

Hedging Strategies for Protecting Appreciation in Securities and Portfolios

by Mark A. Miller, J.D., CFP

Despite recent U.S. stock market weakness, many clients and trusts still have securities or portfolios with large amounts of appreciation and low cost basis. A developing legal standard is placing a higher level of scrutiny on the diversification decision-making process. Also, there is a growing belief that all reasonable diversification strategies should be considered, including hedging strategies.

Because the financial planner often has the broadest view of a client's overall financial situation, awareness of this topic is important. This article discusses the developing legal standard for diversification and provides actual cases illustrating the successful use of hedging strategies, including an overview of the tax issues at the core of hedging strategies.

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Hedge: A conservative strategy used to limit investment loss by effecting a transaction that offsets an existing position.¹

Despite the weakness of many stocks in the U.S. stock market over the last few years, many individuals and trusts still have highly appreciated securities in their taxable portfolios due to the strong rise in stock valuations over the last 20 years.² These stocks may be a large percentage of the overall portfolio (concentrated positions) or low-percentage holdings worth large amounts. While this level of appreciation is wonderful for the owners or trust beneficiaries, it needs to be carefully monitored and protected.

Financial planners are often in the unique position of having a broader view of a client's overall financial situation than the client's other advisors. The investment advisor and trustee may not have such a broad financial view. Therefore, the financial planner may be the most likely advisor to identify and address situations where a client's appreciated security or portfolio might need to be protected from decreases in value. Moreover, there is a growing school of thought that financial planners, investment advisors and trustees may now have a duty to understand the use of applicable hedging techniques.³ Once hedging techniques are understood, they can be rationally discarded or implemented so as to achieve the most appropriate mix of risk and return for clients and trust beneficiaries.

The purpose of this article is to provide financial planners with an overview of the primary hedging strategies that are the most straightforward and conservative, and provide situational uses. As part of the analysis, a review of the tax aspects of hedging strategies is very important because tax savings are one of the primary benefits of hedging strategies.

Protecting Appreciated Securities May Require Quick Decisions

In most situations, protecting portfolio appreciation can be accomplished in a measured and well-reasoned process after a thorough examination of all relevant facts. Yet more recently, large declines in value have been occurring without adequate time to fully unpack the reliable information and sort through the rumors and untruths, while waiting for the release of the true facts. While non-taxable accounts can sell without concern over taxes, clients with highly appreciated positions may be served by hedging strategies that permit time to evaluate and then later decide whether to hold the security (with no taxable sale), or sell.

Duty to Diversify and Hedge Against Declines in Value

While the duty to diversify and hedge appreciated or concentrated holdings (and the duty to recommend diversification and hedging) is not the focus of this article, it is worth a brief discussion. The recent Levy⁴ case provides an excellent fact pattern for an overview of the claims that can arise in the area of the financial advisor's duty to diversify or recommend hedging strategies.

In the Levy case, which does not involve a testamentary trust or the Prudent Investor Rule being adopted by many states, the plaintiff received stock in Corning Inc. through a stock merger with his privately owned company. The Corning stock represented \$8 million in value but was restricted from sale for one year. The plaintiff, on several occasions, made it very clear to the defendant—an investment advisor and trust company—that he wanted his Corning stock to be protected from a decline in value during the restriction period, if possible. The defendant held itself out to the public and to the plaintiff as having sophisticated wealth management and financial planning expertise. The plaintiff alleged that the defendant said that hedging the downside risk of the restricted stock was not possible. The plaintiff later learned from another investment firm that hedging the restricted stock was possible and the plaintiff implemented a hedging strategy (using a combination of put options and call options to provide a floor and ceiling value on the stock) with another investment firm, but only after suffering losses in Corning stock prior to the time the new hedge was in place. The case settled before trial.

While the Levy case involved an investment advisor's duty to hedge, the investment advisor held itself out as a broader wealth management firm that provided financial planning counsel and services. Therefore, Levy is good food for thought for all financial planners.

Not only is the duty to diversify a necessary standard to evaluate, there is a growing persuasion that, in making the diversification decision, all reasonable methods of diversification should be considered. As fiduciary expert George Crawford says, "This tool [hedging strategies] is now so widely used that it should be in every fiduciary's tool kit, even if used only carefully and sparingly. Like any other tool, it can be used, or misused."⁵

The Simple Sale Compared with Hedging Strategies

We fully expect that in most situations a sale is the best decision when it is necessary to further diversify a security or asset class. Offsetting capital gains with capital losses helps make the sell decision the preferred method of protecting appreciation. But over time, the unrealized gains in an equity portfolio should be much larger than the available unrealized losses.⁶ While this is an excellent result for most clients and their investment advisors or trustees, it can be a difficult situation for investment advisors or trustees who inherit highly appreciated securities and portfolios from new clients. Often these gains are in stocks not recommended or followed by the trustee or investment advisor. In these cases, it is important to have an array of choices available to protect gains in various situations, unless an automatic sale is required for all securities not on a firm's approved stock list.⁷

Many state laws, uniform trust investment acts and national regulatory agencies have concluded that hedging strategies are neither inherently prudent nor imprudent.⁸ Unfortunately, the use of hedging strategies for private investment portfolios and trusts is often neglected due to their perception as complex, risky assets. We wish to present an accurate view of hedging strategies and their possible use for taxable private portfolios. Many individuals, such as David McCourt (see section titled "A Real-Life Success Story of Hedging") can thank hedges for saving a substantial portion of their net worth.

