Profit Protection

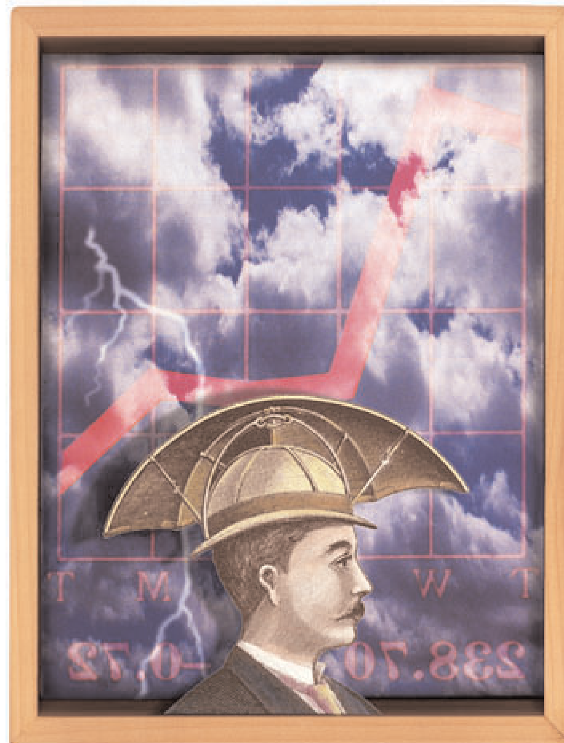
Many wealthy clients want to reap gains from big stock positions while avoiding disastrous declines. A novel strategy can do both. By Roccy DeFrancesco

WHAT IS INVESTING NIRVANA? WHEN holding individual stocks, it would give the client upside growth if the stocks rise in value and at the same time protect the principal investment from downside risk—all at relatively little cost. And if the individual stocks do go in the tank, the client could still be able to recognize a gain of 5% to 7% on the original portfolio.

There is one advanced strategy now available that provides the advantages described above. We call it the Stock Protection Strategy (SPS). This is particularly suitable for high-net-worth clients who have accumulated some sizable single-stock positions over the years. They still like the stocks, perhaps because they worked for the company or inherited the position, and so they don't want just to sell out. But they are concerned about a possible sudden meltdown in a large part of their wealth.

The SPS works through a company that is willing to give a client 90% of the value of his or her stock portfolio (or any portion you chose to use for this concept) today, in cash. The company takes a secured interest in the stock portfolio. If the stocks do well, the client can get the stocks back. If the stocks go down the drain (see WorldCom and Enron), the client still keeps 90% of the original investment, plus the returns on that asset.

There are some key advantages to using an SPS strategy. First, it relies on a derivative-backed, non-callable, and non-recourse stock loan that can create 90% liquidity without selling the stocks and without paying capital gains taxes. Second, it protects the current stock portfolio from downside risk without requiring any repayment of the loan or accrued interest. Third, it offers a more conservative vehicle for new investments. And fourth, as noted previously, it allows the client to recover all of the pledged stocks and almost all of the potential gains as well.



There must be a catch, you say. No, but the technique is complicated, and you should investigate it thoroughly to understand the features involved.

As background, you and your clients now know first-hand about the many dangers of market volatility as well as the vulnerability of an all-equity portfolio. From 2000 through 2003, the Dow Jones Industrial Average recorded highs above 11,000 and a low of nearly 7,000. That is a swing of almost 40%. The Nasdaq had an even wider swing range of about 80% from peak to trough. If your clients had substantial money in the market, chances are their investment portfolios fell at least 30%. And if some of them happened to be concentrated in a few individual stocks (versus mutual funds), they may have suffered losses in excess of 50%.

Talk to someone who lived through the stock market crash in the late 1920s or the Great Depression that followed, and you usually learn that person lives more frugally than the generations that followed. Why? Because people who have never lived through a depression (including this author) believe that the economy will always provide for them, and they will never have to beg for food or wonder if they will be able to heat their houses in the winter or clothe their children.

Similarly, I do believe that investors who lived through the 2000-2003 bear market will carry a unique perspective on investing going forward. For the young investor, the thought of a prolonged period of negative returns from stocks was unimaginable before 2000. If you asked a typical investor who only knew the 1980s and 1990s what the average rate of return should be in the market, the answer used to be 12%, 15%, or even higher. As we all know, that rate of return is not sustainable. Unfortunately, few investors hedged their bets during the bull market. As a result, millions of investors lost billions of dollars, on paper or in real terms.

