



JACOB GREENE

Head Strategist, NB Custom Direct Investing

RORY EWING

Portfolio Manager

FRANK MAEBA

Senior Portfolio Manager

RACHEL WHITE, CFA

Portfolio Specialist

GARRICK HULL, CFA

Associate Portfolio Manager

Diversifying Concentrated Stock Positions

Concentrated, low-basis stock positions often represent substantial portfolio risk but also planning challenges given potential tax liability associated with sales. Importantly, an array of strategies is available to seek to address these issues, with the aim of facilitating risk-reduction and liquidity generation on a tax-efficient basis. In this white paper, we explore the merits and mechanics of these potential solutions.

Navigating the complexities of wealth management becomes particularly nuanced when taxable investors face the challenge of managing substantial, low-basis concentrated stock positions—assets that have fueled significant wealth accumulation, yet now present heightened portfolio risk and potentially onerous tax implications upon diversification.

Many statistics highlight the risk of these positions, showing the number of stocks that underperform the broad market over the long term or the catastrophic drop in returns most stocks will experience at some point in time; however, determining the best solutions for managing these concentrated positions can be far more difficult. In this paper, we set a framework outlining the inherent difficulties associated with low-basis positions, and highlight distinct approaches to addressing those concerns, depending on client objectives.

Highlights

- Various approaches are available to address the portfolio and tax risks associated with concentrated single-stock positions.
- Risk management solutions such as single-stock options and collars can immediately reduce near-term risk, often by trading some potential upside for downside mitigation.
- Tax deferral solutions such as 351 exchanges and tax-managed portfolios (including long-short strategies) focus on deferring the payment of taxes until a later date, allowing more dollars to remain invested and compound with market growth.
- Tax elimination solutions, such as index option overlays can create an additive cash flow used to pay off realized tax expenses and to maximize investment flexibility, optimizing after-tax outcomes over time.
- In practice, we believe that a spectrum of solutions and timelines may be needed to achieve positive outcomes in relation to single-stock positions.

A Distinct Set of Solutions May Be the Most Appropriate

Rarely can a single solution solve a problem as complex and burdensome as the one faced by those with low-basis concentrated stock positions. We break the problem into two distinct, but related, issues: risk and tax. The overweight size of the position may create an outsized risk concern that, while related, is separate from the tax liability that restricts flexibility in diversifying away from the concentrated position.

Not all solutions are created with the same goal, nor do they share the same time horizon. The path to diversifying a concentrated stock position can—and should—be tailored to each investor’s risk tolerance, objectives and time horizon. To help frame the conversation, it is useful to view the universe of solutions through a lens of risk management and tax management.

Risk Management

Risk Management solutions are designed for investors seeking to immediately reduce near-term risk, often by trading some potential upside for downside mitigation. Tools like single-stock options (e.g., protective puts, collars and covered calls) and prepaid variable forwards can help reduce portfolio vulnerability in volatile markets.