Overview of Hedging Strategies

There are as many possible hedging strategies as the creative mind can structure. Therein lies the legitimate concern that hedging strategies can be misused. Furthermore, financial planners might fear that merely suggesting the consideration of a hedging strategy could tarnish their reputation. Yet, once the basic strategies are understood, clients can be educated about their ability to minimize risk, not add risk, in appropriate situations. At their core, defensive hedging strategies transfer the risk of a price decline to another party. Given that appreciation rates for equities the last 20 years have been well above long-term averages, it would seem that clients and their advisors would be open to the concept of transferring price decline risk to others, if the strategies, including costs,⁹ are appropriate.

The short sale. A short-sale strategy involves selling stock borrowed from a third party. If the stock declines in value, the stock is purchased on the open market at a lower price than the initial sales price. The purchased stock is returned to the third party, and the difference between the initial sales price and subsequent purchase price is taxable profit to the short seller.

The short sale can involve stock of a company currently owned in the portfolio. This technique offers perfect correlation because there is a direct offset to declines in the stock and increase in the short sale technique. Often called "short against the box," this hedging technique is fairly straightforward, but has negative tax implications (see discussion of constructive sale rules under "Tax Analysis of Hedging Strategies") and is therefore no longer an effective hedging strategy.

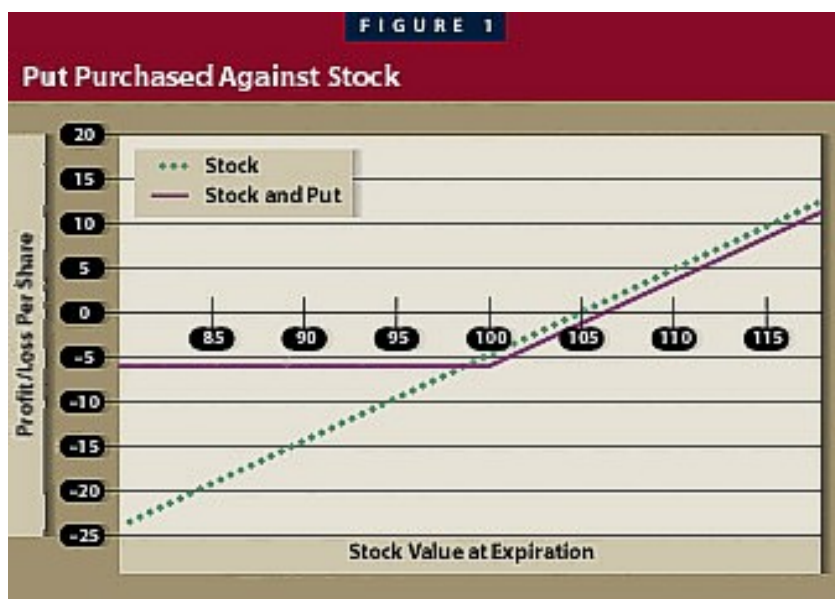
Alternatively, the short sale can involve stock of a company in the same industry, which has a close, but not perfect correlation to the stock that is being protected. An example of this technique might be a client or trust that owns a very significant holding in SBC Communications and sells short a similar amount of Verizon or Bellsouth, all three being U. S. local telephone companies with growing wireless businesses. Yet any time correlation is not absolute, the hedging strategy can go awry. It is impossible to hedge perfectly against fraud or massive liability that is specific to one company.

More recently, exchange-traded index funds have been introduced that permit certain baskets of stocks to be sold short. This can provide a more broadly diversified correlation, such as selling short the S&P health care sector to hedge against a large Merck position, or selling short a communications sector index to hedge against a large SBC position.

The put option. The purchase of a put option permits investors to limit the downside risk of a stock while retaining the opportunity for stock appreciation.¹⁰ A put option permits the purchaser of the put option to sell a certain number of shares at a pre-determined price (the strike price) within a pre-determined time frame. The primary advantages of a put option are

- The investor retains the appreciation potential on the optioned stock.
- The investor's maximum loss on the put option is the amount paid for the put option.
- No capital gains tax is triggered on the stock if the transaction is structured properly.

