

A Unique Solution For Downside Market Protection

Executive Summary

Many high net worth individuals and family trusts have a significant portion of their wealth allocated to publicly traded equities; either in the form of a single concentrated stock position, or a diversified portfolio of securities. In recent months, many have seen their investment portfolios decrease significantly in value. A forward-looking solution for clients in this situation could be a Privately Structured Pledge and Loan Agreement. This relatively simple transaction can provide the following benefits:

- Protect the current and future value of an investor's portfolio.
- Create liquidity without having to sell the portfolio's securities.
- Diversify the overall investment mix of the portfolio (if needed).
- Reduce interest expense on existing margin (or other) loans.
- Eliminate margin calls.

Traditional Solutions

Over the years, a few strategies have been available to protect against declines in the overall value of an individual's investment portfolio or concentrated stock position. One strategy is to hedge against downside risk by purchasing puts. However, options purchased during volatile markets can be very expensive.

A second option is to "collar" the existing position by buying a put and simultaneously selling a call option with identical maturity dates – to off-set the cost of purchasing the put option. This strategy is flawed, however, in that it limits the upside potential in future appreciation of the underlying equity.

The problem with both puts and calls is that they can be difficult to administer on a diversified investment portfolio, and they result in dividends being taxed at ordinary income tax rates rather than the lower qualified dividend rates. The collar strategy is also coming under increased scrutiny by the Internal Revenue Service under the "constructive sale" rule. The purpose of the constructive sale rule is to prevent investors from locking in investment gains without paying capital gains tax, and to limit their ability to transfer gains from one tax period to another.

One other strategy is for an investor to enter into a derivative trade by shorting an index (e.g. the S&P 500). However this too requires significant out-of-pocket expense on the part of the investor and may not directly correlate to the price fluctuation within the investor's underlying stock portfolio.

Privately Structured Pledge & Loan Agreement

There may be a better solution. As an alternative to the strategies listed above, an investor could enter into a “pledge agreement” whereby the investor pledges securities to the lender in exchange for a non-recourse loan. Based on the trading volume and volatility of the underlying stock portfolio, the investor would receive a non-recourse loan equal to roughly 75%-85% of the portfolio’s present value. The agreement is a traditional loan, and is therefore not considered a sale or transfer of beneficial ownership for either IRS or SEC purposes. The loan is also designed to be non-purpose so that the cash proceeds may be used by the investor for whatever they desire. (However, investing in more securities as the type pledged may actually increase overall investment risk and probably should be avoided.) Since the loan is structured to be non-recourse, it has the additional benefit of creating a “synthetic put” without the investor incurring the cost of purchasing a put option in the market. Furthermore, since the transaction is structured as a pledge of the underlying shares, no change in beneficial ownership occurs. The result is that the investor retains all voting rights, dividends, and unlimited future appreciation of the underlying stock portfolio.

How does it work?

Each transaction is unique. Here is an example of the structure of a recent transaction by way of illustration:

The first step is for the investor to enter into a pledge agreement with the lender. This agreement essentially grants the lender sufficient dominion and control over the assets for the lender’s purposes. Next, the lender loans the investor cash in an amount equivalent to approximately 75% to 85% of the current fair-market-value of the underlying securities.

This loan is a non-recourse, interest-only note with a three year (or longer) maturity date. The interest rate charged on the loan is based on the 3-month LIBOR rate (on May 13, 2009, the rate was .99%), plus a spread of between 50 and 100 basis points. This is a “floating” interest rate, but the agreement provides that the interest rate charged on the outstanding principal will never exceed 100 basis points (1%) above the initial contract amount. Thus, the interest rate risk to the borrower is capped.

The investor now has the cash proceeds from the loan to pay down other debt, make other investments, use for personal spending, etc. As long as the investor makes the quarterly interest payments in a timely manner, the lender cannot declare the loan in default, and cannot sell the underlying collateral. Working with his advisors, the investor might structure an investment strategy that returns an annual yield sufficient to cover the cost of the quarterly interest payments. This in effect creates a no-cost hedge against downside movement in the portfolio.