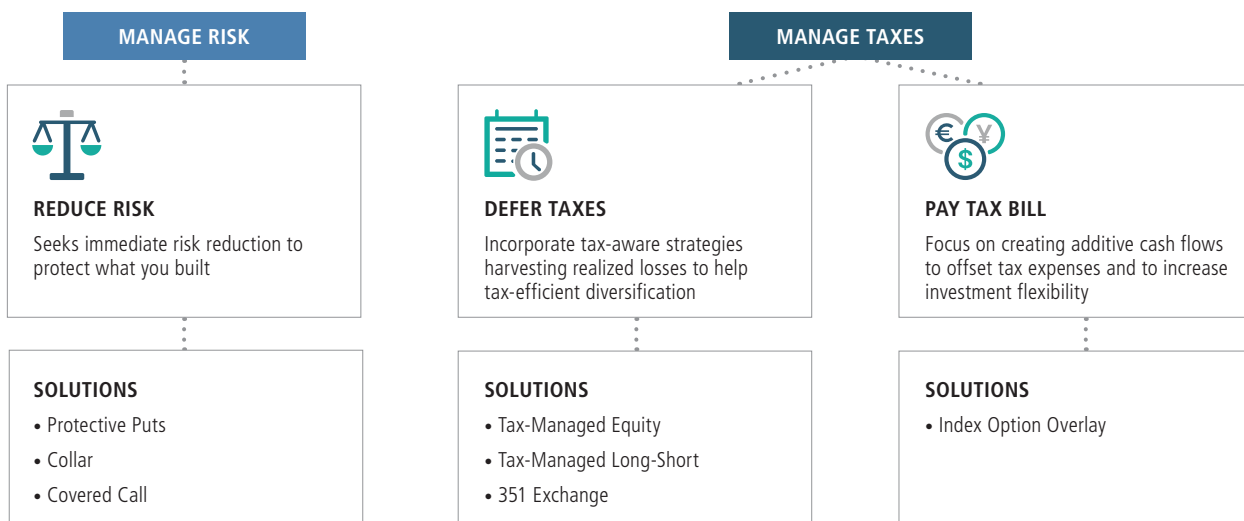
Tax Management

Tax Deferral solutions focus on deferring the payment of taxes until a later date, allowing more dollars to remain invested and compound with market growth. A “351 exchange” can provide diversification and tax deferral. Approaches such as tax-managed equity portfolios or planned giving can gradually and tax-efficiently diversify the investment over multiyear time horizons. Going a step further through the use of leverage, a tax-managed long-short portfolio can more aggressively and tax-neutrally help with diversification efforts.

Tax Elimination solutions aim to reduce a long-term tax bill by creating an additive cash flow used to pay off realized tax expenses and to maximize investment flexibility. An index option overlay with no cost to borrow or need to rebalance current assets can be designed to optimize after-tax outcomes over time.

This framework then allows one to home in on the right solution—or combination of solutions—based on where an investor is on their diversification journey. The table below summarizes how investors can align solutions with immediate needs and long-term goals.

RISK AND TAX MANAGEMENT SOLUTIONS



Source: Neuberger Berman.

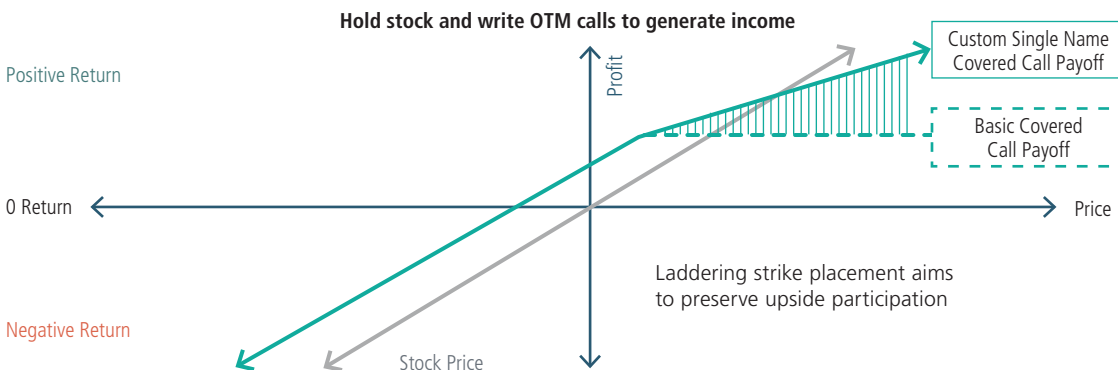
Covered Call Writing

For investors willing to trade some potential upside of a stock in exchange for upfront cash premiums and less downside risk, covered-call writing can be an appealing solution. The strategy involves selling out-of-the-money call options on the stock while retaining ownership of the underlying shares, allowing the investor to earn premium income. This income can help mitigate potential losses and enhance portfolio yield, especially for stocks with expectations of flat to moderate upside returns.