And older investors, while perhaps wiser, face greater problems. The bear market was a major blow to the ability of investors older than 50 to retire in the manner they intended. If these older investors thought in 2000 that they were going to live on an investment portfolio of $2 million (which included money in

A Sample SPS Portfolio

A client has $1 million in three highly appreciated stocks, with a basis of $75,000.

Stock	Shares	Price	Value	Annual dividends
Citigroup	6,678	$49.91	$333,299	$9,349
Coca-Cola	6,678	$49.88	$333,099	$5,877
Occidental Petroleum	7,800	$42.78	$333,684	$8,112
Totals			$1,000,082	$23,338

These shares are pledged in an SPS that has a loan at 9.74%, with dividends used to repay interest. Assuming a reinvestment return of 7%, the hedge cost is 0.37% annually.

Annual loan interest	9.74%
Average dividend yield	2.33%
Effective annual interest	7.41%
Loan term in years	10
Assumed annual reinvestment return	7.00%
Additional annual return needed to break even	0.41%
Loan to value ratio	90%
Annual return “give up”	0.37%

a brokerage account as well as a pension plan or IRA), by 2003 that portfolio could easily have fallen to $1 million or less—at precisely the time when they expected to stop working.

For older investors, a stock portfolio that could be protected from downside risk, thus allowing them to retire with a secure amount of money, would be terrific. If those investors could also enjoy most of the gains if the individual stock portfolio rose significantly, that would be icing on the cake.

So exactly how does the SPS work? Here are the key elements:

Loan. The client typically takes a cash loan from the SPS for 90% of a liquid stock/brokerage account. The loan is non-callable; during the loan term, the lender cannot make you prepay or put up additional collateral. It's also non-recourse, so at the end of the loan term, you do not have to repay it (if you give up the collateral instead). The loan term will usually be 10 years, although the SPS can be structured for as short as two years. The interest rate we use in our examples is a commercial loan rate of 9.33% (9.74 APR).

Investment. Next, the loan proceeds are invested in a fixed or indexed annuity that has a minimum rate of return. In our examples, we use a rate of return of 7%, which is possible using a variable annuity. But any assumption ultimately can be plugged in to illustrate the concept, of course.

Collateral. The SPS then takes the individual stocks as collateral for the loan. If the stocks used in the SPS pay dividends, the dividends will be used to offset the interest due on the loan.

Market returns. The stocks held by the SPS are allowed to go up or down in the market as would normally happen in a stock portfolio.

At the conclusion of the transaction, the client will have one of two likely outcomes. If the market goes up, the client pays back the loan, recovers the pledged stocks, and keeps almost all of the upside. On the other hand, if the market drops sharply, the investor can walk away from the loan without having to repay any principal or interest, but at the same time keeping 90% of the loan proceeds and the reinvestment gains. By hedging the portfolio with an SPS, the client effectively earns 3%-10% on the investment while having a principal guarantee in place.

As always, an example is the best way to understand complex concepts like an SPS. “A Sample SPS Portfolio” above shows a client who has $1 million in highly appreciated stock in three companies. With the annual dividends of $23,338 applied to interest payments, the client will “give up” an annual return of just 0.4% for the cost of the SPS, using the 7% return assumption on the loaned money.

Next, let's compare selling the stock outright to move into a conservative investment with keeping the stocks using an SPS. “The SPS in Action” on the adjacent page illustrates two scenarios, one for high growth (12%) and one for moderate growth (6%) in the pledged stocks. Under the traditional stock sale, it's assumed that the client pays the capital gains due and reinvests the remaining money in a conservative vehicle that returns 7% annually. Likewise, it is assumed that the money borrowed against the stock in the SPS transactions also gets reinvested and grows at 7% annually. Again, you can plug in different assumptions; the point here is not to predict exact returns but to illustrate how the concept works and let the adviser decide if it makes sense to explore with the client.

What are the results? In the traditional sale and conservative reinvestment scenario (the left column in the chart), the client's original $1 million portfolio turns into $1.69 million at the end of the 10-year term. In the high-return SPS example, where the client borrows 90% of the value of the stock and reinvests the proceeds, the return is much greater—$3.04 million, for a net gain of $1.34 million. And even the low-return SPS yields $1.72 million, which matches the sale scenario but adds invaluable downside protection.

Now add the following “disaster” scenario to the comparison. Assume that the client holds stock that loses an average of 12% a year and never sells it. Unlikely, perhaps, but some clients suffered nearly as much after the bubble burst. A 12% annual decline in a $1 million portfolio would leave the client with $278,529 after 10 years.