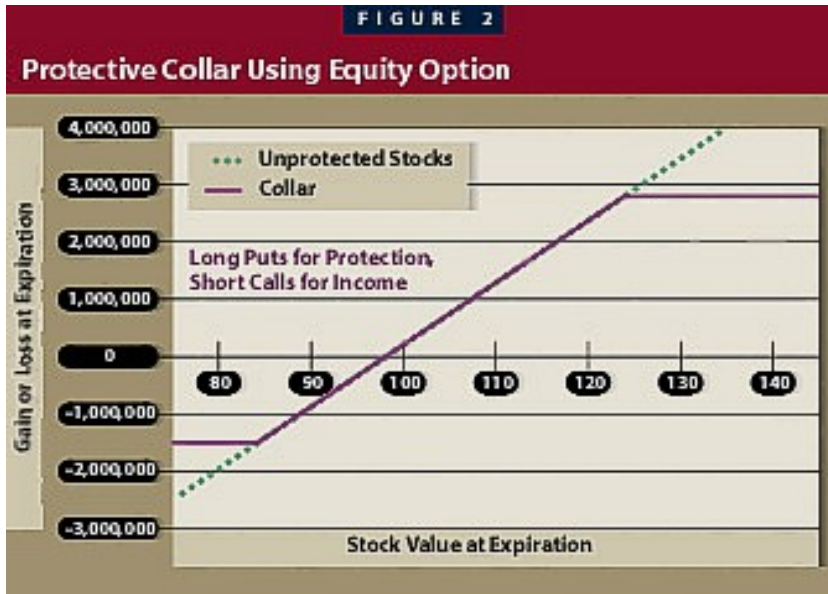
As with short sales, put options can be purchased on the stock that needs protecting (for direct price movement correlation) or can be purchased against a similar stock or index with fairly close correlation. Figure 1 illustrates how stock combined with a put option (purple line) can protect the stock from a decline of more than five percent while permitting full appreciation, whereas the stock alone (green dotted line) has full downside and upside potential.



The collar. A collar involves the purchase of a put option to protect against stock price declines combined with the sale of a call option. As described previously, the put option is structured to limit a price decline according to pre-

negotiated terms for a cost, or a premium. By selling a call option, the investor sells to a third party the right to purchase the optioned stock according to pre-negotiated terms, usually with a corresponding expiration date to the put option. The investor gives up the stock appreciation above a certain price but receives a premium in return, which can offset the cost of purchasing the put option. If the premium received from selling the call option completely covers the cost of the put option the net cost of the entire hedge is zero, otherwise called a "cashless" or "zero cost" collar.

As shown in Figure 2, the collar (purple line) shows a floating value for the hedged stock, with a limit on the upside and downside even though the unprotected stock price (indicated by the green dotted line) can proceed higher or lower than the collar limits.



Collars can be placed on the appreciated stock for exact correlation, but there are some tax issues to consider with collars. The tax issues applicable to collars, and other basic hedge techniques, are discussed later in this article.

Why Hedge, Not Sell

The key question is, why not simply sell a security rather than use a hedge strategy to protect the appreciation of a security or overall portfolio? While there are many reasons to consider the use of hedging strategies, the primary ones include

- A client (which may be an individual or a private trust) is uncomfortable with a large percentage of value in a single stock—that is, a concentrated portfolio—but does not wish to sell and trigger capital gains taxes at the present time.
- A client has a large holding that is facing a potentially substantial decline, but that likelihood is not certain. The holding may continue to appreciate. Time is needed to make a good decision. A hedge may provide time with no adverse tax consequence.
- A client may own a large position in a stock that has trading restrictions due to IPO (initial public offering) lock-up provisions, or trading restrictions imposed by the government or the company due to insider status or other factors.
- An individual with a short life expectancy due to advanced age or illness (or as spousal beneficiary of a marital trust) may wish to protect against a decrease in stock or equity portfolio value, but does not wish to sell because the appreciated positions would receive a step-up in basis at death.
- An individual may be in need of liquidity for a new home purchase, payments to creditors or other cash flow needs, but does not wish to trigger capital gains taxes. By entering into a hedge strategy, the minimum value of the appreciated position can be fixed, providing an asset that can serve as collateral for loans.

Reasons Hedging Strategies Are Not Considered

Many advisors to clients and trusts with taxable portfolios do not consider hedging strategies for several reasons. There is the required time commitment, the complexity of the issue, and the fear of what other people, including the client or other advisors, might think of the advisor who recommends consideration of hedging strategies (that is, reputation risk).¹¹ An underlying trust document might restrict the use of options and short selling. The investment guidelines of a corporate trustee might prohibit certain hedging strategies. Also, the client might not be sophisticated enough to make an informed decision if presented with a hedging strategy. But ignorance on the part of the financial planner and inaccurate perceptions by others (which themselves are often based on ignorance) should not be the reason to decline examining a legitimate risk management tool.

