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advisors

February 2010

Managing a Concentrated Stock Position

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Can you have too much of a good thing?

A large holding of a single stock that dominates your portfolio carries unique challenges. On the one hand, it may represent a large portion of your portfolio because it has done well in the past. On the other hand, you may feel you need more diversification. You may have new financial goals that require a shift in strategy; for example, you may hold a growth stock, but now want your assets to produce additional income. Or, your investing focus may simply have shifted from growing your net worth to protecting what you've accumulated.

How much is too much?

There's no firm, universal answer to this. It depends in part on your particular goals and timelines and your portfolio's ability to withstand volatility, your level of wealth and your overall asset allocation. Even the best stocks can suffer serious reversals on occasion, and that volatility can affect the power of your assets to compound over time. If your current income depends on the same company as your portfolio--for example, if you hold a large amount of your current employer's stock--you're doubly exposed. Though diversification doesn't guarantee a profit or ensure against a loss, it's still the best way to limit the overall impact of a single stock. Benjamin Graham, legendary author of The Intelligent Investor, argued that a diversified portfolio required anywhere from 10 to 30 stocks. Other researchers have subsequently held that at least 50 stocks are needed; still others argue the benefits of several hundred stocks. If you accept Graham's definition, you might start to consider whether your position is too large once it represents more than 10 percent of the stock portion of your portfolio. The financial planners at New Wealth Advisors can help you analyze the potential impact of a single holding on your overall financial situation, and help you assess whether and how to address the issue.

The challenges of a concentrated stock position

A large stock holding can come about in many different ways, and your approach to managing it may depend in part on how you arrived at it. For example, you may have:

- Inherited a large holding
- Exercised options to buy your company's stock
- Sold a private business, or founded a company that subsequently went public
- Benefited from price appreciation or repeated stock splits over the years
- Accumulated restricted or common stock as part of your compensation

Just as there are many different reasons for accumulating a concentrated stock position, there are many challenges involved in the decision about how to address it. Some of the most common hurdles investors face are:

- Reluctance to sell because of adverse tax consequences.
- Legal constraints on your ability to sell.
- Contractual obligations that prevent selling, such as lock-up agreements.
- Practical considerations. In the case of a thinly-traded stock, a large sale could overwhelm the market and potentially depress the price.

About New Wealth Advisors.

New Wealth Advisors is an independent, fee-only, SEC-registered investment advisor, operating as a multi-family investment office. We work with newly wealthy individuals and families to protect, grow and manage assets.

- Emotional attachments to a stock. If you inherited a large position, or if it has been a major factor in increasing your net worth over the years, you may be reluctant to sell.
- Desire to participate in potential future price gains. If you feel a stock still has plenty of growth potential, it can be difficult to contemplate a trade, even for another stock with equal potential.
- Concerns about possible perception of market manipulation or insider trading.

Fortunately, there are a variety of strategies that can help you address these issues. One of them--or a combination--might suit your unique situation. The choices are complex and will depend on your own circumstances and tax considerations, but here is an overview of some of your options.

Selling your shares

Selling frees up funds that can be used to purchase other securities that will help diversify a portfolio. The benefits of diversification have been demonstrated repeatedly; multiple studies have shown that the risk-adjusted returns of a single-stock portfolio have generally not outweighed the benefits of diversification. Even if a stock has done well in the past, there's no guarantee it will continue to do so--and if it does, it could represent an even larger percentage of your portfolio, thus compounding the risk. And the more volatile the stock, the lower its risk-adjusted return relative to the broader market tends to be over time.

The biggest tradeoff is that you may owe capital gains taxes on the difference between your cost basis and the sale price. If you have a highly appreciated stock, that may be no small consideration. However, remember that through 2010, the capital gains tax is at a historically low level. If you plan to sell in the future and will face taxes anyway, you might consider the possibility that a change in the tax law could potentially increase your capital gains burden.

Obviously, you'll need to weigh the tax impact and trading costs against any additional potential return you might gain or potential losses on your concentrated holding that you might avert by diversifying. In some cases, the long-term benefits of diversification may offset your tax bill. Remember that selling doesn't have to be an all-or-nothing proposition. If you want to continue to participate in any upside potential, you could sell only a portion of your position, or consider selling over time. Selling in stages can help you better manage the tax bite in any one year, yet allow you to participate in any future growth. If your stock is one that is thinly traded, a phased approach also could help the market absorb the impact of your sale. However, it could take several years to reposition your portfolio so that your risk is more diversified. You'll need to balance the potential benefits of phased selling with the possible consequences of prolonging your exposure to the downside risks of your concentrated position.

