Executive Stock Options

How to Maximize Your Returns While Minimizing Your Risk

SPECTRUM
ASSET MANAGEMENT, INC.

Employee stock options are great... as long as you understand them.

In theory, stock options are simple.

Your company grants you the option to buy a certain quantity of stock at a set price (the “strike price”). When your options vest, you exercise them. Sometime later you sell the stock and pocket the profit. However, the reality of managing your options is anything but simple.

Stock options can be confusing even for experienced investors, and many employees (including executives) have lost a heck of a lot of money by making some very avoidable mistakes.

The difficulty with stock options largely boils down to three areas:

- **Valuation:** Calculating the value of your stock options (and identifying whether your portfolio is overly concentrated in your company’s stock).
- **Timing:** Deciding when to exercise and when to sell your options for maximum returns.
- **Taxes:** Understanding the tax implications of exercising and selling your options at different times.

In this ebook, we’re going to lay out the basic concepts you need to know in order to make the right decisions for your portfolio.

How much are my stock options worth?

Before you can decide how and when to exercise and sell your options, it's important to understand what you have.

Unfortunately, options are much more difficult to accurately value than ordinary stocks. There are simply more variables to consider. And it's important to understand that while ordinary stocks have a definite value (their fair market value), employee stock options don't. Because they can't be sold on the secondary market, their value can only be estimated.

The value of a stock option includes a variety of factors in their calculations, including the current fair market value of the stock, your strike price, the maturity date (or expiration date), prevailing interest rates, the volatility of the company's stock, and the company's dividend rate.

How much of my portfolio should my employee stock options make up?

To make wealth, bet on yourself and have a concentrated position. To keep wealth, diversify.

Executives often have too much of their net worth tied up in company stock options, and many of them don't even realize it. Like any concentrated position, this puts you at significant risk of losing a big chunk of your portfolio in one fell swoop.

Executives often have too much of their net worth tied up in company stock options, and many of them don't even realize it.

Broadly speaking, advisors tend to recommend that a firm's stock make up no more than 10%-60% of your total portfolio. Where you fall in that range depends on your personal goals and risk tolerance, and time frame. What is most important is to consciously choose the percentage.

So if your portfolio is too heavy in company stock options, what do you do? The short answer is you hedge the position or exercise some of those options, sell the stock, and diversify by putting that money into other investments.

But like everything else with stock options, it's not as simple as it sounds.

There are a lot of considerations to take into account, including the current value of your company stock vs your strike price, where you are in your vesting schedule, your options' expiration date, and the tax implications of exercising and selling your options on different timelines.

We know that sounds like a lot to untangle. That's because it is. The best course of action is almost always to have an advisor who's knowledgeable about options lay out the different scenarios and help you build a multi-year plan.

And the sooner, the better. The last thing you want is to be scrambling to exercise your options ahead of a fast-approaching expiration date. That's a great way to end up in an undesirable tax situation (not to mention the risk of losing your options altogether).

The best course of action is almost always to have an advisor who's knowledgeable about options lay out the different scenarios and help you build a multi-year plan.

What are the tax implications of exercising and selling my options?

Taxes are always a primary consideration when deciding when to exercise and when to sell your options.

The tax treatment for your options depends first of all on which type of options you own: Incentive Stock Options (ISOs) or Non-Qualified Stock Options (NQs).

Tax treatment for NQs is fairly straightforward: NQs are taxed upon exercise (at income tax rates), and again when the shares are sold (this time at capital gains tax rates). With ISOs, it's a bit trickier.

ISOs have tax advantages… but there's a catch

You only report taxable income from ISOs when you sell the stock (not when you exercise them, like with NQs). And if you hold the stock for long enough, your profits from selling are subject to capital gains tax rates, which are typically much lower than income tax rates.

However, there is a catch with ISOs. You must report the "bargain element" (the difference between your strike price and the fair market price of the stock) as part of your Alternative Minimum Tax (AMT) calculation in the year you exercise the options. This means you could end up paying more in income taxes.

In some cases, this might cancel out the savings you would get from paying capital gains tax rates on the sale of the shares.

The only way to avoid reporting the bargain element as part of your AMT calculation is to sell the stock in the same calendar year in which you exercised the options. But then, of course, you lose the perk of having your profits taxed at capital gains rates. They will instead be taxed at ordinary income rates.

Confused? Don't feel bad. Even financial professionals sometimes struggle with weighing all of the tax implications that come with exercising and selling options. That's why it's so important to have someone run the numbers on every scenario and help you weigh your options (no pun intended). For the most part firms have phased out the use of ISO's.