A Real-Life Success Story of Hedging: WorldCom

In 1996, MFS (a telecom company) was acquired by WorldCom in a \$12 billion all-stock, tax-free merger. David McCourt, who is now CEO of RCN, a publicly traded cable/telephone company, was a large investor in MFS and sat on the MFS board of directors. Before hedging his stock in the new MFS WorldCom, his 812,000 shares were valued at roughly \$25 million. McCourt was acquainted with the management of WorldCom but did not know it well enough to place a substantial portion of his net worth at risk, dependent on their success in running WorldCom. As a previously cited investment company president has put it in facing the same situation, "...today we have all our eggs in one basket, but we own the basket; if we take your stock, we'd still be all in one basket, but you'd own the basket, and that's an enormous difference!"¹²

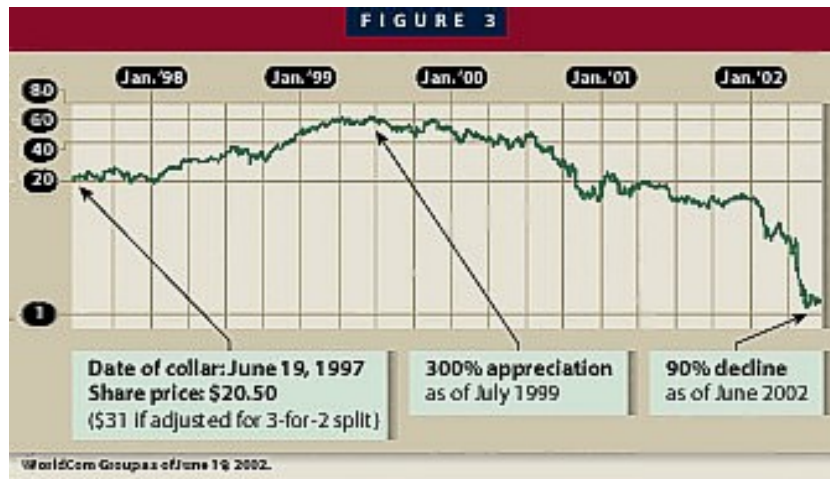
McCourt had a similar view. "I wanted to protect my holding because when you sell something for stock, and you don't know the people, it's a smart way to manage the investment."¹³

McCourt protected his \$25 million position in MFS WorldCom by entering into a "cashless collar." McCourt sold call options, which obligated him to sell his 812,308 shares at \$64 a share, giving up any appreciation above that price for a period of five years from the option date of June 19, 1997. McCourt used the funds received from that transaction to purchase put options which gave him the right, for five years, to sell his shares at \$28 a share, protecting himself from a decline in the share price below \$28. Due to a split in WorldCom stock, his 812,308 shares increased to 1,218,462 shares.

Therefore, McCourt's investment could fluctuate between \$28 and \$64 a share for five years, but no more or less. Put another way, his \$25 million in MFS WorldCom could fluctuate between \$22.75 million and \$52 million in value. He guaranteed the protection of 91 percent of his \$25 million investment, while reserving the right to achieve just over 100 percent appreciation on his investment, but no more, for a five-year period. Figure 3 shows how WorldCom appreciated nearly 300 percent after the collar strategy was implemented. But as of June 2002, the stock has declined dramatically, so that it is worth less than 10 percent of the original \$25 million in value compared with the floor of the collar, which was 91 percent of the original \$25 million in value. The hedge worked wonderfully for McCourt as evidenced by the dramatic decline in WorldCom stock the last few years.

Value of WorldCom stock with hedge	\$22.5 million
6/02 Value of WorldCom stock without hedge	\$2.5 million (\$2 a share)
Value Protected by hedging strategy	\$20.0 million

In a bit of irony, McCourt went on to say that if he had known WorldCom management at the time of his hedge as well as he knew them a few months later, he would never have used options to protect his investment. Luckily for McCourt, he did not know them well and placed the hedge. While WorldCom stock had a very strong performance up through 1999, making the option hedge look like a very unwise decision, the stock plummeted in 2000, 2001 and 2002, making his hedge quite valuable.¹⁴



McCourt's position in MFS WorldCom was a concentrated holding, which likely represented a majority of McCourt's net worth. But just because an appreciated holding does not represent a majority of value does not mean it is not worth hedging or protecting. It simply depends on the client's ability to accept long-term declines in value in relation to the client's anticipated goals and cash flow or liquidity needs in the future.