Hedging your position with options

Selling is by no means the only way to deal with a concentrated stock position. For example, you may want to retain your stock, but also need to protect yourself short-term against the risk of a substantial drop in its value. There are multiple ways to try to manage that risk by using options, which can be especially useful if you're legally or contractually restricted from selling your shares. However, bear in mind that options also can involve substantial risk and are not suitable for all investors. The wealth advisors and New Wealth can help you determine if hedging is right in your specific case.

Donating your shares

Another possibility for dealing with a concentrated stock position is to donate your shares, which eliminates your capital gains tax liability. Depending on your objective, there are many ways to do so. Some methods provide an immediate tax deduction, some offer ongoing income, some enable you to avoid paying capital gains or estate taxes on highly appreciated shares, and some offer a combination of benefits.

Figuring out the ramifications of a concentrated stock position is a complex task that may involve investment, tax, and legal issues. The professionals at New Wealth Advisors can help you decide if this strategy is right for you.

Other options

These are just a few of the options that might be available to you. The financial planners at New Wealth Advisors can help you determine if you have a concentrated position, the long term impact this may have and what options are available to you.

Planning Around the Estate Tax Repeal in 2010

Here we are in early February, and we find ourselves between year-end tax planning and the actual filing period for most individuals. CPAs and wealth planners are working together to design an ideal strategy for their clients, and there is a crucial change in 2010 that will have a significant impact on the year: the temporary repeal of the federal estate tax.

Yes, the one-year disappearing act of the federal estate tax has come to pass. Some believe that quick action will be taken to reinstate the taxes at 2009 levels (see below bullets for details). Others believe Congress will proceed cautiously in an attempt to enact more sweeping reforms. In either case, any reinstated tax may or may not be made retroactive to January 1, 2010.

Needless to say, planning under these circumstances is challenging. Indeed, the failure of Congress to either extend the 2009 estate tax rules into 2010 or enact a permanent estate tax law has created a slew of unfortunate consequences. Some important pieces of the puzzle are:

- Both the federal estate tax and the federal generation-skipping transfer tax (a separate tax on property given to grandchildren, great-grandchildren, etc.) are repealed for 2010 unless Congress enacts legislation to reinstate them, retroactive to January 1, 2010 or otherwise.
- Both taxes are scheduled to return in 2011 at levels that applied prior to 2001. That means a $1 million exemption and a top tax rate of 55% (in 2009, the exemption was $3.5 million and the top rate was 45%).

- The federal gift tax remains in effect with a $1 million lifetime exemption, and the top tax rate has dropped to 35% in 2010 (versus 45% in 2009). However, at this point in time the maximum gift tax rate is scheduled to jump to 55% in 2011.

Along with the repeal of the federal estate tax come new rules for determining the federal income tax basis of inherited assets which, if not changed, could mean heirs will pay more capital gains tax. The old step-up in basis rule that allowed heirs to inherit property with a fair market value as of the date of death of the decedent has been modified. For 2010, the basis for inherited property is the lesser of the decedent's basis (carryover basis) or its fair market value on the date of death.

However, $1.3 million of estate property is afforded a step-up in basis, and up to $3 million of property passing to a surviving spouse receives a step-up as well.

While no one knows for sure what will happen to the estate tax, perhaps we can all agree that the indecision will make estate planning more challenging in the near term. If your estate plan assumed that an estate tax would be imposed in 2010, it may no longer support the intended goals - it may not provide adequately for a spouse, and it may not meet overall tax objectives.

New Wealth Advisors has a few recommendations for first steps to take as we look for the best solution for each individual.

- A visit to your estate planning attorney might be in order to discuss the possible need to revise wills, trusts, and other estate planning documents.
- Getting records organized (both yours and your parents or grandparents) will also help the planning process; the modified carryover basis rules impose strict reporting requirements, including supporting documentation and penalties for noncompliance.
- It's important to be careful not to ignore the impact of state death taxes.

The Big IRA Question: To Convert or Not to Convert?

There has been a lot of discussion about the potential benefits of converting from a traditional IRA to a Roth IRA, spurred on by new rules that are now in effect. Starting this year, the $100,000 income ceiling will be eliminated and married individuals filing separately will be allowed to convert a traditional IRA to a Roth IRA.

Determining whether you should convert can be a complicated and difficult decision. You must weigh the benefits against the income tax consequences and other potential drawbacks.

Here's a quick rundown of advantages of converting:

- Qualified distributions from the Roth IRA will be completely tax free
- For nonqualified distributions from the Roth IRA, the portion of the distribution that represents your contribution is not taxable
- You do not have to take required minimum distributions from the Roth IRA after age 70½
- If you use non-IRA funds to pay the income tax that results from rolling over or converting funds to a Roth IRA, those funds are removed from both your taxable estate and your countable assets
- Qualified distributions from Roth IRAs are not counted in determining the taxable portion of your Social Security benefits
- Individuals in a low income tax bracket (i.e. 15% tax bracket) can calculate the ideal conversion amount in order to maximize the benefit of their lower income tax rate
- There is a special tax incentive for those who choose to convert during 2010 — the option to include the taxable portion of any 2010 conversions in taxable income for 2011 and 2012.

