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EXPERIENCE LIFELONG WEALTH

EQUITY AWARD PLANNING

Strategies for Executives

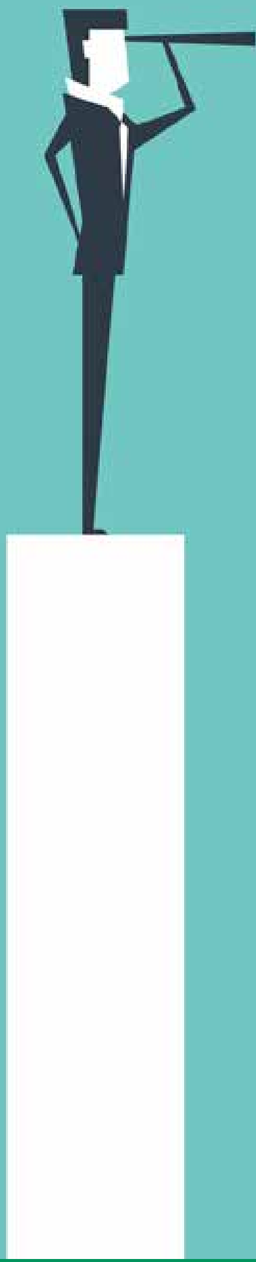

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Table of Contents

CHAPTER 1

Stock Options

It's always a good time to revisit stock options and restricted stock units. How do both of these plans work and what are some strategies for each?

Chapter one will be the first of four chapters on this topic. First, let's focus on the basics of stock options.

How does a stock option work?

Whether stock options are new to you or not, a quick refresher on how they work can never hurt. Typically, a stock option is awarded in unvested shares with a staggered vesting schedule. For instance, let's say you received 10,000 options at DuPont in February 2018. They would vest on a schedule of 1/3 a year from 2019 to 2021. Unlike restricted stock units (RSU), when they vest there is no taxable event.

When stock options vest, there is generally an expiration date for when you must exercise them. Otherwise, you lose the option. When you are awarded a stock option, basically you are just given the option to purchase your company's stock in the future (before expiration) at the price of the stock the day you received them.

When you exercise the option, it's generally a "cashless" transaction. Let's use the above DuPont example. You have all 10,000 of your shares vested. Now, let's assume when awarded your company stock was worth $10/share. Basically, every dollar the stock increases over $10 is worth $10,000 to you before-tax. Simple math, if the stock today is $25/share and you exercise, you don't have to come out of pocket to purchase the $10 option (so long as you are selling immediately). Rather, you just get the $15/share growth (10,000 shares = $150,000 value to you).

With stock options, you are taxed upon exercising the option. Since it's an immediate purchase and sale, you are taxed based upon ordinary income tax rates. Some companies will allow you to actually purchase the option. If you are able, you could possibly avoid paying taxes at ordinary income tax rates. If you own the option for more than a year, then exercised, you would instead pay at a long term capital gains rate. There are two concerns here:

1. Your company has to allow this to happen.

2. You would need the liquidity to afford the purchase. (In my example above, you would need $100,000 liquid just to cover the 10,000 shares.)

Although stock options can be lucrative, they also run the risk of being worthless. Remember, the option is only worth money for every dollar it increases over the issue price. For example, you received stock at $10/share. Over the lifespan of your option, it never goes above that $10 again. Your option would expire in what they call "out of the money." In other words, why would you purchase a stock for $10, if the fair market value is $5?

Why do companies give stock options?

Generally, stock options are awarded to executives in publicly traded companies. They are a great way to both compensate and incentivize these executive level employees. Stock options allow employees to partake in the profitability of the company. Most importantly, they are a "golden handcuff" for the employer. Most often it's hard for someone to walk away from many years of stock options, especially if there is substantial unvested value.

How do companies determine the value of the stock option?

Theoretically, when a company gives an employee a stock option it's worthless on day one. The option price to exercise is the same as the stock price. So, how do they assign a value to these options? Most companies revert back to the Black-Scholes Formula (defined here by Investopedia). This is a way to give a value based on expected price, growth, and time horizon of the underlining option. It is far from an exact science. However, it offers a good way to assign value onto an otherwise seemingly worthless option.

Final thoughts on options.

I have personally seen stock options change people's lives. Despite being riskier than their restricted stock unit counterparts, their upside is much greater. Thus, they have the ability to have a life altering effect. My advice is to work your hardest and try to get into the stock option pool as early as you can. The long term effect could be instrumental to your financial success.

CHAPTER 2

Restricted Stock Unit (RSUs)

Next up is part two of this four-part eBook focused on equity award nuisances. Let's keep the momentum going, shall we? This chapter will focus on stock options' little sister — the Restricted Stock Unit (RSU).

How does a RSU work?

Typically, an executive's first foray into the coveted equity pool is with some form of RSU. Basically a RSU is a stock given to an individual with a future ownership (or vesting) date. Once that occurs, the RSU is owned free and clear by the employee.