Tax Analysis of Hedging Strategies

Taxes are a key factor in evaluating how to most efficiently minimize risk in taxable portfolios. With a sale, the tax liability is a straightforward computation, using appropriate short-term and long-term capital gains rates, both state and federal, offset by available capital losses. With hedging strategies, the transaction costs, especially taxes, are less quantifiable because the final selling prices are not known because the final transaction price is not fixed. Therefore, for an advisor or fiduciary to properly understand and evaluate hedging strategies, taxes are a primary, if not threshold issue, and the advisor must plan for different scenarios and assumptions as to final values.

For hedging strategies, two primary rules govern taxation: (1) the constructive sale rules and (2) the straddle rules. The constructive sale rule governs whether initiation of the hedge is construed to be a sale of the hedged security and therefore a taxable event. The straddle rules govern the tax aspects of closing the hedge, including such issues as tolling or freezing capital gain holding periods, and capitalizing carrying costs of the hedge strategy. For most hedging strategies, the primary goal is to avoid constructive sale treatment and the requirement to recognize gain if a constructive sale is deemed to have occurred (even if an actual sale has not occurred). If the negative aspects of the straddle rules can also be avoided, then the hedging strategy can be a much more tax-efficient strategy.

Constructive Sale Rules

The 1997 Tax Reform Act provides that certain transactions attempting to neutralize gain and loss in a current stock holding are "constructive sales," which cause recognition of gain, if entered into after June 8, 1997.¹⁵ A constructive sale is a transaction in which the owner of an appreciated security enters into one of the following three transactions:

- A short sale of the same or substantially identical property
- An offsetting contract with respect to the same or substantially identical property
- A futures or forward contract to deliver the same or substantially identical property¹⁶

The term "substantially identical" is normally considered to be securities issued by the same issuer, which are commercially identical in all major aspects including dividend provisions. Normally, securities issued by two

different issuers are not considered "substantially identical" unless, for example, the companies are merging and are days away from a merged close and the common stock of each company is trading as the same security.¹⁷ Correlated pricing by the market is the key test for "substantially identical."¹⁸

Initiating a put option purchase is not a constructive sale. A put option, which gives the put holder the right to sell stock at a pre-determined price and time, should not be a constructive sale, even if the put option is for the same stock already owned by the put holder. Although the Internal Revenue Service (IRS) has not issued final regulations to clarify what is and is not a constructive sale, the committee report for the applicable 1997 Tax Reform Act code provisions provides some guidance. The committee report suggests that strategies that trigger constructive sale treatment are those that eliminate nearly all gain and loss.¹⁹ Because a put option only reduces some, but not all, of the loss, and reduces none of the gain, it should not be classified as a constructive sale. If the purchased put option is "deep in the money," then the purchase of the put option could be a constructive sale or taxable event because such a put option is close to being a proxy for the stock itself.²⁰

A short sale on stocks or indexes not otherwise owned is not a constructive sale. A short sale of a stock or stock index that is not otherwise owned by a client or trust is not a constructive sale because the shorted stock is not substantially identical. Therefore, selling short Verizon (which is not otherwise owned by the client) to hedge against a decline in a highly appreciated position in SBC Communications is not a constructive sale resulting in tax, even though the stocks are in similar businesses. This is beneficial for avoiding the constructive sale rules, but a disadvantage in that the hedge may not work due to the lack of complete correlation.

Selling short a stock or stock index already owned is a constructive sale (except for a few limited exceptions for short-term short sales) that triggers tax. Therefore, selling short the same stock that needs to be hedged against is not a tax-prudent hedging strategy.

Initiating a non-abusive collar should not be a constructive sale or taxable event. A collar that provides for some loss and some gain should not be considered a constructive sale unless it comes too close to freezing the value of the stock within a relatively tight range (an "abusive collar"). Collars are not likely to be considered abusive if the term of the transaction is three years or less and the difference between the floor and ceiling price of the collar is at least 20 percent.²¹ The Congressional committee report seems to suggest that collars that are not abusive will be grandfathered under the final regulations.²² The IRS has not issued final regulations covering constructive sales, so any hedge that attempts to control both gain and loss, like a collar, must be evaluated with caution.

TABLE 1

Transaction Type	Example	Constructive Sale?
Put Option Purchased for Stock or Index Not Otherwise Owned	Purchase a Put Option on Verizon to Protect Against Decline in Large SBC Holding	No
Put Option Purchased for Stock or Index Already Owned	Purchase a Put Option on SBC to Protect Against Decline in Large SBC Holding	No

TABLE 2

Transaction Type	Example	Constructive Sale?
Sell Short a Stock or Index Not Otherwise Owned	Sell Short Verizon to Protect Against Decline in Large SBC Holding	No
Sell Short a Stock or Index Already Owned	Sell Short SBC to Protect Against Decline in Large SBC Holding	Yes

There are other exemptions from the constructive sale rule, such as short-term hedges relating to shorting the same stock, but for most situations the put option, the short sale against a similar but different stock or index, and the collar are the most often used hedging techniques.

