CLIENT CHALLENGES & SOLUTIONS: **CONCENTRATED POSITION MANAGEMENT**

Brown ADVISORY
Thoughtful Investing.

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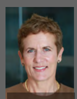

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We provide a wide range of investment management and long-term planning services and solutions, but if we had to choose one phrase to describe what we try to deliver to clients, it would be "strategic advice."

"Strategic advice" is a very open-ended term, but when we use it, we have a specific meaning in mind. We think of our role in relatively simple terms: Our job is to listen to each of our clients, understand the unique nature of their challenges and aspirations, and then deliver effective and creative solutions that help them achieve their goals. The listening component of our work is very important; we can only do good work for clients if we truly devote ourselves to understanding their subjective perspective as well as their objective circumstances.

In many cases, the solution we deliver to a client may be a straightforward answer to a clear request. For example, if an institution asks us for a well-managed small-cap equity strategy with a documented track record, we can provide that. But in other cases, our clients face complex challenges for which there are no universally applicable solutions. It is here where the concept of strategic advice becomes truly essential, so we can help clients with complicated scenarios to develop strategies tailored specifically to their situation.

This publication highlights a particular situation when this sort of approach can add value. Many of our clients have a large proportion of their wealth concentrated in a single asset—perhaps in a large block of a publicly traded company, a sizable interest in a private business or some other asset. Often these have been successful investments over time—hence, they have grown in value far beyond their cost basis. At some point, many of these clients face a similar dilemma: Holding that asset may create meaningful risk, but selling it would create a meaningful tax event.

While these situations may appear similar on the surface, each client's circumstances and perspectives are distinct, involving variations in the attributes of the asset being examined, the client's tax scenario, family dynamics, emotional attachment to the asset in question and many other factors. Our goal with each client is to address their challenges holistically—from a strategic advisory perspective. We seek to draw on diverse expertise from around the firm and choose the approach that best addresses the risks and opportunities that are most important to each specific client. Oftentimes, this means executing on a range of ideas. A client may wish to retain some exposure to a holding as part of a family wealth transfer plan (perhaps using Grantor Retained Annuity Trusts [GRAT] or other trust mechanisms), while also reducing risk (by selling, hedging or gifting to charity) as well as mitigating taxes through various means. A comprehensive strategy using multiple techniques can help to accomplish a variety of goals at once.

This publication seeks to summarize the nature of the challenges presented by these scenarios and offer a snapshot of the various solutions we use to deliver results to clients. Along the way, we also hope we can offer a window into how this concept of strategic advice serves as the foundation of our client relationships.

INVESTMENT PLANNING CONSIDERATIONS

Author: Jane Korhonen, CFA | *Portfolio Manager*

The decision to sell or hold a concentrated position may sound simple, but these situations are often more complex than they appear and require the investor to reconcile investment dynamics, tax considerations and a variety of subjective, emotional factors. Taxes are not the only reason that a client may want to hold onto a concentrated position—a holding may have understandable sentimental value based on family history, or it may have proven its worth in the past with exceptional performance. We have found that focusing on each client one at a time is the only way to help them make the right choices.

Concentration — A Double-Edged Sword

Our firm has always believed in the value of concentrated investment—in other words, in the merits of putting our clients' capital behind a select set of high-conviction ideas. Our partner Ben Griswold continuously reminds us that one of the best ways to build wealth over time is to put your capital behind great companies and let the power of compounding work for you.

However, it's equally important to remember that holding a concentrated position carries risk. A bank with one borrower is in trouble if that borrower doesn't pay them back; a company with one customer is in trouble if that customer goes elsewhere. Similarly, investors should be cautious about a heavy weighting in a single investment. One also needs to consider that time is not always your friend if you hold a single, concentrated investment. Very few companies have generated above-average returns for shareholders over extended periods of time, and even great companies are eventually susceptible to strategic failures, management mistakes or disruptive innovation.

Given all of this, we believe in addressing concentration explicitly with our clients—either with a plan to diversify over time or at least with an examination of trade-offs associated with maintaining the concentrated position. Here are some of the considerations we often discuss with clients:

Liquidity: How easily can we sell or trim the position? Does it have limited daily trading volume? Does the client hold restricted stock or need to consider time windows during which selling is authorized?