Let's take another example using DuPont. At DuPont (now DowDuPont), RSUs are typically given in February. They then vest 1/3 every year (starting on the first year anniversary). Therefore, if an executive is given 9,000 shares February 1st 2018, the first vesting would occur February 1st 2019 in the amount of 3,000 shares and then again the following two years.

When the vesting of shares occurs they are taxed as ordinary income. At that point, most companies withhold the taxes in the form of shares. Therefore, if you're in the 33% tax bracket, you'd be left with 2,000 shares in your account. The net value in your brokerage account becomes the value of the stock (at the time of vesting) multiplied by the amount of shares. Thus, if the shares are worth $100 at the time of vesting, your after-tax net value would be $200,000.

Unlike a stock option, when the stock trading price is above zero the shares will provide an immediate value in your account as long as the company is still around when these units vest. Also, there are no additional taxes owed on appreciation from the issue date to the vesting date. You are simply taxed at the fair market value the date they vest.

Once you receive RSUs for a certain number of years (in DuPont's case four years), you'll fall into a period of multiple vesting schedules at one time. Think of it like this: in 2021, you'll be get the last year vesting of the 2018 tranche, the second year vesting of the 2019 tranche, and the first year vesting of the 2020 tranche. Basically, it'll feel like you received one entire year of issue all at once!

Why do companies give RSUs?

Companies give RSUs for many of the same reasons they give stock options — to entice and keep key employees. Going back to my DuPont example, you can see if you leave the company at any point, you'll be giving up some amount of unvested units. Typically as you are moving up the corporate food chain, the amount of units given increases. Thus they become more valuable and harder to walk away from.

The other added bonus (from the company's perspective), is that they have a way to incentivize the employee and drive the value of the stock up. Company performance directly affects the stock price. At the end of the day, it aligns senior management, executives, and (most importantly), the shareholders to whom they are beholden.

How do companies determine the value of the RSU?

Thankfully, this is less convoluted than valuing a stock option. Instead, a RSU is given to you based on current value. Let's say your target employee bonus is 25% of your base pay. If you make $200,000/yr in base pay, that would be $50,000/yr in "bonus dollars." If your cash bonus is $30,000, then the company would give you $20,000 in restricted units. In our example of a stock being valued at $100/share that would mean you would receive 200 shares in addition to your cash bonus.

Final thoughts on RSUs.

The life altering ability of RSUs are less than stock options. That said, there is much more certainty and less finessing when handling them. Most people look at RSUs as "found money." Often, I see it as a source of funds for that addition on your home or payment for your child's college costs. RSU's are typically given before one enters the stock option pool and generally given in conjunction with stock options once you hit a certain level. My advice is to get into this pool as soon as you can. It makes you more desirable to other companies and is typically the first sign that you've "arrived."

CHAPTER 3
Strategies for Handling Stock Options

In parts one and two, I reviewed the intricacies of stock options and their impact. Let's now dive a little deeper. Here are a few of my favorite Equity Award Planning strategies.

Hopefully, you'll find them beneficial as you work on personal strategies to maximize these potential game-changing investments!

Two important factors.

Because of the below two factors, it's important you create a strategy which appropriately removes you from these positions.

First, if you receive company stock options, generally you are heavy tied to that company. Your salary, benefits, bonus, pension, restricted stock units, etc., are contingent on continued employment with that company.

Second, a stock option is a leveraged relationship. This means a dollar movement in the actual company stock has an exponentially larger impact to your total value (over you holding the stock outright).

Strategy 1: Utilize Dollar Cost Averaging.

I'll start with my favorite strategy for liquidating company issued stock options — dollar cost averaging! We've all heard about dollar cost averaging into the markets. But, what about flipping it on its head and dollar cost averaging out of the markets?

Think about it, why do we dollar cost average anyway? It's a way to ensure an average price on acquiring stock over a certain period of time.

If dollar cost averaging is reversed, how does that work? For starters, establish the expiration date of these options. From there, you work backwards. You'll establish a given time before that expiration date and start dollar cost averaging out. For illustrative purposes, let's assume 2 years from expiration to begin this process. Also, let's assume the option is a 10 year option. We typically want to start with the expiration date when utilizing this strategy; generally, we expect the stock value to increase over time.

Next, you create the frequency of exercising these options (i.e. dollar cost averaging out). I prefer quarterly when utilizing this strategy. Therefore, over the last 8 quarters of this options' shelf life, systematically liquidate every quarter on the quarter. Don't let the price, greed, or fear get in the way.

What you have now effectively done is:

1. Given your options maximum time to appreciate.
2. Taken any emotion out of the decision making process.
3. Assured yourself the average price over the given time period.
4. Have an actual strategy for handling your options!

Strategy 2: Find your number.

The first strategy is a great one, but it really tries to maximize the end result. This next strategy is much more planning focused. I liken this to "a bird in the hand." In figuring out your number (or stock price) which gives the desired yield, you have to shift your thinking. Focus more on the impact these dollars have on your financial goals.