Straddle Rules

When an investor owns an appreciated security and seeks to protect the value of that security with a hedge, avoidance of the constructive sales rules is the threshold tax issue. The second tax issue is whether the hedge is a straddle. While the constructive sale rules apply to a transaction that attempts to lock in value within a certain range, eliminating the chance for both gain and loss, the straddle rules are broader and include most situations where a taxpayer is attempting to limit losses on an appreciated security by owning another security. If a hedge is a straddle, numerous tax implications arise with respect to closing out the hedge, as discussed later in this article. The tax impact of a straddle is usually much less onerous than a constructive sale, but the straddle rules are nonetheless a very important tax factor with hedges.

Straddles defined. A straddle is defined by the Internal Revenue Code as "offsetting positions with respect to personal property."²³ A straddle can be viewed as a teeter-totter. The original stock is on one side and the offsetting position is stock or some other security on the other side. Offsetting positions generally include any transaction that is intended to substantially limit risk of loss to one position.²⁴ Therefore, if a client shorts a stock or buys a put option, that position goes on the other side of the teeter-totter. The next issue is whether the new security is intended to offset the risk of a decline in the value of the original stock, and if so, it is likely a straddle unless it fits into an exception.

In evaluating if the offsetting positions meet the facts and circumstances test of "intent to substantially limit risk of loss," the Internal Revenue Code provides several tests, which, if met, result in a rebuttable presumption that a straddle exists.²⁵ These rebuttable presumptions assume a straddle if the hedge involves the same security as the protected security, even if in substantially different form.²⁶ These tests also presume a straddle if the hedge is sold or marketed as an offsetting position (regardless of the name used).²⁷ But, as part of these tests, there is a requirement that there be an inverse relationship in valuation changes between the offsetting positions.²⁸ The net effect of these rules is that nearly any attempted hedge is likely to fall within the targeted scope of the straddle rules.

To summarize the basic straddle rules:²⁹

1. A straddle occurs when an investor owns stock and then enters into an offsetting position such as
 - An option on such stock or substantially identical stock
 - A position with respect to substantially similar or related property (not including stock). Property is substantially similar or related to stock when the fair market value of the offsetting positions primarily reflect the performance of:
 - A single firm
 - The same industry
 - The same economic factors such as interest rates, commodity prices, or foreign currency rates (by way of illustration and not limitation)
 - Furthermore, changes in fair market value of the offsetting positions are reasonably expected to move inversely, whether as a fraction or multiple of each other. In other words, if appreciated stock is on one side of the teeter-totter, then a put option on the same stock or substantially similar stock on the other side of the teeter-totter is a straddle.
2. A straddle does not appear to exist with an offsetting position in substantially similar stock.³⁰ This is similar to what former Enron CEO Skilling did when he sold short energy company AES in August 2001 while owning Enron stock.³¹
3. Very important, stock acquired before January 1, 1984, is not subject to the straddle rules.³² For these

stocks, puts can be purchased against stock positions with identical correlation and protection, yet without adverse tax implications under either the constructive sale or straddle rules.

There are many other hedge strategies that have straddle implications, including selling short or buying puts on an index fund (either broad based or by sector). These strategies have additional complexity, but can offer higher correlation than hedge strategies on one other stock in the same industry as the appreciated stock.³³

Transaction Type	Example	Straddle?/ Constructive Sale?
Sell Short a Substantially Similar Stock Not Otherwise Owned	Sell Short Verizon Stock to Protect Against Decline in Large SBC Holding	No/No
Sell Short a Stock Already Owned	Sell Short SBC to Protect Against Decline in Large SBC Holding	Yes/Yes
Purchase a Put Option on Substantially Similar Stock Not Otherwise Owned	Purchase a Put Option on Verizon to Protect Against Decline in Large SBC Holding	Yes/No
Purchase a Put Option on Stock Already Owned	Purchase a Put Option on SBC to Protect Against Decline in Large SBC Holding	Yes/No
Non-Abusive Collar on Stock Already Owned (ie., collar does not hold value in very tight range)	Purchase Put Option and Sell Call Option on SBC to Limit Value to a Range	Yes/No

Straddle rule tax implications on closing the straddle. If a straddle does exist, the tax implications primarily relate to the closing of the offsetting positions.

- There is a suspension of the capital gain holding periods during the time of the offsets.³⁴ Therefore, put options or other similar offsetting positions stay short-term in nature since they are prevented from becoming long-term by the tolling effect of the straddle.
- No current deduction for losses is permitted to the extent of any unrealized gain in the offsetting positions.³⁵ Therefore, losses on a straddle are deferred until unrealized gains on the offsetting position are eliminated.
- All carrying charges and interest expense (including margin) during the offset period (net of dividends) are capitalized and added to the basis of the owned stock position. This has the effect of reducing the amount of capital gain when the owned stock position is sold.³⁶

Economics of Primary Hedging Strategies

After the tax analysis is completed, the basic question is whether the economics merit a hedging strategy considering all relevant taxes (including estate taxes) and the variety of potential price changes for the security or portfolio to be hedged. Several possible outcomes should be modeled, using various rates of appreciation and taxation and other economic impacts such as lost dividend income and transaction costs.