Long-term planning is the key to managing your stock options

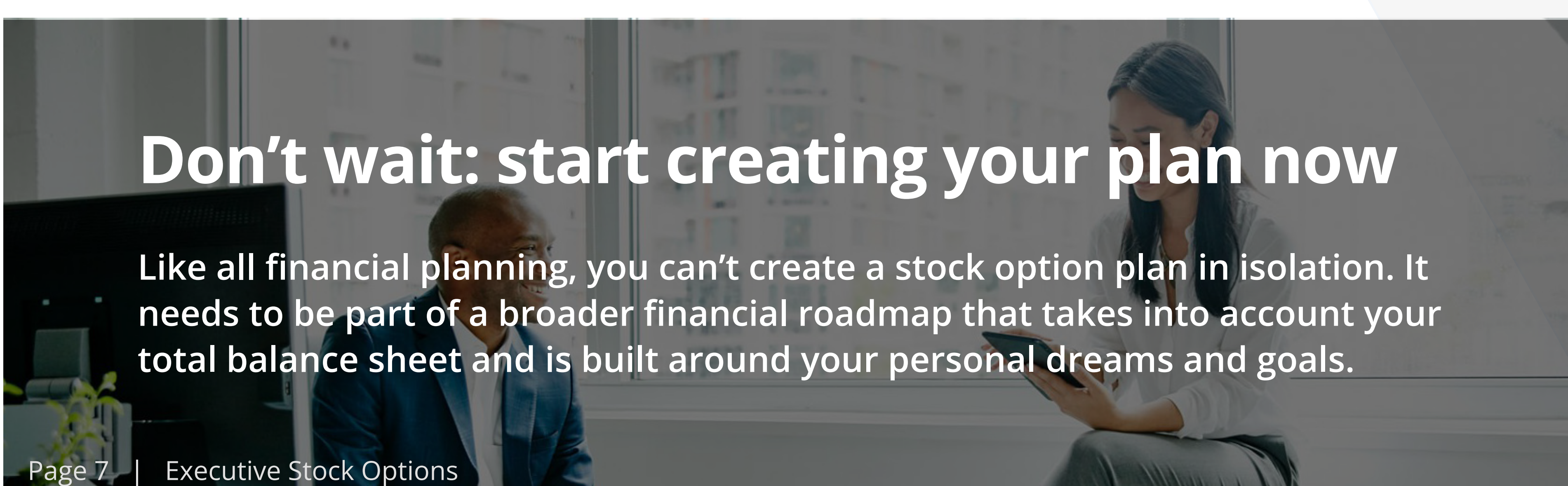
If you take only one thing away from this ebook, make sure it's this: **maximizing your returns from employee stock options requires a long-term plan.**

It's not a one-time decision. The best course of action is often to exercise and sell your options gradually, according to a strategic plan that:

- Maximizes your returns
- Minimizes your taxes
- Allows you to create and maintain an adequately diversified portfolio
- Provides you with the rate of cash flow you need or desire
- Keeps your risk at an acceptable level

Is it possible to do this on your own? Well, technically yes. But for the vast majority of people with employee stock options (especially busy executives), it's simply not worth it. There are too many pitfalls and it takes a tremendous amount of planning to get it right.

So seek out a knowledgeable advisor who understands employee stock options inside and out. Your future self will thank you.



Don't wait: start creating your plan now

Like all financial planning, you can't create a stock option plan in isolation. It needs to be part of a broader financial roadmap that takes into account your total balance sheet and is built around your personal dreams and goals.

About Spectrum Asset Management

Spectrum Asset Management provides comprehensive wealth management services to successful individuals and business owners. Instead of putting you on an assembly line in a financial planning factory, we take the time to understand your personality, your situation, and your ultimate goals. The result is a customized financial plan that helps you build your wealth, transfer your assets across generations, and invest in ways that align with your values.

Contact us today to find out how we can help you create certainty and peace of mind about your financial independence.

SPECTRUM
ASSET MANAGEMENT, INC.

Disclosures:

The opinions expressed in this eBook are those of Spectrum Asset Management and are subject to change without notice. This eBook is provided exclusively to current and prospective clients of Spectrum. It is intended to provide information only and does not constitute an offer to buy or sell any security. This eBook is not intended to provide personal investment advice and does not take into account the unique investment objectives and financial situation of the reader. Investors should only seek investment advice from their individual financial adviser. Information provided in this eBook includes information from sources Spectrum believes to be reliable, but the accuracy of such information cannot be guaranteed.