Taxes: What are the tax consequences if the position is sold? This is a central question driving this publication and a critical factor for many of our clients who hold concentrated positions.

Fundamental Risk: What is the strategic and operating backdrop for the company or asset, and what can we expect in terms of return and volatility going forward? What would a worst-case scenario look like, and how likely is that scenario?

Role in Portfolio: Is this a growth or income asset? Does the client rely on the income stream produced by the holding? Can the asset's attributes be replicated by other investments?

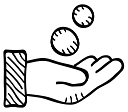
Client Perspective: Is there a meaningful emotional attachment to the company that should be considered (family legacy, for example)? Is there a benefit that wouldn't be apparent from financial analysis (for example, does the client's familiarity with a company provide confidence about its returns)?

In many of these situations, some amount of diversification from a concentrated holding is warranted, but there are often reasons why a client many want to hold onto some or even all of a concentrated position. These decisions are never easy for anyone involved. It is not uncommon, for example, to see a stock that we are selling do well enough to make us second-guess our thinking. But, if we are selling to reduce risk, everyone involved—our team as well as the client—should feel confident that the decision was warranted regardless of the near-term performance of the asset. This is why a comprehensive review of all relevant factors is so important—once a decision is made, everyone should feel comfortable that the decision was made for the right reasons and that it addresses the right priorities.

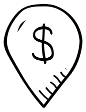
Many Options for Reducing Exposure

When it comes to concentrated, low-basis holdings, we rarely recommend an immediate sale of a client's entire position. Generally, we seek to implement a gradual strategy that uses a combination of actions to mitigate risk, and we regularly re-examine our ongoing approach to ensure that we remain in sync with the client's circumstances and market conditions.

There are a variety of tools we can use to mitigate the exposure risk of a concentrated equity position.

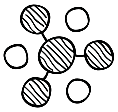


Outright Sale of Stock: We can choose to lay out a sale plan that gradually reduces the holding to a targeted size (or eliminates it entirely). Assuming that gains are taxable, we would generally seek to sell shares with higher cost basis first, as well as shares held for longer than one year (to ensure that the proceeds are taxed as long-term capital gains rather than ordinary income). We may also choose to coordinate sales to assist with other portfolio objectives; for example, we might look to use sales proceeds to fund regular portfolio disbursements for spending purposes.

