Your Money Matters

With Stock Hedges, Outcomes Can Vary With the Strategies

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So, you've had a great decade -- or a really great year -- in the stock market. But your fortunes are largely tied to a single stock, most likely shares of the company you work for.

Knowing about the risks of putting all your eggs in one basket, you want to hedge your bets and protect yourself against the bottom falling out.

That's what Charles Volpe and John Kelley Jr. did, with opposite results. The hedging strategy that bought Mr. Volpe peace of mind could cost him more than $3 million in lost profits on his stock when his hedges expire next year. A similar strategy saved Mr. Kelley more than $7 million, before costs associated with the transaction, after the price of his shares plummeted.

Their stories tell the upside and downside of hedging strategies that have become increasingly popular as the red-hot stock market has created scores of multimillionaires. These creative hedging strategies cut the risks of a concentrated stock portfolio at a time that share prices are ricocheting like ping-pong balls.

It's impossible to precisely gauge the popularity of these hedges, but derivatives specialists suggest that hundreds, perhaps even a couple thousand, are executed each year. Executives using such strategies include Ted Turner, Time Warner Inc.'s vice chairman, whose hedge could cost him more than $190 million at current prices for the stock (though if anyone can afford it, Mr. Turner can, as his Time Warner shares are currently worth nearly $9 billion.)

Wall Street firms like Morgan Stanley Dean Witter & Co. and Salomon Smith Barney Inc., a unit of Citigroup Inc., regularly pitch these strategies to wealthy clients who want to sleep better at night.

Tax-law changes have dimmed the luster of many once-popular techniques that wealthy investors used to cut their downside risks without incurring a hefty tax bill, says Rande Spiegelman, a senior manager for KPMG Personal Financial Planning. The hedges "are all Wall Street has to offer in terms of an effective diversification and tax-deferral strategy," he says.

Although executives who are required to report "insider" transactions to the U.S. Securities and Exchange Commission also must report these hedging transactions, the filings are often so complicated that it would be hard for an average investor to figure out what's going on. As a result, these deals draw less attention than an outright sale of stock, but still free up cash for diversification or other purposes.
To be sure, the simplest -- and often best -- strategy for many investors is to sell some stock and use the proceeds to diversify. "We don't believe [hedges] are a silver bullet," says Alan Feld, a managing director at Sanford C. Bernstein & Co. "You're not creating a permanent solution." If the stock moves up or down significantly, he says, a hedge can create unfavorable tax consequences that can force an investor to sell shares anyway.

But not everyone can sell stock when they want to. Hedges are particularly popular among entrepreneurs and executives who have sold their companies in exchange for restricted stock that can't be unloaded for at least a year. A big advantage of these hedging transactions over standard call and put options -- which give investors the right or obligation to buy or sell shares at a preset price in the future -- is that there is typically no upfront cash outlay, although as Mr. Volpe's experience shows, there can be a substantial cost.

Mr. Volpe was an executive at Kemet Corp. when the maker of ceramic and tantalum capacitors went public in 1992. He decided to opt for hedging strategies last year when the stock -- which had traded as low as $8.75 in 1998 -- was trading in the mid-20s. "If that's where all your eggs are, it's not a very good feeling," says Mr. Volpe, 62, who retired as president of Kemet in 1996, but remains a director of the Greenville, S.C., company and still has most of his assets in Kemet stock.

At Tuesday's 4 p.m. New York Stock Exchange price of $51.1875 per share, his stake on paper is worth nearly $16 million, though the hedging strategy means that he may not realize a sizable portion of the stock's gains.

Mr. Volpe last summer entered into two complex arrangements with his broker intended to offer downside protection and free up cash to diversify, without actually selling his shares. "I wasn't ready to sell my Kemet stock," he says. "It was a way to just insure the future."

The first hedge, known as a "zero cash collar," gives Mr. Volpe the right to sell 100,000 of his 305,266 Kemet shares for $22.37 when the collar expires next January; his broker has the right to buy those same shares at $30.07 at that time. Essentially, he's guaranteed at least $22.37 a share, but gives up any gains above $30.07.

Deals like these typically carry a fixed expiration date, says Paul Elliott, an analyst at First Call/Thomson Financial, which tracks insider holdings. That means the broker can't grab the stock beforehand; if the investor unwinds the deal early the price depends on market conditions. If the stock is trading within the preset bands when the collar expires, no cash or shares change hands, and the investor is free to do what he wants with the shares.

Assuming Mr. Volpe's collar expires with Kemet trading at $51.1875, the 100,000 shares will be worth $5.1 million. But he will have to deliver those shares to his broker in exchange for a payment of about $3 million before taxes, or he could keep the stock and pay the broker $2.1 million in cash.

Mr. Volpe also entered into a "liquidity contract," or a "prepaid variable forward" to free up money for diversification. His broker gave him $2.162 million, or $21.62 per share, against 100,000 Kemet shares. When the agreement expires next August, Mr. Volpe will pay the broker a sum based on Kemet's closing price and a price range set when the contract was established.

If that hedge expires with Kemet trading at $51.1875, Mr. Volpe will have to hand over to his broker roughly $4.75 million-equivalent to nearly $2.6 million in interest on what he received from his broker just a year earlier. Mr. Volpe's true cost will be lower, however, because he earned a profit investing the money he was advanced.

Mr. Kelley put collars on 553,500 of the 758,658 shares in Ha-Lo Industries Inc. he owns, following the firm's acquisition of his company in 1998. He then borrowed against the collared stock and used the proceeds to diversify. When he closed out the hedges early, after he was named Ha-Lo's chief executive in November, shares
in the Niles, Ill., marketing company were trading below $8 per share. The collars guaranteed prices of slightly more than $20 per share.

Mr. Kelley realized a profit of more than $7 million, excluding the cost of the loan and the cost of unwinding the hedge early. He also got to keep the collared shares—worth $4.95 million at yesterday's 4 p.m. Big Board price of $8.9375—plus any profits he made investing the borrowed money.

The collars were "the right investment strategy to maximize the value of the equity I received in selling the agency," says Mr. Kelley, adding that he entered into the hedges "without ever imagining I would be named CEO in November of 1999." Mr. Kelley says he closed out the hedges early to show "that I felt very strongly about the direction of where the new company was going. ... As soon as I'm out of blackout because of fourth-quarter earnings, I'll be a buyer" of Ha-Lo shares.

To protect their positions, brokers who put together these deals short-sell some, though not all, the shares being hedged. A short sale involves the use of borrowed stock, which the investor hopes to replace with shares that have fallen in value. The brokerage firms' profits are tied to the pricing of options they use to hedge their exposure. The cost to the investor is embedded in the structure of the transaction.

Individual investors could, in theory, create their own collars using exchange-traded puts and calls. "But you sure need to know what you're doing," says KPMG's Mr. Spiegelman. "Don't try this at home, folks."

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