BOULDER COUNTY BUSINESS REPORT

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Consider hedging company stocks/options

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Life gets in the way of your best intentions. As a busy executive, work and family usually are your highest priorities, while portfolio management gets left to a few moments on weekends and evenings.

Owning company stock and/or options throws an extra challenge into the mix. Overconfidence can lead to an underestimation of the real risk of these investments. Since you work for the company you feel that you will be able to tell in advance when to get out of the stock, even though you are not supposed to.

But trying to find the best strategies to hedge or dispose of your company stock and options can be a daunting task. Hedging your company stock requires skill and persistence and knowledge of sophisticated techniques.

The most common strategy is to create a collar on the stock, establishing a ceiling and floor to which the stock can't go above or below. To do this, you purchase a put option on the stock and sell a call option.

For this example, we'll assume you own 10,000 shares of stock XYZ and the price is $50 per share and your cost basis is $25 per share. First, figure the option expiration date you should use to hedge your stock. Typically, option expirations run in three-month cycles, so options would expire in three, six or nine months, or one-year time frames with some options expiring in as long as two years.

If it's a six-month expiration, you would purchase a put option that expires in six months and sell a call option that expires in six months. Say you purchase 100 June 40 puts for $4 (one put hedges 100 shares, so 100 puts hedge 10,000 shares) and you simultaneously sell 100 June 60 calls for $4. You have effectively hedged your stock for no cost or in other words have created a zero cost collar.

We also forgot to mention that all this has to happen simultaneously otherwise you are exposed to individual company risk. A typical individual company stock is two- to three-times more risky that a diversified portfolio of mutual funds. Now that you are hedged you have to understand the mechanics of the hedging. On expiration day which is the third Friday in June, your stock will be sold if it is above $60 or below $40 per share.

GUEST OPINION

Robert J. Pyle

You might think you are all set, but other things can occur to derail your plans. You have muted the range of outcomes for your company stock to plus-or-minus 20 percent, or basically what you would expect from a diversified portfolio over a six-month period.

Now suppose the stock closes at $51 per share on the third Friday in June, then you have to redo the whole process again by buying 100 December 40 puts and selling 100 December 60 calls. In this case, you may even make a little money, but no point should you leave your company stock unhedged at the risk of the stock losing more than 20-percent of its value overnight

Logistically, the continuous hedge requires a lot of work. For example, if you chose options that expire on the third Friday in June and you wait until the next Monday to re-hedge, you are exposed to company stock risk all weekend, which can be unsettling. What if you are in a blackout period during the time the options expire and you can't rehedge your position? Or, what if the blackout period lingers longer than expected leaving your position unhedged?

Alternatively, you could purchase the call and sell the put before expiration but this would also result in another set of transaction costs and then rehedge with another set of options all in one day. This will take time and discipline and also double your transaction costs.

Other options might include selling some your company stock for a profit while tax rates are low in exchange for investments in a diversified portfolio of stock and bond mutual funds around the world. Either option would likely reduce investment risks and stress, while increasing free time with your family and doing the things you love.

Robert J. Pyle is president of Boulder-based Diversified Asset Management Inc. and an investment adviser registered with the Securities and Exchange Commission. This column reflects the writer's views and is not a recommendation to buy or sell any investment. Pyle can be reached at 303-440-2906 or via email at rpyle@diversifiedassetmanagement.com.