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CAPITAL MANAGEMENT

Employee Stock Ownership – Risks and Rewards

“Money can’t buy happiness, but it can buy you the kind of misery you prefer.”
- *Author Unknown*

"I'M NOT GOOFING OFF. I'M LETTING MY MONEY WORK FOR ME."

Today, more and more employees are incentivized to invest or hold onto their company’s stock. No place on earth is this truer than in the Bay Area, where many established and early stage technology companies rope in talent by offering equity-based compensation. Owning company stock could feel safe for many employees as they may believe they are in a position to know a lot about their business. However, putting most of your money in just one company, no matter how well you think you understand it is risky. While putting most or all of your savings in the company where you work could be reckless.

What to do with an over-concentrated position in your employer’s stock is one of many things to consider when working with a financial adviser on strategies to diversify and

decrease risk. Fidelity Investments recently put together a thoughtful list of mistakes to avoid on this very subject. For this month's newsletter, I'd like to present an edited version of their list below, which highlights what I believe to be the most important considerations.

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Employee Stock Plan Mistakes to Avoid

Company stock grants and employee stock purchase programs can be good opportunities to help build potential financial wealth. When managed properly, these benefits can help pay for future college expenses, retirement, or even a vacation home.

But many investors get tripped up, don't pay attention to critical dates, and haphazardly manage their employee stock grants. As a result, they may lose out on the many benefits these stock plans can provide.

To help ensure that you maximize your benefits, avoid making these common mistakes:

Mistake #1: Concentrating too much of your wealth in company stock
Earning compensation in the form of company stock or options to buy company stock can be highly lucrative, especially when you work for a company whose stock price has been rising for a long time. At the same time, you should consider whether you have too much of your personal wealth tied to a single stock.

Why? There are 2 main reasons. From an investment perspective, having your investments highly concentrated in a single stock, rather than in a diversified portfolio, exposes you to excess volatility based on that one company. Moreover, when that company is also your employer, your financial well-being is already highly concentrated in the fortunes of that company in the form of your job, your paycheck, and your benefits, and possibly even your retirement savings.

Second, history, is littered with formerly high-flying companies that later became insolvent. Consider, too, that income from your employer pays your nondiscretionary monthly bills and your health insurance. Should your company's fortunes take a turn for the worse, you could find yourself out of a job, with no health insurance and a depleted nest egg.

Stock from an equity plan can be a large component of an employee's annual compensation, so it's easy for your portfolio to become overly concentrated in your employer's stock. You may need to take a step back, consider how these benefits fit into your long-term financial objectives and develop a plan to diversify accordingly.

Tip: Consult with a financial adviser to ensure that your investments are appropriately diversified.

Mistake #2: Failing to understand the tax consequences of ISOs
There are 2 kinds of stock option grants: incentive stock options (ISOs) and nonqualified stock options (NSOs). When you receive an ISO grant, there's no immediate tax effect and you do not have to pay regular income taxes when you exercise your options, although the value of the discount your employer provided and the gain may be subject to alternative minimum tax (AMT).

However, when you sell shares of the stock, you'll be required to pay capital gains taxes, assuming you sold the shares at a price higher than your strike price. To qualify for the long-term capital gains rate, you must hold your shares at least 1 year from the date of the exercise and 2 years from the grant date.

If you sell ISO shares before the required holding period, this is known as a disqualifying disposition. In such a case, the difference between the fair market value of the stock at exercise (the strike price) and the grant price—or the entire amount of gain on the sale, if less—will be taxed as ordinary income, and any remaining gain is taxed as a capital gain. For most people, their ordinary income tax rate is higher than the long-term capital gains tax rate.

While taxes are important, they should not be your sole consideration. You also need to consider the risk that your company's stock price could decline from its current level.

Tip: Consult with a tax adviser before you exercise options or sell company stock acquired through an equity compensation plan.

Mistake #3: Not knowing stock plan rules when you leave the company
When you leave your employer, whether it’s due to a new job, a layoff, or retirement, it's important not to leave your stock option grants behind. Under most companies' stock plan rules, you will have no more than 90 days to exercise any existing stock option grants. While you may receive a severance package that lasts 6 months or more, do not confuse the terms of that package with the expiration date on your stock option grants.

If your company is acquired by a competitor or merges with another company, your vesting could be accelerated. In some cases, you might have the opportunity to immediately exercise your options. However, be sure to check the terms of the merger or acquisition before acting. Find out if the options you own in your current company's stock will be converted to options to acquire shares in the new company.

Tip: Contact HR for details on your stock option grants before you leave your employer, or if your company merges with another company.

Mistake #4: Ignoring your company's employee stock purchase plan
Employee stock purchase plans (ESPPs) allow you to purchase your employer's stock, usually at a discount from the stock's current fair market value. These discounts

typically range from 5% to 15%. Many plans also offer a "look-back option," which allows you to buy the stock based on the price on the first or last day of the offering period, whichever is lower. If your company offers a 15% discount and the stock rose 5% during the period, you could buy the stock at a 20% discount, already a healthy pretax gain.

Unfortunately, some employees fail to take advantage of their company's ESPP. If you are not participating, you may want to give your ESPP a second look.

Tip: Look at your current savings strategy—including emergency fund and retirement savings—and consider putting some of your savings in an ESPP. You may be able to use future raises to fund the plan without impacting your lifestyle.

Mistake #5: Failing to update your beneficiary information
As with your 401(k) plan or any IRAs you own, your beneficiary designation form allows you to determine who will receive your assets when you die—outside of your will. If you have made no beneficiary designation, under most plan rules the executor (or administrator) will, in fact, treat equity compensation as an asset of your estate.

Each time you receive an equity award, your employer will ask you to fill out a beneficiary form. Many grants range in life from 3 to 10 years, during which time many factors can change in your life. For example, if you were single when you received an option grant, you may have named a sibling or parent as the beneficiary. But 5 years later, you may be married with kids, in which case you would likely want to change your beneficiaries to your spouse and/or children. The same holds true if you were married and got divorced or divorced and remarried. It's important to always update your beneficiaries.

Tip: Review your beneficiaries for your equity award as well as your retirement accounts on an annual basis.
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Sincerely,

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