Fidelity INVESTMENTS

Stock Plan Services

Equity compensation strategies for volatile markets

By John P. Barringer

Key points

- *Sooner or later, market volatility may force you to make decisions that affect your financial future and long-term wealth. If you have a financial plan with goals for your stock grant gains, stick to it. If not, create it now before the market recovery excites you into taking risks without thinking.*
- *Don't obsess about tax consequences that stem from the timing of option exercises or sales of shares after restricted stock/RSU vesting. Market volatility can be much more costly.*
- *Be realistic and flexible. Exercise and hold with caution. Diversify. Know your investor type. Act fast when you leave your job.*

Market volatility and sharp declines rattle even the most experienced holders of stock compensation. Many employees, especially those who are new to the stock grant experience and whose company stock prices over the last decade had done nothing but go up before COVID-19 rattled the markets, may find that they are less than fully prepared to cope with the emotional toll caused by the impact of sudden stock market volatility on their equity compensation.

Generally, those who stick to a financial plan tend to experience better investment returns than those who try to time the market.

Economic cycles cause the markets to rise and fall over time. So-called "black swan" events, such as the impacts of the 2020 coronavirus outbreak, can cause sudden corrections. Sooner or later, market volatility may force you to make decisions that affect your financial future and long-term wealth. Following are some important considerations.

1. Engage in financial housekeeping.

If you have a financial plan with goals for your stock grant gains, stick to it. If not, create it now before the market recovery excites you into taking risks without thinking. Generally, those who have committed to a plan and stuck to it have experienced better investment returns than those who have tried to time the market.

Meanwhile, a balanced portfolio built with the stock-sale proceeds at exercise performed a little better than the broader market and exhibited significantly less volatility than the company's stock. Discipline imposed by a strategy of periodic diversification will keep an investor from ending up with all the risk in their portfolio being concentrated in their company stock.

2. Do not overplay tax changes.

It is a good idea to review your financial plan periodically to see how tax increases, tax cuts, or changes in your marginal tax bracket may alter your situation. But don't obsess about tax consequences that stem from the timing of option exercises or sales of shares after restricted stock/RSU vesting. Market volatility can take the equivalent of the top 37% marginal tax bracket away from you in a matter of days.

3. Use ongoing grants.

While down markets mean the exercise of patience, not options, they are a terrific time to receive new grants. You may now be receiving grants of restricted stock, RSUs, or performance shares along with or instead of stock options. These grants continue to have value in a down market and therefore can both lessen the pain from underwater stock options and ease "volatility" in the value of your stock grants. This is good news for people who are now receiving grants of employee stock options and/or restricted stock/RSUs.

4. Be realistic.

The recent decade-long market rise may have come to an end. As mentioned earlier, a so-called "black swan" event may be the catalyst. But even if the market's rise doesn't "end" but merely corrects by a dramatic amount, stay calm. Employees with equity compensation and company shares who embraced a healthy degree of skepticism during the run-up in stock prices, and made the decision to take some profits, are glad they did when events they never anticipated intervene to cause the markets to drop. Once markets begin to fall, it can be difficult to find a good place to exit so the best choice may end up being to ride it out.

5. Exercise and hold with caution.

Employees with incentive stock options (ISOs) may be asking: "Should I exercise and hold when the market price is down?" Their question really should be: "Should I exercise now, avoid or pay very little AMT, and hold for a long-term capital gain?" Generally, buying with the price close to, or at, the strike price is no different (or very little different) than buying in the open market.

When you consider open-market purchases, you should ask yourself: "Are there reasonable, fundamental reasons to believe the stock will rise and that I do not already hold a substantial amount of company stock?" If the answer is yes, then you may consider exercise and hold. If the answer is no, then you do not want to exercise and hold. Whether you have ISOs or nonqualified stock options (NQSOs), when you exercise and hold you need to consider the alternative-investment returns on the same cash you are putting into the stock, the diversification of your portfolio, your risk tolerance, and your needs for cash, as if you were buying any other stock.

One of the advantages of stock options (when the market is rising) is the leverage they afford. If you hold options to purchase stock at $2 when the market price of the stock is $10, you have at your control a lot of profitable stock with no cash committed. When the market price declines, the leverage declines with it.

6. Diversify.

You should consider whether you have too much of your personal wealth tied to a single company's performance. Why? If your investments are highly concentrated in a single stock, rather than in a diversified portfolio, you may be exposed to excess volatility, based on that one company. Moreover, when that company is also your employer, your financial wellbeing is already highly concentrated in the fortunes of that company in the form of your job, your paycheck, and your benefits—and possibly even your retirement savings.

7. Know your plan rules if you are terminated.

If you change or lose your job while the market is down, understand how long you are permitted to exercise your vested, in-the-money stock options. As with any stock you can buy, consider the implications of holding the stock after option exercise or restricted stock vesting unless you view this as a good investment decision. An ETF or a mutual fund may hold less risk than this single stock.

Investing involves risk, including risk of loss.

This article is based on an article from myStockOptions.com written by John P. Barringer, a financial advisory.

923381.1.0