Covered-call writing can also be a helpful tool for diversifying the concentrated position. While the investor will continue to participate in the stock return up to the strike price of the call option, if the stock rises above the strike price, it may be sold at that price or “called away,” enabling the investor to reduce exposure at an appealing price point. Alternatively, some investors may wish to manage or avoid exercise by electing to buy back options that are at risk of being exercised. Although this approach may help to avoid unwanted taxable events and maintain exposure to the underlying stock, it can require a periodic capital outlay, making it important to understand the costs and trade-offs of such a strategy.

A customized approach to covered-call writing gives investors the ability to tailor their investments to their specific investment goals. Investors can select how aggressively they would like to set income objectives, determine where to set exercise targets and even establish settlement processes to align with their specific goals.

COVERED-CALL MECHANICS



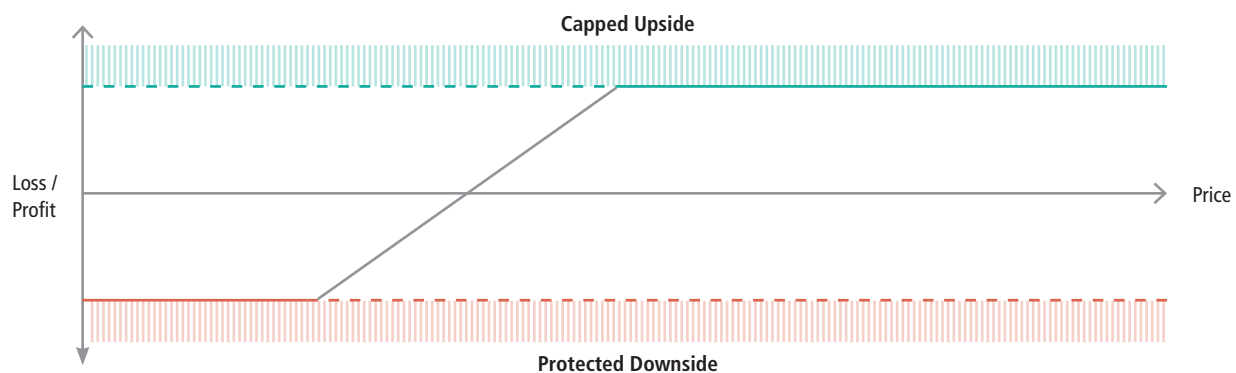
Source: Neuberger Berman.

Establishing a Collar

In some cases, while selling some or all of the concentrated stock may not be desired in the near term, there may be an appetite for narrowing potential return outcomes and/or protecting against a major sell-off. A collar strategy can be used in these cases to provide downside protection while preserving some upside potential. This strategy involves simultaneously purchasing a protective put option and selling a call option on the same stock. The protective put ensures that the investor can sell the stock at a predetermined price (the strike price of the put), limiting potential losses if the stock's value declines significantly. In contrast, the sale of the call option generates premium income, which helps offset the cost of purchasing the put option, making the strategy more affordable but capping potential upside.

A collar is particularly beneficial for investors seeking to manage risk without fully liquidating their concentrated stock position. By limiting downside risk through the put option, the investor gains peace of mind in volatile markets, knowing that their stock's value will not fall below a certain level. At the same time, the call option caps the upside potential, as the investor agrees to sell the stock at the strike price of the call if the stock appreciates beyond that level. This trade-off makes the collar a balanced strategy, ideal for investors who prioritize risk reduction over maximizing gains.

COLLAR MECHANICS



Source: Neuberger Berman.