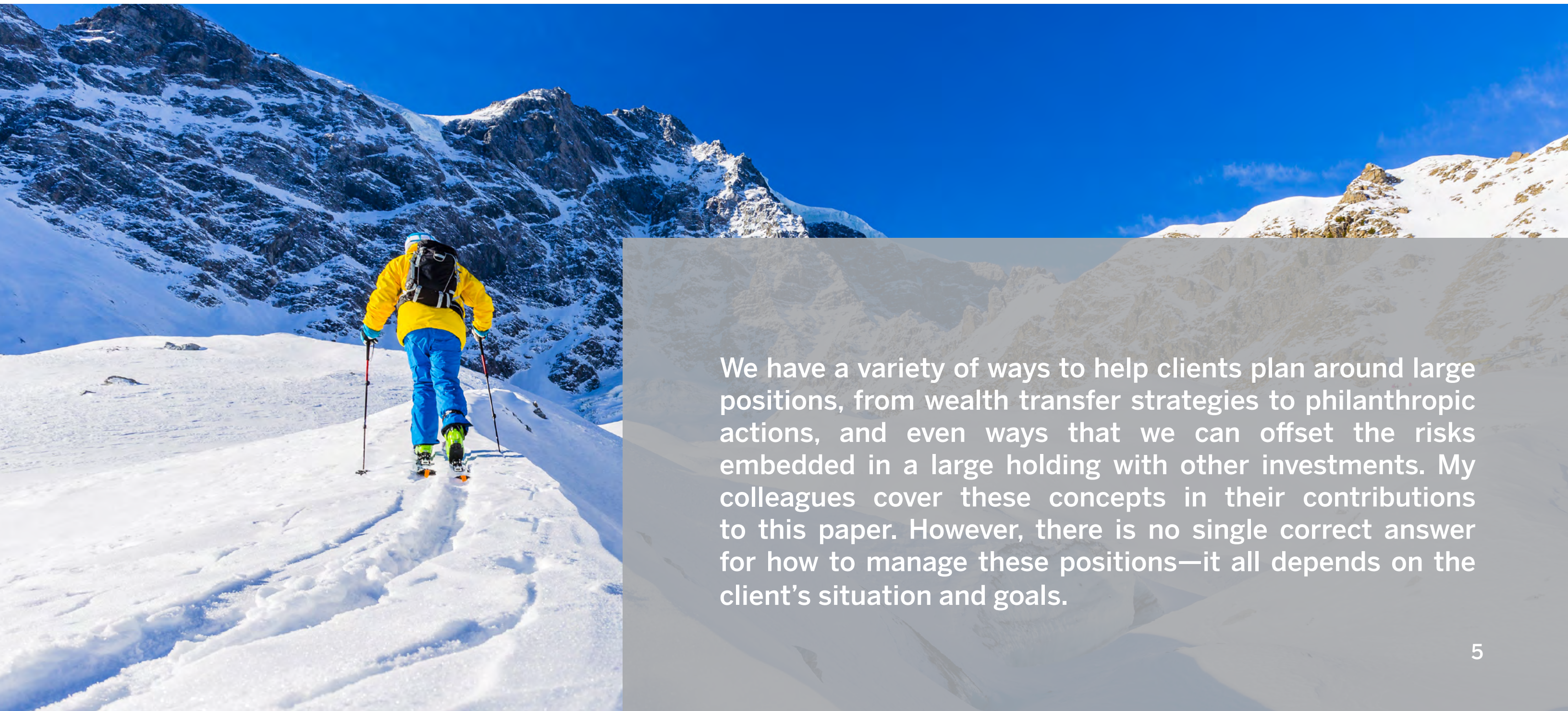


Staged Sale of Stock: We can also develop a sale plan based on agreed-upon price targets—in other words, we will sell the stock over time but only at certain prices. These plans may include provisions for a variety of scenarios (e.g., if a stock's price rises more than expected, or if it falls to a level that threatens other investment goals).

Exercise Options / Sell Restricted Stock: If a client is actively employed by a company in which they own a large amount of stock, we can deploy 10b5-1 selling plans or help them exercise vested options and sell shares in a cashless transaction. This may help reduce the client's exposure to risk associated with their company or at minimum prevent that risk from growing larger.



Hedging and Other Strategies: Without actually selling a position, we can still reduce exposure to it. We can sell options to provide income that may offset some downside risk; buy options that provide a more "pure" form of downside protection; use shorting strategies to counterbalance exposure to a specific name or industry sector; or choose from a host of other, more complex option strategies. Exchange funds are an additional option. These allow a client to swap shares of a single holding for units in a broader portfolio. Because this swap is not an actual sale, the client is able to defer capital gains taxes while diversifying their holdings, All of these techniques can help mitigate the risks of a concentrated position; the client's specific situation dictates which technique is likely to be most helpful.

