Compensation packages for corporate executives are becoming increasingly complex. For many years, grants of incentive stock options (ISOs) were the primary type of equity compensation. Recently, there has been a shift toward using non-qualified stock options (NQSOs), restricted stock (RS), and restricted stock units (RSUs). Vesting terms also have seen a shift from time-based to performance-based. Changes in taxation/regulation, corporate scandals, and shareholders’ perception of the lack of incentive tied to equity compensation packages all can be used to explain these changes. These factors also have led to so-called “say-on-pay” agreements in which shareholders have demanded that executive compensation be tied more closely to company performance. In fact, a recent report showed that more than 80 percent of S&P 500 companies now use performance equity awards for senior officers, compared with about 65 percent five years ago. All this has resulted in increasingly complex compensation arrangements for corporate executives and a greater need for advice from a client’s entire advisory team, including investment and tax advisors.

A Three-Pronged Approach
Executives often apply simple rules of thumb when making decisions about equity compensation. But these mental shortcuts just won’t cut it when putting together a comprehensive plan. When advising corporate executives, we have found it useful to use a three-pronged approach to develop a holistic plan that starts with having your client answer the following questions:

What do you have? It’s critical to know what an executive has been granted and what is expected in the future. Did stock that’s owned outright come from vesting of restricted stock and was an 83b election made, or were options exercised, and if so, what kind of options? Are any ISOs still within the window of making a disqualifying disposition? It’s also important to understand how the equity compensation fits in with other invested assets and resources. Figure 1 presents a planning pyramid that helps answer this first question. The base supports near-term spending, and the core reflects the amount of money needed to endow one’s lifestyle. To arrive at the core amount, we use a conservative figure that accounts for poor market outcomes and a long life-expectancy, and assume a well-diversified portfolio of liquid assets. Any assets beyond those held in the base and core are considered surplus. This informs executives’ decisions on whether they can accumulate shares or if they should seek cash proceeds to meet portfolio or cash-flow funding needs. Aside from any minimum holding requirements, this framework determines how much of a position in company stock the executive can afford to hold.

What do you want to do? The goals of an executive can vary. A younger executive who is still building wealth may rely on equity compensation to fund lifestyle needs, but a mid-career executive may be required to build and hold a minimum amount of company stock. Finally, an executive nearing retirement may be looking to unwind equity exposure in the most tax-efficient manner. These executives often are looking for the best way to fund goals for retirement such as the purchase of a private jet or a custom yacht, or leaving a charitable legacy, such as building a wing in a favorite hospital.

What should you do to get there? This is where we can develop an action plan that considers the complexities of each situation. Importantly, the advice also needs to
consider personal biases and professional constraints. An executive may face internal pressure to maintain high exposure to the company's stock; a named executive may have concerns over the public's perception of publicly reported equity transactions or be expressly forbidden from entering into hedging strategies on concentrated company holdings. Although an executive may desire to use equity compensation in one way, internal politics or legal restraints may prevent this and it's in our interest to understand these situations.

Managing the Complexity
The devil is in the details when it comes to developing an action plan for a corporate executive. It requires us to recognize the underlying motivations that drive an executive's decisions and also to understand the interplay among the different equity grants and the implications of decisions on meeting goals.

Understanding What Lies Beneath the Surface
Executives often come with personal biases that lead them to want to either cash out or hold their company stock. Demonstrating an understanding of their motivations can help build confidence and trust with clients.

Executives who choose to cash out often are concerned about having too much exposure to the company. They understand the risk of having both their salary and their investment portfolio tied to the success or failure of the same entity. A secondary motivation for executives who cash out is simply a need for the money. An executive's lifestyle may be based on total compensation rather than salary alone. When a substantial portion of compensation comes as equity, an executive may be forced to sell shares to meet spending needs.

Other executives use all or a portion of their equity compensation to build a position in the stock. The two main reasons executives do this are because they either must hold a minimum amount of the stock (in some cases C-suite executives are required to hold at least one to six times their base salary in company stock), or because they have strong sentiment for the company and its future prospects. Finally, some executives exercise options and keep the shares in order to accumulate voting rights. Knowledge of these issues and the ability to incorporate them into the advice we give creates the trust necessary for clients to move forward with the action plan.

Multiple Types of Equity Compensation Are Common
An executive's exposure to equity may come, broadly, in three forms: (1) common stock held outright; (2) grants of restricted stock and/or units; and (3) grants of stock options and/or appreciation rights. In many cases, an executive may have exposure to all three. Diversifying out of multiple types of equity compensation can be tricky, and advisors can add significant value. Specifically, we can help answer two important questions:

- When multiple types of equity grants are held, what is the most efficient way to diversify?
- When stock options are held, when is the best time to exercise?

We propose the following five-step framework for thinking about how to diversify in an efficient manner:

1. **Sell stock held at a gain in taxable accounts.** Selling these securities first has two benefits. First, the executive reduces direct exposure to the stock immediately. Second, the executive reaps the benefits of realizing the losses that can be carried forward indefinitely to offset gains elsewhere in the portfolio.