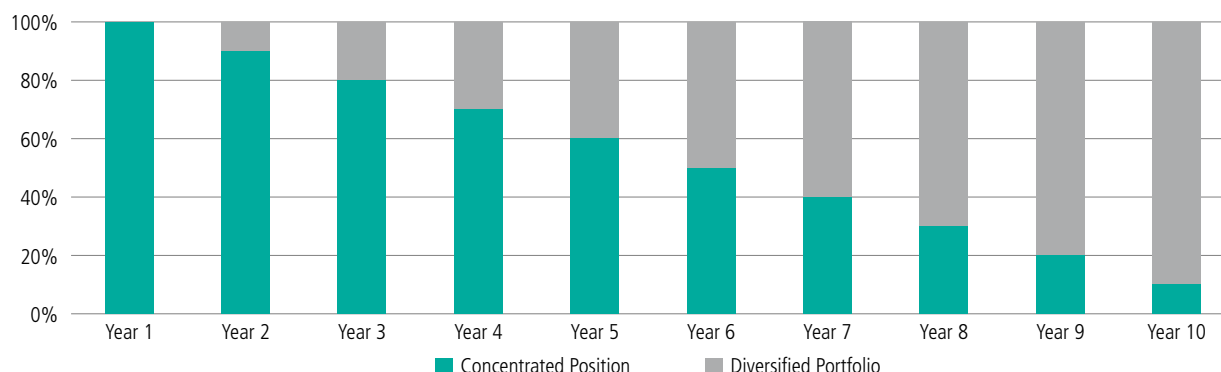
Staged Selling and Tax-Loss Harvesting Through a Tax-Managed Equity Allocation

The most straightforward and commonly employed strategy for diversifying out of a low-basis, concentrated stock position is staged selling, where investors gradually sell shares of the stock over a period of time rather than selling a large amount all at once. By spreading the sales across multiple tax years, investors limit the tax payments to smaller amounts, and potentially lower tax rates, as opposed to triggering a higher tax rate on a large one-time sale. The result is a gradual diversification of the investment portfolio, slowly reducing the concentration risk.

The proceeds from these sales can then be used as appropriate to help build out diversification in the broader asset allocation. One use of the proceeds may be into a public equity portfolio with systematic tax-loss harvesting, which the industry has coined "direct indexing" but in practice can be used to track any benchmark, core or active. This provides both immediate diversification toward an investor-selected benchmark as well as opportunistically realizing losses throughout the remainder of the year to offset the realized gains from selling the concentrated position, potentially reducing one's tax bill.

Staged selling may not be appropriate for all investors given that the tax bill is generated on top of other tax liabilities, and the time horizon often needed to create acceptably small tax bills for the investor in a given year.

STAGED SELLING DIVERSIFICATION TIMELINE



Source: Neuberger Berman.