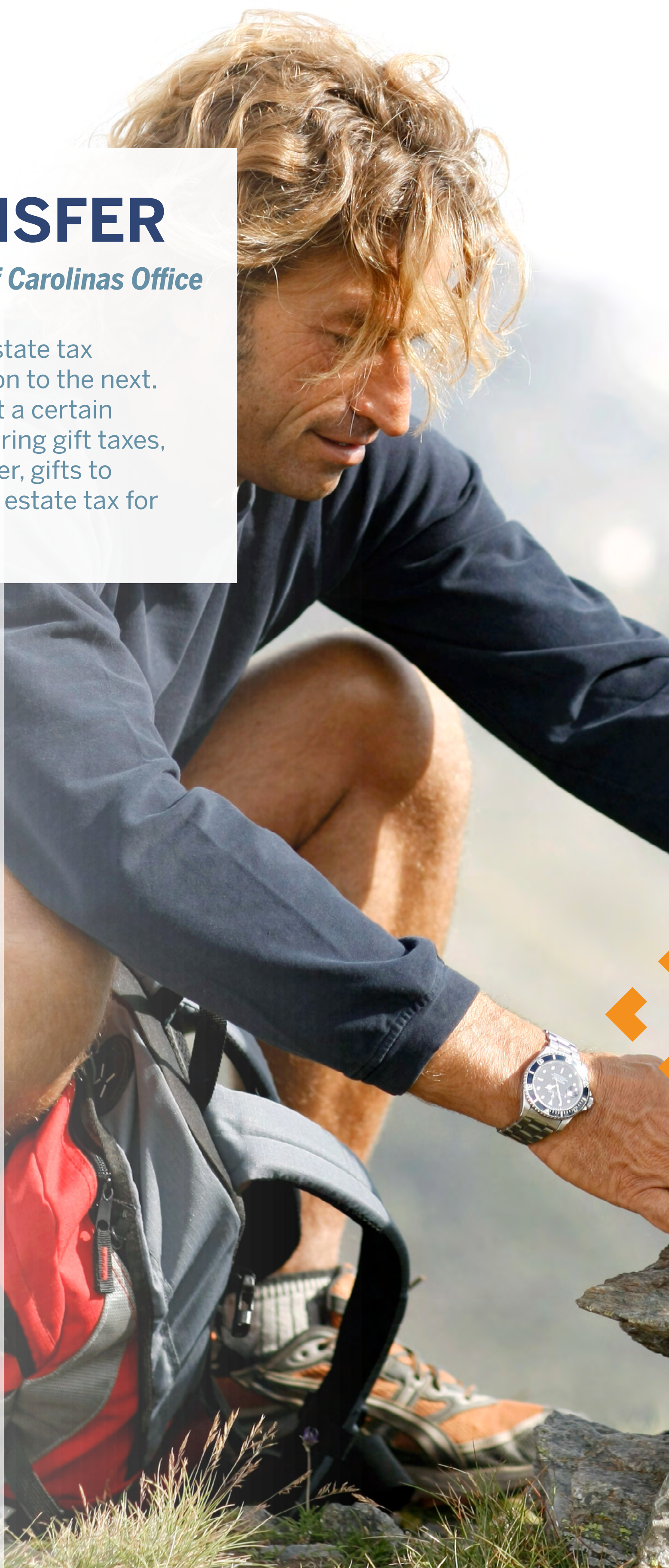


We have a variety of ways to help clients plan around large positions, from wealth transfer strategies to philanthropic actions, and even ways that we can offset the risks embedded in a large holding with other investments. My colleagues cover these concepts in their contributions to this paper. However, there is no single correct answer for how to manage these positions—it all depends on the client's situation and goals.

FAMILY WEALTH TRANSFER

Author: Stuart Dorsett | *Strategic Advisor & Head of Carolinas Office*

Families can use a variety of strategies to reduce their estate tax burden. One of those is gifting assets from one generation to the next. By using various exemptions and exclusions, you can gift a certain amount of assets to your family members without triggering gift taxes, thereby reducing the size of your taxable estate. Moreover, gifts to so-called dynasty trusts may insulate gifted assets from estate tax for multiple generations.

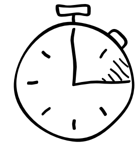


One of the primary benefits of lifetime gifts is that of "estate freezing." In other words, once you've made a gift to a beneficiary, any future appreciation of those gifted assets occurs in the hands of the beneficiary and outside of your taxable estate. We often help clients deploy strategies such as GRATs to accomplish these estate freezing goals; the interplay of investment and tax considerations in these matters helps us identify windows of opportunity where we can take advantage of volatility or other market conditions to make notable progress on wealth transfer objectives.

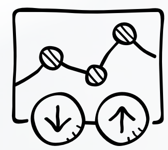
However, are these transfers advisable with low-basis assets that carry a meaningful amount of unrealized capital gains? Generally, no, because your tax basis in a gifted asset carries over to your beneficiary. If you gift a low-basis asset to a beneficiary who eventually sells it, the capital gains tax he or she incurs could offset or even outweigh the estate tax savings achieved by gifting the asset in the first place. In contrast, assets passed to a beneficiary at death receive an adjusted (often referred to as "stepped up") cost basis equal to the value on date of death, which eliminates unrealized capital gains.

Accordingly, low-basis gifts typically make sense only when your estate tax rate is much higher than the beneficiary's capital gains tax rate. Historically, estate and gift tax rates were much higher than capital gains rates, so gifts of low-basis assets generally made more sense in the past than they do today. But the differential between the two taxes has narrowed; federal estate tax rates have fallen, and estate taxes in many states have been eliminated, while capital gains taxes have risen at the federal level and in some states.

However, a gift of low-basis assets may still be advisable in some cases. While not an exhaustive list, here are several scenarios in which gifts of low-basis assets may make sense.



