High Transparency	Tax Efficient	5+ Year Horizon	No Credit Risk
Stock protection trust (SPT)	YES	YES	YES	YES	YES	YES	YES
Put options	NO	YES	YES	NO	NO	NO	NO
Collars	NO	NO	NO	NO	NO	NO	NO
Prepaid variable forwards	NO	NO	NO	NO	NO	NO	NO
Exchange funds	NO	NO	NO	NO	YES	YES	YES

— *Intelligent Edge Advisors, LLC*

similar to an investment in a diversified portfolio comprised of 20 unrelated stocks, with the risk reduction due to the changes in value of the individual stocks in the portfolio (that is, the dispersion of returns) over time; therefore, the straddle rules don't apply.

Dividends must satisfy certain holding period rules to qualify for LTCGs treatment.[11] If dividends received on a stock otherwise satisfy the dividend holding period requirements and are "qualified dividend income," an investor's participation in an SPT won't cause the loss of "qualified" dividend status.[12] Therefore, dividends will be taxed at the LTCG rate.

On liquidation of an SPT, if the amount of the cash distribution to an investor exceeds his tax cost basis in the SPT (that is, the original cash contribution into the SPT), the gain will be treated as LTCG; on the other hand, if the amount of the cash distribution (if any) is less than the tax cost basis, the loss will be treated as a currently deductible long-term capital loss.[13]

Other SPT Considerations

The shares being protected by an SPT needn't be pledged or encumbered in any way, can be held in custody wherever the owner chooses and can be sold at any time by the owner. And, there's no dealer counterparty credit risk.

An SPT is easy to understand and fully transparent, and valuation can be viewed "real time" during any business day.

Due to cognitive and emotional biases, many investors (rightly or wrongly) have developed a powerful and long-standing emotional attachment to the particular stock they own and are often extremely reluctant to sell their concentrated position. The affordability of an SPT allows investors who, for whatever reason, have become emotionally committed to continued ownership of their stock, to cost effectively reduce the downside risk of their stock position on a long-term basis.

An SPT gives investors, fiduciaries and financial advisors the flexibility to take advantage of the shorter term, tactical, derivatives-based hedging tools, as well as a longer term, strategic approach.

Who Else Can Use an SPT?

The owners of substantial private companies—including families and private equity groups—can use an SPT to insure against their specific company risk in an affordable and tax-efficient manner until a liquidity event occurs.

Investors can also use the SPT methodology to affordably mitigate the downside price risk of other highly appreciated assets, such as real estate and art.

Finally, trustees of trusts holding such highly appreciated special assets can employ the SPT methodology to reduce the associated concentration risk.

Endnotes

1. *See* Uniform Prudent Investor Act Section 3 (1995) and comment to Section 3. *See also Restatement (Third) of Trusts* Section 227.
2. *See Levy v. Bessemer Trust Co.*, 197 WL 431079 (S.D.N.Y. July 30, 1997) and *Brane v. Roth*, 590 N.E.2d 587 (Ind. Ct. App. 1992).
3. *See* George Crawford, "A Fiduciary Duty to Use Derivatives?" 1 *Stanford Journal of Law, Business & Finance* 307 (1994-1995); Randall A. Borkus, "A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivative Techniques," 36 *ABA-RPPT Journal* 127 (Spring 2001); Mark A. Miller, "Protecting Appreciation in Taxable Investment Securities and Portfolios With Hedging Strategies," *Journal of Wealth Management*, Vol. 5, No. 2 (Fall 2002); Thomas Boczar, "Mitigating the Legal Duties of Fiduciaries and Financial Advisors to Manage Stock Concentration Risk—Conceptualizing and

Implementing a Best Practices Framework," *Journal of Wealth Management,* Vol. 10, No. 1 (2007).

4. *See* Michael Cembalest, "The Agony and the Ecstasy: The Risks and Rewards of a Concentrated Stock Position," J.P. Morgan Asset Management, *www.chase.com/content/dam/privatebanking/en/mobile/documents/eotm/eotm_2014_09_02_agonyescstasy.pdf.*
5. These unflattering tax results are achieved because, in most instances, the stock position, when combined with the derivative hedging instrument, will be deemed a "straddle" under Internal Revenue Code Section 1092; further, the dividend holding period requirements of IRC Section 1(h)(11)(B)(iii)(I) won't be satisfied.
6. The stock protection trust (SPT) methodology described herein is protected by a portfolio of U.S. patents: Nos. 7,720,736; 7,739,177; 7,987,133; 8,229,827; and 8,306,897.
7. *See* John L. Evans and Stephen H. Archer, "Diversification and the Reduction of Dispersion: An Empirical Analysis," *Journal of Finance* 23, no. 5 (December 1968), at pp. 761-767; Thomas M. Tole, "You Can't Diversify Without Diversifying," *Journal of Portfolio Management* 8, no. 2 (Winter 1982), at pp. 5-11; and Meir Statman, "How Many Stocks Make a Diversified Portfolio?" *Journal of Financial and Quantitative Analysis* 22, no. 3 (September 1987), at pp. 353-363.
8. *See* Frank Reilly and Keith Brown, *Investment Management and Portfolio Management* (5th ed), at pp. 284-285, summarizing the relevant research studies and findings.
9. The legislative history to the constructive sale rules of IRC Section 1259, more specifically the Senate Finance Committee Report (pps. 126-127) and the House Ways and Means Committee Report (virtually identical language), make it clear that transactions will be treated as constructive sales only if they have the effect of substantially eliminating both the investor's risk of loss and opportunity for gain with respect to the underlying stock.
10. *See* Treasury Regulations Section 1.246-5(b)(2). *See also* "Tax Management Portfolio (Transactions on Stock, Securities and Other Financial Instruments)," 184-4th, at p. A-32(5) stating that, "In general, non-technical terms, the essential features of a straddle are: 1) the positions are valued by some type of market on or through which they may be liquidated at any time, and 2) market forces resulting in any change in value of one position will almost always result in an inverse change in value of the offsetting position although not necessarily in the same amount."
11. *See* IRC Section 1 (h)(11)(B)(iii)(I).
12. A participant's interest in an SPT isn't "substantially similar or related property" *(see* Treas. Regs. Section 1.246-5(b)(1)) and doesn't result in a "diminished risk of loss" *(see* Treas. Regs. Section 1.246-5 (b)(2)).
13. The SPT elects to be treated as an association taxable as a corporation, and SPT investors will be treated as shareholders and their SPT interests as stock that they purchased. On the termination date, a complete liquidation of the corporation will occur under IRC Section 331. Therefore, the cash distribution will be treated as the proceeds of a purchase of the shareholder's interest by the corporation and will qualify for capital gain or loss treatment, provided that the stock of the liquidating corporation is a capital asset in the hands of the shareholder.

SPOT LIGHT

Mean Green

"Femme Assise" ($21\frac{5}{8}$ in. by $13\frac{1}{8}$ in.) by Tamara de Lempicka, sold for $368,358 at Christie's recent Impressionist/Modern Day Sale in London on Feb. 5, 2015. A leading representative of the Art Deco style, Lempicka was a favorite among the rich and famous and was commonly referred to as "The baroness with a brush."