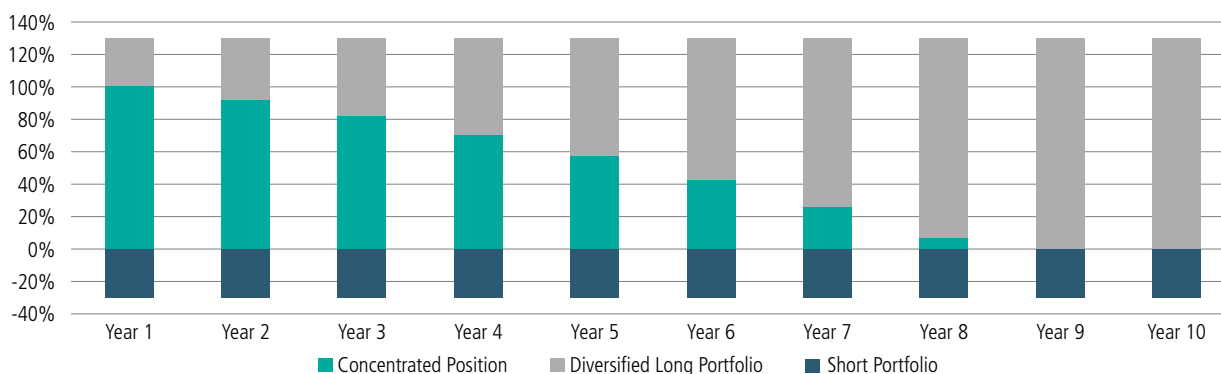
Tax-Managed Long-Short

Tax-managed long-short strategies have evolved from long-only tax-loss harvesting and, for certain clients, can be a useful tool to address some of the considerations noted above. This long-short approach can be an effective way to diversify out of a concentrated stock position while more aggressively addressing the tax implications that often accompany selling highly appreciated assets. For example, in a 130/30 strategy, an investor takes long positions equal to 130% of the portfolio's value and short positions equal to 30%, resulting in a net exposure of 100%. By carefully managing these positions, investors can reduce dependence on the concentrated stock and gain exposure to a broader range of assets, sectors or investment themes.

One of the key advantages of a tax-managed long-short strategy is its ability to facilitate diversification without triggering immediate capital gains taxes from selling the concentrated stock. Instead of liquidating the stock, an investor can use margin to add long exposure to complementary stocks, while also going short low- or negative-correlated stocks to minimize overall portfolio risk. These short positions act as a hedge, reducing the portfolio's overall exposure to the concentrated stock while enabling the investor to retain ownership and tax-efficiently diversify over time. Meanwhile, the long positions in other assets or sectors provide immediate diversification, helping to mitigate the risks associated with concentration.

This strategy incorporates tax efficiency into its design. By managing gains and losses strategically across the portfolio, investors can offset realized capital gains with losses from other positions, minimizing their overall tax liability. For example, losses from the short positions or other investments in the portfolio can be used to offset the gains generated by selling down the concentrated stock, reducing the tax burden. Additionally, the premiums earned from short-selling or adjustments to the portfolio can create opportunities to rebalance without incurring immediate tax consequences.

LONG-SHORT DIVERSIFICATION TIMELINE



Source: Neuberger Berman.

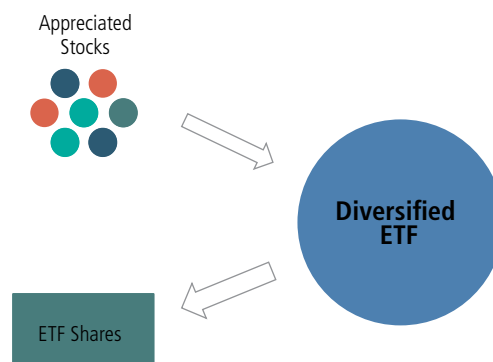
351 Exchanges

Exchange Traded Funds (ETFs) are often favored for their intraday liquidity, potential tax efficiency and applicability in estate planning. A Section 351 Separately Managed Account (SMA)-to-ETF exchange offers notable advantages to investors by facilitating a tax-efficient transition of eligible securities into an ETF. With a 351 exchange, an investor transfers their existing investment into the ETF in exchange for shares of the ETF without any taxable event, with their cost basis carried over to the ETF position.

This approach enables diversification while deferring taxation on unrealized gains. By postponing taxes at the outset, investors may reinvest those savings and potentially achieve substantial long-term wealth accumulation through the power of compounding. The investor will recognize the gain only if they later sell an ETF at a price in excess of the basis.

By exchanging a concentrated position for a basket of diversified assets, investors can reduce single-stock risk and improve the overall risk profile of their portfolio. A 351 exchange can also play a role in estate planning. By deferring taxes, investors can potentially pass on a more diversified and tax-efficient portfolio to heirs, who may benefit from a step-up in basis at inheritance, further reducing future tax liability.

351 EXCHANGE OVERVIEW



Source: Neuberger Berman.