When you can retain the income tax liability of the gifted asset. In some situations, you can retain the income tax burden inherent in the gifted asset (both ordinary income tax and capital gains tax upon a sale), even while the economic value of the asset is passed to a beneficiary. A primary mechanism for achieving this result is a so-called intentionally defective grantor trust (IDGT). If you create an IDGT, you are deemed the owner of the trust for income tax purposes, but the trust beneficiary receives the economic benefit of the trust's assets. If you contribute a low-basis asset to an IDGT and the asset is sold, you would pay the tax on that sale; functionally, this serves as an additional gift to the trust but is not treated as a gift for gift-tax purposes. Essentially, your beneficiary receives a greater net return on the gifted asset than you would because his or her return is not subject to income tax. What's more, the tax payment reduces your remaining assets and thus lowers your eventual estate tax bill.



When you can discount the fair-market value of the gift for gift-tax purposes. You can discount the value of a gifted asset if the beneficiary will not have administrative control over a received asset and/or they cannot easily sell the asset. Tax law allows discounting in these situations to reflect the lack of control and lack of marketability of the asset. For example, if you hold minority interest in, or nonvoting shares of, a closely held business, you may be able to discount the value of that asset for gift-tax purposes. There are other ways to generate valuation discounts through indirect gifting strategies. For example, publicly traded securities wouldn't normally be eligible for a discounted valuation, but if you place them in a family limited partnership and gift interests in that partnership to your beneficiaries, you may be able to apply a discounted valuation to the partnership units. Such discounting enhances estate tax savings because the amount of the discount is the functional equivalent of additional post-gift appreciation in the value of the asset.

When it is unlikely the transferred asset will ever be sold. If your beneficiary is highly likely to retain the asset, concerns about capital gains taxes become irrelevant—if those gains are never realized they will never be taxed. Accordingly, any asset viewed as a "family legacy," such as a family vacation home, could be a good candidate for low-basis gifting.

So, while it is generally better to gift higher-basis assets and to pass lower-basis assets through inheritance, there are also some clear exceptions where it may make sense to consider lifetime gifts, even when the gifted assets are highly appreciated. As is always the case in matters of estate planning, your decisions depend greatly on your unique circumstances, and we consider it our responsibility to help you devise an estate plan that helps your family achieve its specific multigenerational goals.

PHILANTHROPIC OPTIONS

Authors: Craig Standish | *Strategic Advisor*   Amy Seto | *Strategic Operations Director*

Philanthropic giving is an essential component of many of our clients' long-term financial plans. A well-developed philanthropic strategy involves a great deal of planning; there is upfront work to prioritize specific causes and issues, followed by decisions on optimal giving structures. Finally—in keeping with the topic of this publication—there is the choice of which assets the client will donate.

Many of our clients' first instinct is to make charitable gifts with cash. However, making an in-kind gift of highly appreciated securities can often be a better solution from an income-tax perspective.

Structural Options

Before discussing the advantages of gifting appreciated securities vs. cash, we should briefly review some of the primary philanthropic structural options. We generally discuss four main giving options with our clients.

Direct gifts—in other words, outright donations of cash or other property directly to a charitable organization—are a relatively simple option and very common. When making an outright gift, you are generally entitled to an income tax deduction for the value of the gift (subject to income limitations).

Donor advised funds, or DAFs, have become extremely popular, and for good reason. Gifts to a DAF are eligible for an immediate income tax deduction, but charitable distributions out of the account can be made gradually over time—this provides a great deal of flexibility to donors who may wish to deploy charitable assets gradually rather than all at once.

Private foundations are a third option. They are particularly good options for families who want to move beyond gifting and become active in a more programmatic manner. When considering private foundations, families should understand the administrative burdens of such structures, as well as the fact that these foundations must distribute at least 5% of their assets annually. In contrast, DAFs do not have an annual distribution requirement; there have been recent conversations in Congress about instituting annual payout requirements for DAFs, but it is far too soon to speculate about whether this will come to pass. Another consideration: If you gift an interest in an operating business to a private foundation, you may face complications later with regard to taxes on income earned by that business.

