Building Your Stock Options and Restricted Stock Strategy

Topic: Fitting Your Options and Restricted Stock Strategy into Your Financial Goals

Author: Terry L. Kaul, CFP

Sponsor: Vantage Financial Partners Limited

Date: June 25, 2001 as updated January 11, 2005

Executive Summary: There are four cornerstone strategies that must be balanced to meet the individual financial goals of the executive. Each of the four is explained and analyzed.

At Vantage Financial Partners, we will analyze your stock options and restricted stock to create a plan geared to helping you achieve your financial goals. The specifics of your Nonqualified Stock Options (NQSOs), Incentive Stock Options (ISOs), and Restricted Stock Plans (RSPs) are considered as well as your goals and tax situation. We begin by creating cornerstone strategies that maximize each of the following:

- Highest Value – greatest Total Portfolio Value (TPV)
- Cash flow – least out -of-pocket expenses created by stock options and restricted stock
- Diversify – best reasonable diversification within the stock option and restricted portfolio
- Taxes – minimize tax liabilities created by stock options and restricted stock

The best of each cornerstone strategy is incorporated to design Your Stock Option and Restricted Stock Strategy.

Highest Value

This strategy is designed to give you the greatest Total Portfolio Value (TPV) from your stock options. You purchase the stock in the year the option expires and then hold it until the end of the 15-year period. We assume stock performance will meet or beat the performance of a diversified portfolio in order to obtain the highest value. To implement this strategy you will need cash to exercise the options and pay the annual tax consequences. It would need to stay invested for the remaining of the 15 years. If the above assumptions are true, then this strategy will provide you with the greatest Total Portfolio Value (TPV), but it will also entail the greatest risk. If the company stock under performs a diversified portfolio, then this strategy will not return the highest value. You also risk not only the options themselves, but the cash you have invested as well.

Cash Flow

This strategy is designed to eliminate the need for you to use available cash to exercise your options. Each option is exercised as late as possible to achieve the greatest Total Portfolio Value (TPV), but each year, some of the stock is sold to pay taxes and cover the cost of exercising other options. In this strategy, there are no proceeds available to diversify your portfolio until the end of the 15-year period, so it does not provide diversification protection, but it does minimize the risk of having other monies invested.

Diversify

This strategy acknowledges that the greatest risk involved in planning for your stock options is the performance of your company stock. To minimize this risk, we assume that you will exercise and sell enough stock each year to achieve a targeted level of diversification each year. Usually we aim for a portfolio with 20% diversification in the first year, 40% in the second, 60% in the third, 80% in the fourth and 100% in the fifth year. This will vary depending on individual circumstances. Using diversification minimizes the risk of having the entire portfolio invested in company stock. It is furthermore assumed that you will use proceeds from the exercise of stock options each year to pay tax liabilities from the options.

Taxes

This strategy works to minimize tax liabilities associated with stock options. Some stock options (ISOs) have tax advantages and tax pitfalls. We consider federal and state income tax, capital gains tax and alternative minimum tax (AMT). Although these taxes cannot be eliminated, there are advantages spreading the tax liability over several years and paying a lower overall rate. This strategy does not provide diversification. Ironically, paying the least in taxes does not always provide the highest Total Portfolio Value because of other factors such as company performance. That is why tax minimization is only a part of a well-designed stock option strategy.

Your Stock Option and Restricted Stock Strategy

To design your personalized stock option strategy, will combine components from each of the cornerstone strategies. Your goal may be to use the stock options portfolio to fund education or retirement goals. You may want to generate an annual income stream. Perhaps other facets of your tax situation make avoiding AMT your highest priority. Whatever your goals, we will create a strategy for you that balances each of the cornerstones while providing for your needs.

Because each facet of your portfolio will be affected by the performance of company stock, your tax situation and changes in your personal goals, we recommend at least an annual evaluation to ensure your strategy is working for you.

The information contained herein is of a general nature and should not be relied upon without first consulting a financial advisor. If you would like further information please email info@vantagefinancial.com.

VANTAGE FINANCIAL PARTNERS LIMITED
Nine North Vail Avenue, Arlington Heights, IL 60005-1430
(847) 590-9191 Fax (847) 590-9009
www.vantagefinancial.com