Artemis
FINANCIAL ADVISORS

Artemis Brief: No. 38

Building A Stock Option Plan To Manage Volatility And Downside Risk

By Scott Gillespie, CFA

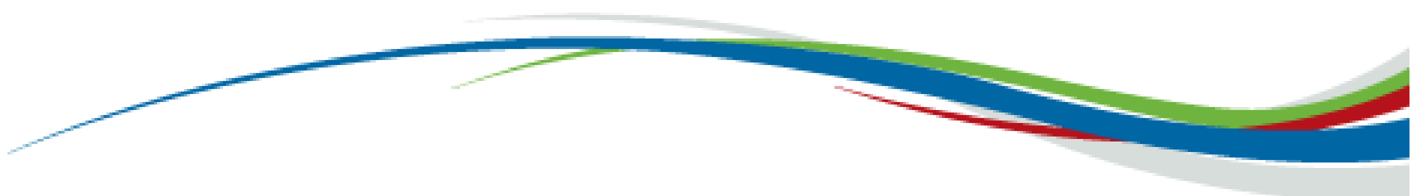
Volatility is an expected part of investing in the stock market. For people with stock compensation, creating a strategy that allows for upside, but hedges both the downside market and specific company risk over time is a key to success.

As such, most stock compensation strategies should not seek tax efficiency as the core objective. While tax optimization is important, any good stock compensation strategy must carefully consider the inherent cost/benefit of being perfectly tax optimized and the risk of holding an overly large single stock position. The benefits of diversifying your investment risk are often underappreciated, particularly during boom periods when markets are rising.

When markets are buoyant, the rising tide typically lifts all boats and most folks with stock compensation see their concentrated positions rewarded handsomely. In such periods, like the one we have seen over the last decade, and particularly so over the past three years, risk is rewarded and stock investors can be lulled into a false sense of security. The fear of missing out on a big stock run leads them to take far more risk than they need for a financial plan to be secure.

It is important to hedge individual stock risk by developing a strategy and committing to a “sell discipline.” The below diagram shows the potential impact of stock price movements on an individual stock. It shows the impact of an increase or decrease by 4%, 12% and 20% annually over a typical 4-year vesting period.

The biggest risk in stock compensation is that your company stock price has a sharp or prolonged decline. By taking chips off the table along the way you significantly reduce the worst-case outcome and can reinvest the proceeds in a more diversified portfolio. In so doing, you retain upside but in areas that complement rather than overlap with your concentrated position. While it is easy to have confidence in your company, firm vision, and your team, what many underestimate is that the sector your company is in may become less attractive or impaired, or an unknown risk (potentially a faulty accounting practice, loss of a key customer, or disruption by a competitor) negatively impacts the company.



Bottom Line

Good stock compensation planning is largely about the investment decision and proactively creating a “sell and diversify plan” related to your vesting schedule, while incorporating tax strategies. Volatility and downside risk need to be understood and managed relative to your specific circumstances. We recommend developing a comprehensive financial plan by which you can frame your very important stock compensation strategy decisions.

If you would like to learn more, please get in touch at sgillespie@artemisadvisors.com.

Stock Volatility Example 2022-2025

Biogen Stock Price $240
Options Value $1,000,000

Upside Case				Downside Case			
Return*	Year	Price	Value	Return*	Year	Price	Value
+4%/Yr (+13% Total)	2022	$240.0	$1,000,000	-4%/Yr (-12% total)	2022	$240.0	$1,000,000
	2025	$270.0	$1,124,864		2025	$212.3	$884,736
+12%/Yr (+40% total)	2022	$240.0	$1,000,000	-12%/Yr (-32% total)	2022	$240.0	$1,000,000
	2025	$337.2	$1,404,928		2025	$163.6	$681,472
+20%/Yr (+73% total)	2022	$240.0	$1,000,000	-20%/Yr (-49% total)	2022	$240.0	$1,000,000
	2025	$414.7	$1,728,000		2025	$122.9	$512,000

*Yearly compounded return

Artemis Financial Advisors
115 Newbury Street
Suite 302
Boston, MA 02116

DISCLAIMER: Artemis Financial Advisors is an SEC-registered advisory firm. The material in this document is prepared for our clients and other interested parties and contains the opinions of Artemis Financial Advisors. Nothing in this document should be construed or relied upon as legal or financial advice. All investments involve risk – including loss of principal. An investor should consult with an investment professional before making any investment decisions as not all recommendations will be suitable for all investors. Fac-