One other planning technique to consider is the use of younger family members or family trusts to implement the hedge. For example, a child with sufficient resources could implement a hedge to protect against the decline in value of a security owned by a parent. The loss of value to the parent would reduce the estate tax, while the gain in the value of the put option or other hedging strategy could accrue to the benefit of the child, without inclusion in the parent's estate. Alternative ownership structures are a further planning issue, worthy of consideration.

Conclusion

The decision-making process for diversification and risk management of highly appreciated securities and portfolios is becoming more prevalent and more complex. While the sale decision is usually simplest, the alternatives including hedging strategies should be evaluated for possible use. Hedging strategies can be used to effectively manage risk, with favorable tax treatment. In the limited situations where hedging strategies are appropriate, the same diligent attention that is given to evaluation and implementation of hedges must be given to proper management and monitoring of hedges.

Financial planners may see opportunities for hedging strategies that investment advisors and trustees may not be aware of. Given the dramatic increase in the number of clients and potential clients with appreciated securities and portfolios, a working knowledge of hedging strategies is of growing importance from an advising standpoint. Such knowledge can also further distinguish the financial planner from many other financial professionals, for the ultimate benefit of the client and the financial planner's practice.

Endnotes

1. *High-net-worth Investors and Listed Options*, Chicago Board Options Exchange, p. 23.
2. The focus of our analysis is taxable portfolios that must carefully factor tax considerations into diversification and sell decisions. Similar lines of thinking can apply to hedges of real estate, closely held businesses, or other non-publicly traded assets.
3. Summarizing the key argument found in one of the seminal papers on a fiduciary's duty to hedge. George Crawford, *A Fiduciary Duty to Use Derivatives*, 1 STAN. J.L. BUS & FIN. 307 (1995). For a complete discussion of the duty of fiduciaries to hedge, Crawford's paper is an excellent overview. See also, *A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivatives Techniques*, Randall H. Borkus, 36 REAL PROP., PROB. & TR.J. 150 (2001).
4. The 1997 New York case of *Levy v. Bessemer* is an example of the fact patterns that are becoming more prevalent (No. 97 Civ. 1785, 1997 U.S. Dist. WL 431079 (S.D.N.Y. July 30, 1997). Defendant's motion to dismiss for the plaintiff's failure to state a claim upon which relief could be granted was denied. In the original complaint by the plaintiff, claims of negligence, negligent misrepresentation, breach of fiduciary duty, breach of the duty to supervise, breach of contract, and fraud were alleged. The only claim dismissed by the court was the breach of contract claim.
5. Crawford, *supra* note 3, p. 328.
6. "Loss realization is a good horse, but it's a horse you usually can't ride very far for very long." Robert H. Jeffrey, "Tax-Efficient Investing Is Easier Said Than Done," *The Journal of Wealth Management*, Summer 2001, p. 11.
7. It seems odd that a trustee or investment advisor would automatically sell a security, regardless of its investment fundamentals, simply because it does not appear on the approved list, yet this is often the case. Because tax liability incurred upon the sale of highly appreciated securities can dramatically lower long-term portfolio returns, an in-depth analysis of the merits of holding or selling an appreciated security would seem to be the best course of action. However, most investment firms follow an approved model and attempt to liquidate all other securities unless the client objects. Customized investment reviews on specific securities not on the approved list are not customary practice. Yet it seems that providing such a service to clients is at the heart of being an independent investment advisor. "Years ago, when money managers were still called investment advisors...client advisories like this were not uncommon." *Id.*, p. 14.
8. This concept is also supported by the Foundation for Fiduciary Studies. "No investments are imprudent on their face. It is the way in which they are used, and how decisions as to their use are made, that will be examined to determine whether the prudence standard has been met. Even the most aggressive and unconventional investment can meet that standard if arrived at through a sound process, while the most conservative and traditional one may not measure up if a sound process is lacking." *Prudent Investment Practices Handbook* (2001), p. 3.
9. Most versions of the Prudent Investor Rule from the Restatement (Third) of Trusts require trust