2. **Sell stock held in tax-deferred accounts.** Transactions in tax-deferred accounts, such as the executive's 401(k) or individual retirement account, have no tax consequences, which permits an executive to reduce direct exposure to the company’s stock price and reallocate funds without having to worry about the tax consequences.

3. **Exercise stock options with little time value remaining.** After having diversified directly out of the stock holdings that have tax advantages, options that have little time value remaining are good candidates for exercise. Low time value suggests that the remaining upside potential of the option, given the length of time to expiration, is limited.

4. **Sell stock held at a gain in taxable accounts.** Although selling these holdings will realize capital gains, direct exposure to the company will be reduced. It is because of the gains incurred that these securities are recommended to be sold second-to-last.

5. **Exercise stock options with higher amounts of time value remaining.** This is the final group of securities to be diversified out of in our proposed sequence. The executive who holds options does not have direct exposure to the stock. If the stock price declines, the executive experiences a drop in the potential proceeds but doesn’t actually own the stock. At the same time, by holding the options, the executive maintains the upside potential of the stock. If the options have high time value remaining, they are better candidates to continue holding.

Strategies Specific to Working with Stock Options
Stock options come with their own set of additional considerations. Unlike holders of restricted stock and RSUs, option holders decide when the exercise takes place, thus controlling when proceeds are received and taxes are paid. Executives typically fall into one of two groups when it comes to timing decisions: those who exercise soon after vesting and those who hold onto options until they are nearly expired. Delaying exercise is often done (1) to postpone taxes and (2) to give the maximum life to the option while maintaining the upside potential of the stock. Cashing out is usually done to reduce risk of a significant stock decline that would cause the value of the option to become worthless. The problem is that when delaying exercise, options can become riskier as they near expiration, and cashing out too quickly runs the risk of leaving money on the table.

We have found there may be a better way. A traditional Black-Scholes model used to estimate employee stock option value...
overlooks the impact of dividends entirely. But we have found that including assumptions about the underlying stock’s yield and examining the relationship between a stock’s dividend yield and volatility provides insight into when to exercise options. We examined all S&P 500 constituents over a 10-year period (2006–2016) and placed them into one of four categories, or quadrants: those with high dividends and low volatility; low or no dividends and high volatility; high dividends and high volatility; and low or no dividends and low volatility (see figure 2). On average, the stocks in each of these quadrants displayed unique characteristics different from the other quadrants that may help signal when exercise is appropriate. Of course, our analysis is based on past results, which are not predictive of results in future periods. The quadrants are discussed in detail below.

High dividends/low volatility. Executives of companies in this quadrant can potentially benefit by exercising options well before expiration. The reason is twofold. First, historically low-volatility stocks are, on average, relatively unlikely to plummet or surge in price. Thus, the upside of continuing to hold an in-the-money option for too long can be modest compared with the potential benefit of collecting dividends over time. Second, by their nature, options become increasingly more risky over time. The longer an option is held, the greater the potential for loss because the value of in-the-money options becomes more synchronized with the underlying stock price, and with less time to recover from a downturn, the option could be underwater at expiration.

Low or no dividends/high volatility. Many companies in this quadrant either don’t offer a dividend or have such a low payout that the yield doesn’t meaningfully affect the value of the option. Therefore, it’s generally advisable for executives to hold these options for a greater number of years to gain from potential price appreciation in the stock. However, as with all options, there is a risk of holding for too long. That’s especially so in this quadrant, where stocks have high volatility. For these reasons, it may be advisable to consider exercising these options nearer to the expiration date relative to the other quadrants, but not waiting until just before.

Conclusion
We have highlighted several items that, in our experience, have proved helpful in working with executives in light of the ever-changing compensation environment. We have provided two frameworks to help think through equity grants and options. To make the most of equity compensation, simple rules of thumb no longer work. As advisors, we believe the best advice should incorporate the executive’s unique compensation structure into a holistic plan.

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Endnotes


3. The original Black-Scholes formula does not account for dividends, but it may be modified as follows to include assumptions for continuous pay-outs on the underlying stock:

Original formula:
\[
C = S N(d_1) - K e^{-r t} N(d_2)
\]
\[
d_1 = \frac{\ln(S/K) + (r + \sigma^2/2) t}{\sigma \sqrt{t}}
\]
\[
d_2 = d_1 - \sigma \sqrt{t}
\]

Modified formula:
\[
C = S e^{-q t} N(d_1) - K e^{-r t} N(d_2)
\]
\[
d_1 = \frac{\ln(S/K) + (r - q + \sigma^2/2) t}{\sigma \sqrt{t}}
\]
\[
d_2 = d_1 - \sigma \sqrt{t}
\]

C = option value

S = stock price
\(t\) = time until expiration
K = strike price
\(r\) = risk-free rate
\(N\) = cumulative normal distribution
\(e\) = exponential term
\(\sigma\) = standard deviation
\(\ln\) = natural log
\(q\) = dividend yield

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