Index Option Overlay

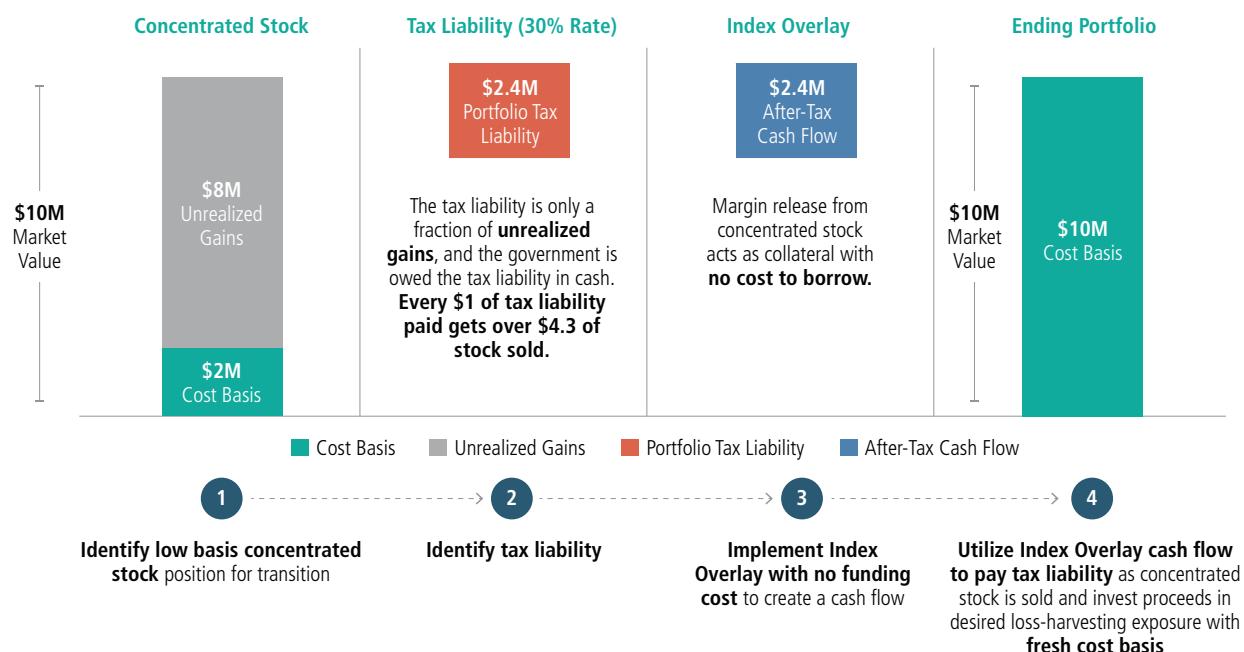
An index option overlay offers an innovative way to create a tax-advantaged cash flow that is additive to the concentrated stock position without funding the strategy and without altering the return profile of the underlying stock. The cash flow can then be used to pay the realized tax expense from staged sales of the low-basis stock position over time, helping diversification through the outright reduction of the tax expense that was limiting portfolio flexibility.

The strategy accomplishes this by unlocking the value of a concentrated stock position—without the need for immediate liquidation or disruptive borrowing. At its core, the strategy employs “margin release,” allowing investors to use the borrowing power of their concentrated stock position as collateral for an option overlay strategy. Importantly, this does not require going “on margin” or incurring the costs typically associated with borrowing.

For example, even with a zero-cost-basis position, every dollar of after-tax overlay income can help pay the realized tax expense associated with selling approximately \$3 – \$4 worth of stock, enabling a more tax-efficient transition out of the concentrated holding. This process can effectively convert a dormant asset on the family balance sheet to a productive investment allocation. Once shares are sold with the tax expense already offset, the full cash proceeds can then be invested into a tax-managed equity portfolio, which provides immediate diversification and systematically harvests losses to further offset gains. This combination can accelerate the timeline to diversification by reducing the overall tax drag and providing flexibility in both the timing and size of stock sales.

Ultimately, using an index overlay along with a tax-managed equity portfolio can convert a concentrated, low-basis position from a static holding into a dynamic, income-generating asset, providing investors with control, flexibility and a more efficient path to a diversified portfolio.