- expenses to be reasonable. Hedging strategies usually involve transactions costs (excluding taxes) that are greater than the outright sale.
10. *High-net-worth Investors and Listed Options*, Chicago Board Options Exchange, p. 4.
 11. There are many legal and compliance issues surrounding hedging strategies, especially when dealing with trust investment portfolios. A most useful discussion of these issues is contained in OCC 96-25, a 1996 bulletin issued by the Office of the Comptroller of the Currency (OCC). This document summarizes general risk management principles for national bank fiduciary activities, specifically in the area of financial derivatives or hedging strategies. Financial planners might find helpful the valuable guidance provided by the OCC, even though the OCC supervises national banks.
 12. "Reflections on Portfolio Management After 25 Years," Robert W. Jeffrey, *Journal of Investing*, 2001.
 13. "WorldCom Director Uses Exotic Play to Hedge Stake," Elizabeth MacDonald, *The Wall Street Journal*, October 15, 1997.
 14. We are uncertain whether McCourt kept his hedge position in place. The options were originally structured to terminate in July 2002.
 15. The 1997 Tax Act added IRC Section 1259 titled "Constructive Sales Treatment for Appreciated Financial Positions."
 16. IRC Section 1259 (c).
 17. Treasury Regulation 1.1233-1.
 18. *Taxes and Investing*, Ernst & Young, September 1999, p. 6.
 19. Committee Report on P.L. 105-34 (Taxpayer Relief Act of 1997).
 20. According to the Chicago Board Options Exchange (CBOE), a put option is in the money if the strike price is greater than the market price of the underlying security. If the put option strike price is significantly higher than the market price of the underlying stock, the put option trades somewhat like the stock itself and is considered "deep in the money." Because deep in the money puts correlate much more closely with the price movements of the underlying stock than out of the money puts, there is a risk that the deep in the money put is substantially identical property that triggers a constructive sale. Future regulations may deem a deep-in-the-money put as an abusive hedging transaction that is not grandfathered.
 21. These are the views of Deutsche Bank Alex Brown (DBAB), but DBAB also adds that, to avoid arguments of an abusive collar, the collar should not be used to hedge a stock with exceptional volatility. However, given the volatility of the entire market the last several years, that suggestion may no longer be valid. "Strategies for Concentrated Equity Positions," Deutsche Bank Alex Brown, June 1999, p. 18.
 22. H.R. Conf. Rep. No. 105-220, at p. 514 (1997).
 23. IRC Section 1092 (c) (1).
 24. IRC Section 1092 (c) (2) (a) states that a taxpayer holds offsetting positions "if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding 1 or more other positions...(whether or not of the same kind)."
 25. IRC Section 1092 (c) (3).
 26. IRC Section 1092 (c) (3) (A) (i) and (ii).
 27. IRC Section 1092 (c) (3) (A) (iv).
 28. IRC Section 1092 (c) (3) (A).
 29. The straddle rules contain other, more detailed provisions involving futures contracts and corporations formed to enter into hedging strategies. IRC Section 1092 (d) (3) (B) (i) (III) and (ii).
 30. "Stock offset by another position (other than an option) in substantially similar or related stock...does not constitute a straddle." Joint Committee of Taxation's General Explanation of the Tax Provisions of the Deficit Reduction Act of 1984 at p. 309.
 31. Former Enron CEO Jeff Skilling is reported to have sold short millions of dollars of stock in AES, a competitor to Enron in the energy industry. Skilling may have used this trade to hedge his holdings in Enron under the theory that the stocks were somewhat closely correlated, or he may have simply sold the AES stock short hoping for a good result, unrelated to a hedge of his Enron stock. The stock prices were correlated to an extent, as AES stock plummeted during the same period as Enron plummeted. But AES stock did not decline to zero value, as did Enron. "A spokeswoman for Mr. Skilling confirms that he made the wager: a short sale initiated on Aug. 24 against shares of AES Corp., a big energy

producer. A person familiar with the matter puts the trade's value at \$30 million, though Mr. Skilling's spokeswoman says the estimate is 'way out of the ballpark' on the high side." *The Wall Street Journal*, January 15, 2002, page C2.

32. IRC Section 1092.
33. See BNA U.S. Income Series, Volume 184, *Stock Related Tax Issues*, pp. 108–111.
34. Treasury Regulation 1.1092(b)-2T(a). Security positions that are long-term prior to the creation of the straddle maintain their long-term nature when the straddle is unwound.
35. IRC Section 1092 (a) (1) (A).
36. IRC Section 263(g).

Editor's Note:

The Fall 2002 issue of *The Journal of Wealth Management* is publishing another article by Mark Miller that focuses on the role of investment advisors and trustees with regard to hedging strategies of appreciated securities and portfolios. For more information on that article, go to www.ijwm.com.

For More Information...

The author recommends these Web sites:

1. www.cboe.com—Chicago Board Options Exchange (go to the Learning Center)
2. www.ffstudies.org—Foundation for Financial Studies
3. www.twenty-first.com—Twenty-First Securities Corporation (Go to the Academic Press)
4. www.occ.treas.gov/handbook/invmgt.pdf—Office of the Comptroller of Currency (*Handbook for Investment Management*)
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