Finally, various **trust structures** can offer benefits to both the donor and the charitable recipient. Let's say that you wish to provide an income stream to a charity for a period of time while retaining your principal for yourself or your heirs. You can create a **charitable lead trust** to accomplish this. Conversely, you may wish to establish an income stream from a pool of capital for yourself during your lifetime, and then bequeath that capital to a charity at your death or at some fixed future date. In this case, you would use a **charitable remainder trust**. Using these types of structures adds complexity to a philanthropic plan, but trusts can be highly effective for clients who want a synergistic strategy that produces positive outcomes for family and charity at the same time.

We have summarized these options for charitable giving, along with some relevant considerations for each, in the table on the next page.

We often work with clients to help them develop their philanthropic strategy, and, as mentioned previously in this publication, we find that our role in advising clients on both investment and tax matters can be quite helpful. For example, we can effectively address the need to reduce portfolio risk with a set of actions that also achieve desired charitable goals. In some cases, we work alongside the philanthropic advisors of the community foundations and other organizations that our clients wish to support, reviewing the variety of solutions that these organizations offer their donors and choosing the strategies that best fit each client's goals and circumstances.

Gifting Appreciated Assets

As noted above, many people primarily think about gifting with cash, but a gift of a low-cost-basis asset can provide tangible benefits to the donor. Consider a donor who purchased stock at $20 that is currently worth $100. If the donor sold that stock, after capital gains taxes, they might have $80 or less to donate to charity. A better solution would be to gift that stock directly. The donor would be eligible for a tax deduction for the full $100 fair-market value of the stock (again, subject to income limitations). The charity could sell the stock for $100 and because it is tax-exempt would not need to pay any capital gains tax, thus benefiting from the full $100 donated.

Beyond this basic equation, there are other ways we have helped clients leverage appreciated holdings for charitable purposes. For example, if a client is attached to a family legacy holding that provides a healthy dividend, they might want to place that stock in a private foundation or even a charitable lead trust and direct those dividends to charities of their choice. This would remove the risk of the concentrated position from their personal portfolio while still allowing them to use the position to accomplish philanthropic objectives.

It is a privilege to help our clients make an impact in the world. By being thoughtful about each specific step in the philanthropic process, we aim to help them maximize that impact.

	Direct Gifts	Donor Advised Fund (DAF)	Private Foundation	Charitable Remainder Trust (CRT)	Non-Grantor Charitable Lead Trust (CLT)
TAX CONSIDERATIONS	Income tax deduction of up to 30% of adjusted gross income (AGI) for gifts of stock	Income tax deduction of up to 30% of AGI for gifts of stock	Income tax deduction of up to 20% of AGI for gifts of stock	Immediate income tax deduction based on the value of the remainder passing to charity Deduction limitation dependent on whether remainder passes to private or public charity	No upfront income tax deduction—used primarily as a gift tax strategy
OTHER CONSIDERATIONS	Gifts of appreciated stock are good options for direct gifts. Neither the donor nor the charity will realize any capital gains tax on the sale.	DAFs are user-friendly and require no reporting or tax filings on the donor's part. Donors should ensure they understand all related administrative fees. DAFs do not require annual distributions.	Private foundations are a good choice for those who want to actively work on a philanthropic mission. Private foundations must distribute 5% of the value of their net investment assets annually. Operating costs and ongoing compliance requirements are meaningful considerations.	Annuity payments to the income beneficiary are taxable over a number of years. Both private foundations and DAFs can be named as remainder charities.	Less frequently, these are structured as a grantor CLT, which involves different tax treatment of both your initial contribution and the ongoing income generated by the trust. Both private foundations and DAFs can be named as lead charities.

BUILDING A PORTFOLIO TO OFFSET POSITION RISK

Authors: Tim Hathaway, CFA | *Director of Equity Research*   Theresa Balaran | *Portfolio Manager*

For years, our firm has built equity strategies that fit squarely into traditional style boxes, like "U.S. large-cap growth" or "small-cap value." But when our clients tell us what keeps them up at night, they don't speak in terms of style boxes; they ask for things like income, protection against a market correction or (of particular relevance to this publication) a way to offset the risks of a large, concentrated stock position they hold.

Today, we are focused on developing strategies that specifically address our clients' stated needs. Working in close collaboration, our equity research team and private client portfolio managers have opened a new frontier in portfolio building, enabling us to offer truly customized portfolios that fit our clients' specific circumstances.