INDEX OPTION OVERLAY EXAMPLE



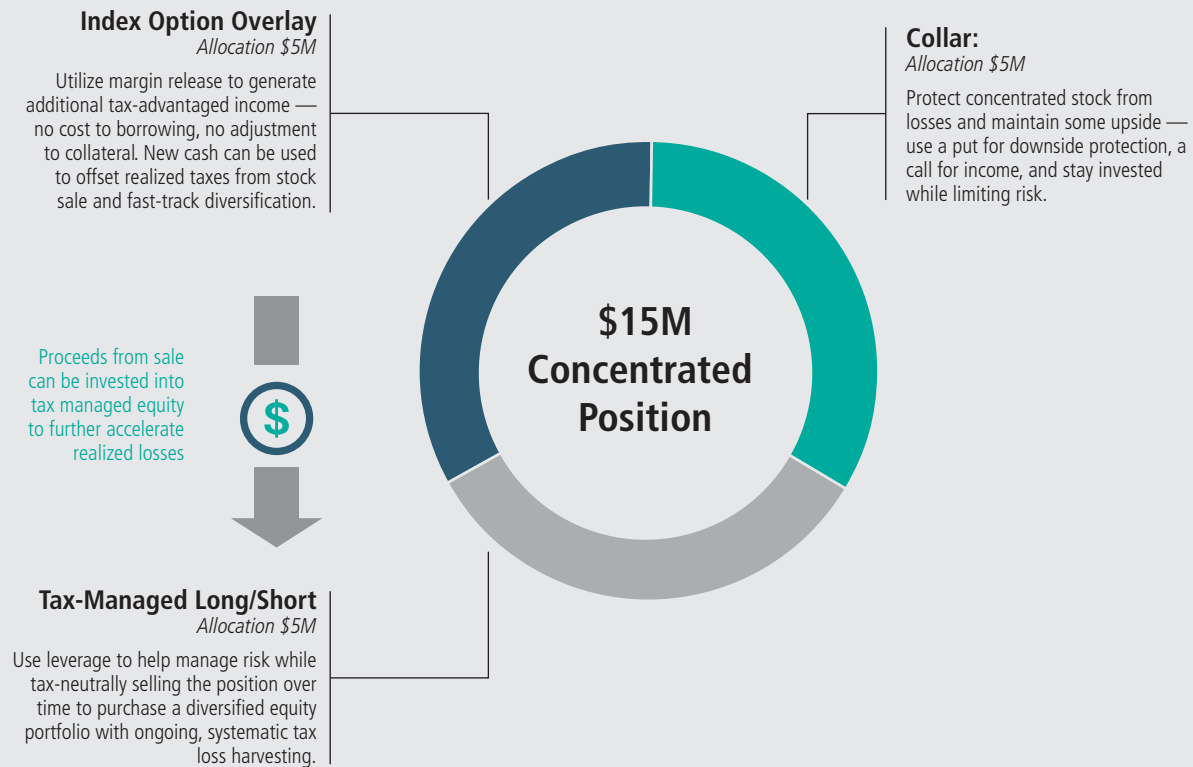
Source: Neuberger Berman.

Conclusion: A Blend of Solutions

In practice, we believe that a spectrum of solutions and timelines are needed to competently serve clients with low-cost basis positions. Unearthing client concerns surrounding risk, taxes and the time frame of diversification can help guide the potential blend of these strategies. Having a variety of strategies at one's disposal can allow for custom solutions to maximize each client's chances at an effective outcome (see the example below). The professionals at Neuberger are available to explore these approaches to help achieve client goals.

Pair Strategies and Tax Tools to Diversify, Manage Risk and Boost Flexibility

The following is a simple example of a client with a low-basis, concentrated position that is interested in immediately managing risk (collar) while planning tax-efficient solutions for longer-term diversification that can defer realized losses (tax-managed long/short) while also paying down the tax liability (index option overlay).



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Neuberger Berman
1290 Avenue of the Americas
New York, NY 10104-0001

www.nb.com