And some disadvantages:

- Funds that you convert or roll over from a traditional IRA to a Roth IRA are subject to federal income tax, to the extent that such funds represent investment earnings and tax-deductible contributions to the traditional IRA
- Using IRA funds to pay the resulting income tax (the "conversion tax") has significant drawbacks
- Special penalty provisions may apply to withdrawals from Roth IRAs that contain funds converted or rolled over from traditional IRAs
- The taxable income that results from converting funds can increase the taxable portion of your Social Security benefits
- There always exists the risk of future changes in federal law governing the taxation of Roth IRA distributions

There is one last tactical consideration to keep in mind with regard to the decision to convert. Individuals may "recharacterize"(i.e. undo) the Roth IRA conversion in the current year or by the filing date of the current year's tax return. For example, an individual can convert their IRA in January 2010 and decide to recharacterize their conversion as late as October 2011; in other words, the individual has approximately 21 months to determine if it makes investment and/or tax sense to do the conversion. This powerful tool essentially provides individuals with an ability to "see into the future" before making a final decision about their IRA conversion!

Despite the potential benefits of a conversion, the rocky markets of the past two years have resulted in a general hesitancy on the part of investors to pay taxes in advance or to make any drastic changes in their investments. Time will tell if that reluctance will fade with more education on the subject, but it is something all of us need to begin thinking about as 2010 approaches.

Photo by John Nelson Ferrara

What's an Exchange-Traded Fund?

Like a mutual fund, an exchange-traded fund (ETF) pools money from investors to buy a group of securities.

Though diversification alone can't guarantee a profit or protect against potential loss, such an investment helps you spread your risk over many individual securities.

Most ETFs are passively managed. Instead of having a portfolio manager who uses his or her judgment to select specific stocks, bonds, or other securities to buy and sell, ETFs try to approximate the performance of a specific index, which can be either broad-based or narrowly focused. In this, they are somewhat similar to an index mutual fund.

However, there are some substantial differences between mutual funds and ETFs. Perhaps the biggest is the ability to trade ETFs throughout the day. Mutual funds are priced once a day after the market closes. If you buy or sell after that, you'll receive the next day's closing price. By contrast, ETFs are priced throughout the day. Also, they can be bought on margin or sold short; in other words, they can be traded just like stocks. As a result, investors may use ETFs to actively trade a particular sector or industry.

ETFs typically have no minimum investment requirements or redemption fees for brief holding periods. And because most ETFs are based on an index, the administrative costs can be relatively low. However, ETFs must be purchased through a broker. Since you'll pay a brokerage commission with every transaction, ETFs may not be well-suited to a systematic investing program such as dollar cost averaging--transaction costs could quickly eat up any cost efficiencies.

Because the differences between one ETF and another can be dramatic, you should carefully consider a fund's investment objectives, risks, charges, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing.

How can I use Exchange-Traded Funds?

There are many ways an exchange-traded fund (ETF) can be used to help round out or supplement an existing investment portfolio.

Investing in a sector rather than an individual stock. An ETF allows you to invest in an industry or sector without relying on the fate of an individual company. If you have broad based stock funds, you can give more weight to a particular sector by also investing in an ETF that focuses on a relevant index.

Minimizing taxes. ETFs can be relatively tax efficient. Because a passively managed ETF trades relatively infrequently, it typically distributes few capital gains during the year. That means you won't incur the same tax liability as if you received significant capital gains. However, make sure you consider just how an ETF's returns will be taxed. Depending on how the fund is organized and what it invests in, returns could be taxed as short-term capital gains, ordinary income, or even as collectibles, all of which are generally taxed at higher rates than long-term capital gains.

Staying invested after selling stock for a tax loss. If you have sold a large stock position to realize a capital loss for tax purposes, but still believe that industry as a whole will soon experience a big short-term move, you can use an ETF to try to take advantage of that volatility.

If you buy the same stock within 30 days, the tax-loss deduction will be disallowed. However, buying an ETF based on a relevant index as a proxy for that investment until you are able to buy the stock again allows you to preserve the tax deduction on the stock loss while staying invested in that industry.

Limiting losses. With an ETF, you can set a stop-loss limit on your shares. A stop-loss order instructs your broker to sell your position if the shares fall to a certain price. If the ETF's price falls, you've minimized your losses. If its price rises over time, you can increase the stop-loss figure accordingly. This strategy lets you pursue potential gains while setting a limit on the amount you can lose.

Be sure to carefully consider a fund's investment objectives, risks, charges, and expenses, which are included in the prospectus available from the fund. Read it carefully before investing.

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