As addressed elsewhere in this publication, we appreciate the many reasons that a client may want to maintain exposure to a large, concentrated stock position. Tax considerations may outweigh the risk of the position losing market value, and other factors may also come into play in the decision to hold the position. But to the extent that the client can deploy other funds—either from liquidating a portion of the concentrated position or from freeing up assets elsewhere—we can use those funds to construct a portfolio that can act as an anchor to windward that offsets the risk embedded in a client's concentrated stock.

We recently had a situation where a client came to us with nearly his entire liquid net worth invested in one stock (the result of selling his business to a public financial services company). Let's call the stock XYZ. After consulting with the client, we decided to sell the XYZ shares over multiple tax years, but only if we could maintain the level of income currently generated in dividends from XYZ (the client relied on this income). So, our task was to build a portfolio of equities that matched or exceeded the XYZ dividend (approximately 3%) and whose performance was relatively *insensitive* to the specific attributes that drive the performance of XYZ. As a financial services company, those factors include interest rate sensitivity and financial-sector exposure.

Typically, we begin building a client-driven portfolio by targeting a specific metric or set of performance attributes. That was the case here: We were aiming for a specific minimum level of yield, plus a low level of sensitivity to the risks embedded in XYZ. By supplementing our research team's fundamental stock-picking efforts with analytical tools to guide portfolio construction, we were able to target those specific income and risk reduction outcomes.

To begin, we analyzed XYZ stock's performance over time in detail vs. that of a broad-market stock index to see how closely the stock tracked the index. We also tested its sensitivity to various economic and financial considerations (to identify what are commonly referred to as "macro risks"). Has the stock tended to move up or down in tandem with the financial sector? Has its performance been heavily influenced by changes in interest rates? Through our analysis, we found that the performance of XYZ stock was in fact strongly linked to both of these factors.

Armed with this knowledge, we then set about building a portfolio with reduced exposure to the primary macro risks we found in XYZ stock. The aim was to truly diversify the client's risk—for example, if the financial sector suffers a major setback next year, we would expect XYZ stock to suffer, so we would want a portfolio that we believe could hold up relatively well in that scenario.

In terms of stock selection, we have a very strong head start: The body of research created by our global research platform (our equity research team performs deep due diligence on hundreds of stocks each year and meets with hundreds of management teams) gives us an ample universe of stocks that our team favors based on fundamentals and valuation. From this set of names, we can build a portfolio based on both our fundamental judgment (i.e., our highest-conviction stock ideas), alongside data that help us see how the addition of any name or the sizing of any position may influence the attributes of the overall portfolio.

What did all of this analysis eventually produce? After several iterations, we recommended a portfolio of 35 stocks—each of which were strongly recommended by our research analysts—that offered a yield of approximately 3%, volatility on par with the broader stock market and a low exposure to the macro risks embedded in XYZ stock. We determined that if the client sold 35% of his XYZ stock to fund this new portfolio, the resulting combined allocation (to be clear, 65% XYZ stock and 35% in this newly created portfolio) would cut nearly in half the client's exposure to financial-sector and interest rate risk vs. the status quo of simply holding onto the initial position.

This exercise delivered a strong result for our client and also opened the door for a new solution that we can now offer other clients. Building an "offset" portfolio like this will not be the right answer for every client with a concentrated position, but we now have an additional solution to offer to clients in these situations.

Step 1 Identify key attributes of existing asset.

Primary Asset

- 3.1% dividend yield
- Primary risks
  - Interest rate exposure
  - Financial-sector exposure

Step 2 Set desired attributes of offset portfolio.

Offset Portfolio

- Match approx. yield of existing asset (~3%)
- Mitigate existing asset's primary risk exposure

Step 3 Create offset portfolio.

Offset Portfolio

- Select stocks using existing body of fundamental research
- Leverage technology to construct portfolio with specific attributes

Step 4 Monitor and confirm results.

Primary Asset   Offset Portfolio

65% of assets in original concentrated asset, 35% in new "offset" portfolio

Combined Portfolio Attributes:

- 3% dividend yield
- Portfolio beta of ~1.00 (volatility on par with broader market)
- Reduced exposure to interest rate risk and financial-sector risk by ~50%

The example shown is for illustrative purposes only. The investment team will customize portfolios to meet the guidelines, requirements, and risk tolerance of the client.