How much paperwork is involved?

The transaction is very straightforward and although there is a certain amount of documentation necessary, the total amount of paperwork is minimal. A transaction can usually be closed in thirty days or less.

What is the exit strategy?

At maturity, the investor has three options.

- The investor may pay off the principal balance of the loan and regain control of the securities.
- The investor and the lender can re-document the pledge and loan agreement, based on the new value of the underlying equity portfolio. Assuming the value of the portfolio has increased, the investor can then draw down more money based on the portfolio's appreciated value and lock in a new non-recourse loan.
- If the investment portfolio or concentrated stock position has decreased in value below the level of the initial loan principal, the investor has the option to just keep the non-recourse loan proceeds and "put" the stock to the lender.

The loan is non-recourse, so in the event of a put as described above, the lender only has the underlying securities as collateral for the loan. The lender cannot hold the investor liable for any shortfall between the portfolio's value and the outstanding principal on the loan.

Important Note: The put alternative is a sale which may have significant income tax and, in the case of a company insider, potential SEC filing consequences, and therefore should be carefully considered in consultation with the investor's legal and tax advisors.

Is there any pre-payment penalty?

An additional benefit of this structure is that unlike a collar or pre-paid forward contract, there is no off-setting derivative trade in this structure. Therefore, it is also important to note that, unless there is an interest rate swap involved, each of the exit strategies above is available to the investor at anytime during the term of the agreement and there is no pre-payment penalty for unwinding the contract early.

How does this compare to a margin loan?

This structure is far superior to a traditional margin loan in that margin balances are still “recourse” to the investor. That means if the investor’s portfolio value drops significantly, the margin lender retains the right to require the investor to personally make good on the loan. Also, in the event of a margin call, the investor is required to infuse additional capital from other sources, or may be required to sell a portion of the underlying securities at depressed market values.

Who is a candidate for the transaction?**Downside Protection**

Any investor who is concerned with the potential downside risk currently associated with their investment portfolio can use this structure to create a “synthetic put”, to guarantee a value below which their investment portfolio will not decrease and without having to incur the out-of-pocket cost typically associated with purchasing such puts in the open market, and without giving up profit potential on the underlying portfolio.

Business Sale

This pledge and loan structure is well suited for a business owner who has just sold his/her private company to a publically traded company in exchange for stock. Since the entrepreneur is no longer in control of the company, but may have much of their net worth tied up in the business, they may want to protect against the potential downside risk in their newly acquired stock. This is especially true if there is a “lock-up” associated with the transaction whereby they are precluded from selling shares for a certain period of time.

Margin Account Rescue Strategy

Individual investors who have significant margin positions against their marketable portfolio and are (or soon will be) receiving margin calls could be good candidates. This structure would allow the investor to convert their margin balance to a non-recourse loan with a higher loan-to-value ratio and a lower interest rate.

Life Insurance Premium Financing

The structure may be a possible rescue strategy for underwater premium financing situations, or as a predictable solution for new premium-financed life insurance policies.

Insufficient Income Generated from Current Portfolio Holdings

A shareholder in a non-dividend paying stock might use this strategy to create a “synthetic dividend”. This can be accomplished when the investor takes advantage of the interest rate arbitrage between the interest charged on the loan, and the interest earned on other investments currently available in the market.

What is the minimum transaction size for this strategy?

The minimum transaction size is \$1 Million (U.S.)

What are the costs of implementing the strategy?

All implementation costs (except investor’s legal counsel) are paid from the loan proceeds and usually range from 2-5% of the initial loan amount, depending on the size of the transaction.

Conclusion

In summary, when your goal is to protect your clients against downside risk or monetize the securities in their portfolio, this tool has many benefits over traditional strategies.

If you are interested in learning more, contact us at 630-596-5090 x80