Create a spreadsheet to understand what certain dollar increases mean to your net value. From here, you have a working model to understand the impact of specific stock prices to your pocketbook. Then, sit down with your financial planner (or someone who can help look at things objectively) and figure out what you would like to accomplish with these dollars.

I've seen many items on this list, including:

- I want to buy a boat!
- I want to pay for my children's college!
- I want that beach house!
- I want to retire 2 years early!

My point is this: if these dollars hit a price which allows you to accomplish your dreams... then what are you waiting for?! Put a limit order at your goal price and don't think twice.

It's common for people to change this sell price once the price gets close to the target. I caution you not to adjust, except in extreme circumstances. Fact of the matter is, you've done it. You've hit your goal! Why in the world would you ever want to jeopardize that? Remember the old adage: Pigs get fat, hogs get slaughtered.

Strategy 3: Combination of both.

The last strategy is a combination of both. Depending on the amount of options you've received, this might be a prudent solution. Let's say you want to pay off your mortgage, or fund your child's college tuition. Maybe there is a number which allows you to exercise some of your options and helps achieve a stated goal. Then, you can "roll the dice" on a bigger pie in the sky goal.

Perhaps you can have your cake and eat it, too!

Final thought.

These are three of the many strategies you can implement to handle your employer issued stock options. These happen to be a few of my favorites, however. It is important to remember no matter what, have a plan for them when issued. All too often I see people "winging it" and getting in their own way. Don't risk these plans on emotions or a "gut feeling." With the volatile and risky nature of stock options, it generally behooves you to have a plan in place.

Remember that's what we aim to do here at Diversified, so let's put that plan into motion!

CHAPTER 4
Strategies for Handling RSUs

Welcome to the final stretch of this 4 part series on equity award planning. Thus far, we've identified how stock options and restricted stock units operate, as well as strategies for dealing with stock options. For this final piece, I'll discuss my general thoughts on RSU planning and a few strategies for handling these awards.

What we know:

Receiving restricted stock units means you are heavily tied to your employment company (just as it is with stock options). Being more than just your salary, your compensation continues to align with the company's success (or failure).

Unlike a stock option, a RSU is not a leveraged relationship. A $1 increase in the stock price is simply $1 of profit for you. I like to refer to these as 1:1 relationships. They are no different than owning stock in any company for that matter; the exception is that you are employed by that specific company.

This logic means it's both important to understand the value to be gained and lost, as well as the risk worth taking and the risk worth avoiding. Below, you will find some expert thoughts on these restricted stock units.

Strategy 1: Sell! Sell! Sell!

This happens to be my favorite strategy in most cases. Ideally, the restricted nature of these units allow a few years of growth from when it was first issued. Once received, I generally see little reason to stay so concentrated in any one position. At Diversified, we believe in broad diversification at its core. Even though you continue to work for the company, we don't see this general philosophy changing. The risks associated don't change just because they are your employer.

You are taxed when you receive the RSU. Therefore, why not sell it at that time to help diversify more appropriately in your portfolios? There is generally more risk to be had on the down side (over the upside) by holding a heavy concentration in one position. That's why we typically try to have our clients avoid these risks.

I recognize sometimes you are very close to the situation and it may be hard to see the forest from the trees. However, that is why we partner with our clients. We help frame the dialogue and see the "big picture."

Strategy 2: Set a limit and stick to it!

I gave similar advice when it came to stock options. I've called on this strategy when:

1. There is a strong conviction to a stock (or its heightened growth potential).
2. When we've seen an unusual dip in the price.

I'll give an example of each; I've seen them both play out:

Example 1: You believe in heightened growth.

We've worked with some companies that were/are in the midst of merger talks. Everyone's general belief is this is a really good thing for the company. They have also seen when talks get heated, the stock price spikes. Conversely when these deals fall through, the stock reverts back to its previous trading price (or below). This would be a case where picking a certain stock price could be beneficial.

Example 2: We've seen an unusual dip.

Chemours (a company we deal a lot) went through a very similar situation. When they spun off from DuPont into an independent company, the stock instantly dropped. It went from about $20/share to about $3/share. Lots of executives had RSU's given to them at the higher price of $20. When they vested, these shares were worth a fraction of what they were when issued. There were still strong fundamentals to the company, however. So, this was a great circumstance to hold onto the stock until it hopefully rebounded. (Spoiler alert, it did rebound. Now it has been trading in the $50 share range.)

Whichever of the two main reasons lead you to hang onto this closely held stock, it is important to keep a few things in mind:

1. Think through your threshold of risk and the return necessary to get what you expect out of this stock;
2. Don't deviate from this initial strategy; and
3. Check your emotions at the door.

That was a mouth full.

There you have it — our high-level thoughts on equity awards. They are exciting, but also nerve-wracking at the same time. A lot of thought and strategy should go into deciding which path is best for you. It is one part science, one part math, and one part experience. If you don't think you are equipped to handle all three, we suggest working with someone you feel comfortable with who can help fill the void(s).

We welcome the opportunity to speak with you. If you have any questions about anything you read in this eBook or general questions about financial planning and wealth management, please don't hesitate to contact one of the partners.

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