Instead, if the client implemented an SPS as described above and the underlying stocks lost 12% annually, the created asset at the end of 10 years would still be worth $1,770,612. Since

The SPS in Action

The client considers selling all the stocks outright, paying taxes, and reinvesting in a 7% return vehicle. Alternatively, the SPS presents a way to keep the stocks and capture a high return, or break even at a lower return. Meanwhile, any loss is avoided if the stocks crash, since the client can walk away from the loan and hand over the stocks.

	Outright Stock Sale	SPS High Return	SPS Low Return
Initial portfolio value	$1,000,082	$1,000,082	$1,000,082
Capital gains due on sale*	$138,762		
Sale/loan proceeds to reinvest	$861,320	$900,074	$900,074
Reinvestment term in years	10	10	10
Value of proceeds at end of term**	$1,694,347	$1,770,582	$1,770,582
Interest rate on loan		9.74%	9.74%
Dividend yield on pledged stocks		2.33%	2.33%
Effective annual loan rate		7.41%	7.41%
Annual return on pledged stocks		12.00%	6.00%
Value of recovered portfolio		$3,106,103	$1,790,995
Total assets at end of term	$1,694,347	$4,876,685	$3,561,576
Loan balance at end of term		$1,839,608	$1,839,608
Net to client	$1,694,347	$3,037,077	$1,721,968
Gain from SPS		$1,342,730	$27,622

*15% tax rate. **Assumes 7% annual return.*

the stocks have fallen sharply, the client would either reposition the loan (out of the scope of this article) or let it collapse and lose the stocks to the lender. Even so, the client keeps nearly $1.8 million from the SPS transaction. This, of course, is a much better end result than if the client had simply held on to the original stocks and lost more than 70% in the process.

Finally, what if the client insists on keeping the stocks and goes on to enjoy a 12% annual gain in those holdings? At the end of 10 years, the $1 million portfolio is now worth $3.1 million. A nice outcome, indeed. But remember that the same 12% annual gains in the stock, under an SPS, would give the client total assets (after paying back the loan balance) of $3.04 million.

Look closely: The client, by holding the stock and taking all of the downside risk, ends up with about $70,000 more than he or she would have using the SPS. If I were advising a client, old or young, it would be difficult to recommend holding on to the portfolio and taking all the risk for a decade on those stocks, for a potential increased total return of about 2% on the overall asset.

There are, of course, other strategies that can be used to hedge or protect a portfolio for a client. Each of these can be effective, but I'll briefly point out their limits compared to an SPS.

Principal-protected funds. There is a tremendous difference between an insured mutual fund that usually owns hundreds of stocks and protecting one individual stock from downside risk.

Guaranteed annuities. While it is true that principal is protected with guaranteed annuities (which usually offer a guaranteed positive return), your client is probably not invested in individual stocks that will have much more potential for upside (and downside) returns. What's more, guaranteed annuities typically impose stiff surrender charges should the client need access to cash before a certain date.

Certificate of deposits. CDs have principal protection as well as guaranteed returns by banks. But again, they lack the real upside potential that individual stocks can provide.

Collar loans. As structured by investment banks, collar loans can protect a portion of the downside risk of a stock portfolio, but they imit upside returns significantly. In other words, both gains and losses are collared.

Prepaid variable forwards. While these do protect some smaller portion of the downside to a portfolio, they trigger an immediate capital gains tax. They also tend to limit upside returns.

In summary, the SPS does seem to offer the best combination of portfolio protection while still allowing the client to capture some growth. It's difficult to explain the SPS thoroughly in a short article, but advisers should explore the following factors for any of their clients who own significant amounts of individual stocks in their portfolios.

- Investing in individual stocks can be both rewarding and tragic for clients. Individual stocks have the biggest opportunity to increase—or decrease—your overall wealth.
- The SPS is a nice way to reinvest 90% of a liquid stock portfolio without incurring capital gains.
- Older investors should seriously consider whether having individual stocks is in their best interest. The post-2000 crash has reminded us all that the stock market does not crank out 12%-15% returns per year. It can go down—at times severely—and for an unexpectedly extended period.
- The SPS is one creative way for clients to hedge against downside market risk without giving up extra growth if the individual stocks significantly increase in value.

The costs to implement an SPS, by the way, are reasonable. This is not a tax-driven strategy, so legal or accounting reviews will be minimal. The vendor is basically selling an annuity, which throws off a commission that is split with the agent. Clients should see the value in insulating themselves from a stock collapse or systemic risk, while they can still enjoy long-term gains. **FP**

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