Stock-Based Compensation: Part 1

Life happens…Don't lose track of your RSUs

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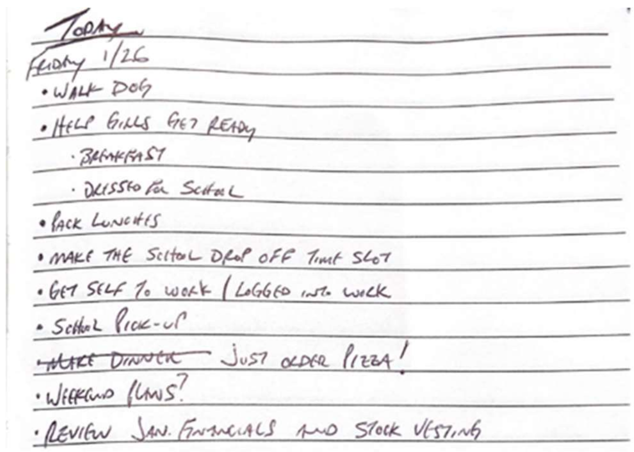
Congrats! The restricted stock units ("RSUs") you received for being a rock-star employee have now vested and you own them outright. Unsure of what to do next? You're certainly not alone. Like most professionals, your days are already packed – a demanding career, a growing family, and the constant juggling of activities, play date logistics, and school sick day coverage. It adds up to A LOT.

Here's a sample of my family's household to-do list…I bet yours looks similar:

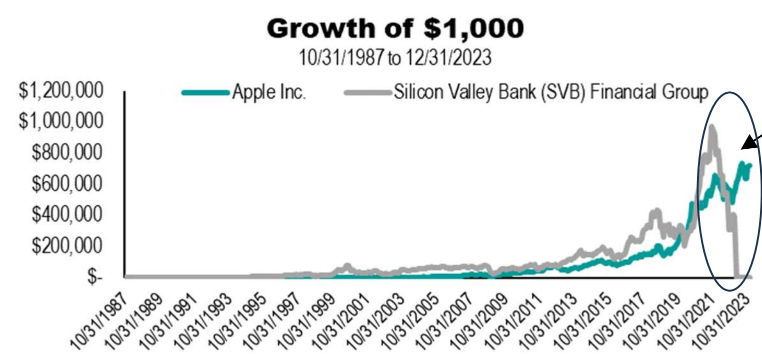


Did you notice the task at the very bottom? If you're like most of our clients, this is the one that consistently gets buried at the bottom of your to-do list. All the while, those valuable RSUs you've accumulated, some of which are now fully vested, continue to pile up like the clothes in the laundry hamper. If only they could get sorted with weekend laundry!

Of course, you know you should do something with the pile of company shares, but what to do— and how to even figure out what to do— quickly feels overwhelming. Plus, since stock compensation usually comes in sizable amounts, a significant amount of money hits your account at once. This adds to the feeling that, by the mere fact of receiving shares, you're already ahead. It's a bonus, anyway, right? At the same time, such large sums also raise the stakes of any decision you make. It's one thing to invest an extra few hundred dollars on your own, but tens of thousands—or hundreds of thousands of dollars?

Left alternating between self-assurance and overwhelm, you continue to kick the proverbial "can" down the road. You think, "I'll have more time another day. This can wait. The stock is fine for now; it's not going anywhere." You've also likely heard the fabled stories of employees who held onto their company stock for years, and over that time, the stock increased 100-fold in value. Simply by doing nothing and by being at the right place at the right time, that fortunate employee was able to retire at 45!

But look past the clickbait headlines, and you'll discover that an individual stock is inherently risky. Its value can fluctuate dramatically. For every Apple, there's at least one Silicon Valley Bank.[1] Remember how quickly its stock price collapsed?

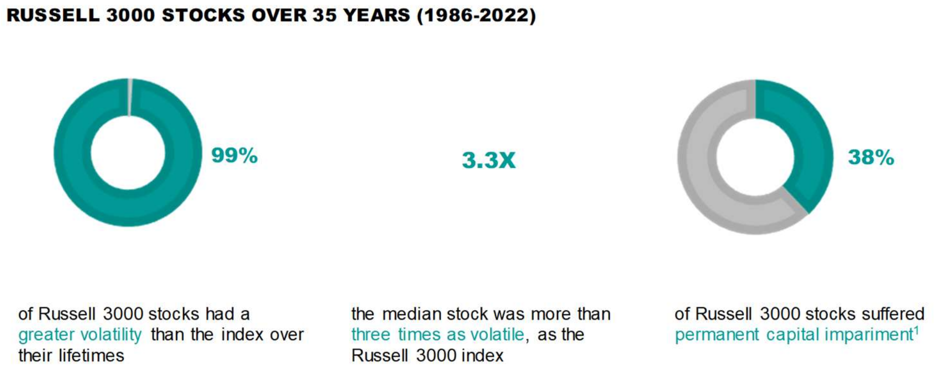


Source: Morningstar Direct
Growth of $1,000 using monthly stock total returns. Analysis assumes the reinvestment of all dividends.

In less than 2 years (10/31/2021 to 3/31/2023) SVB stock lost nearly 100% of its value.

Preceding October 2021, the stock was publicly traded for nearly 34 years and generated a lot of value.

Exactly how much riskier is an individual stock? Historical data for the Russell 3000® Index (which represents approximately 96% of the investable US equity market) shows that almost every individual stock has greater volatility than the index as a whole. Further, the stock in the middle of the pack wasn't just a little bit riskier than the index; it was a lot riskier. Lastly, nearly 40% of individual stocks suffered permanent capital impairment.[2] Said another way, those stocks experienced such substantial declines that they never fully recovered.



Source: FactSet, Goldman Sachs Asset Management as of 12/31/22

1.Permanent capital impairment is defined as a stock that loses more than 75% of its value and does not recover to 50% of its original value.

Diversification does not protect an investor from market risk and does not ensure a profit.

Can your financial plan afford this risk?

The truth is, you work really hard to earn this bonus money and you don't have the luxury to go back in time to earn it again. Therefore, making timely, well-reasoned decisions when shares vest will help put you in the driver's seat so that you can manage unnecessary risks. It can feel really good to make money in a stock you know so well; however, it feels even worse to lose it. In fact, research has shown that losses hurt twice as much as compared to equivalent gains.[3]

In closing, company stock can be a wonderful form of bonus compensation; however, the risk characteristics that accompany it expose you to vulnerabilities that are particularly difficult to recover from. Given these competing features we wanted to share some 'behind the scenes' information we talk with our clients about when we help them tackle RSU tasks. Interested in knowing what's coming down the pipe with this series? Below is a sneak peek:

- Part 2 – "Drinking the Kool-Aid" – How behavioral and emotional biases complicate the decision-making process
- Part 3 – "That's more than I thought…AND I have to pay more taxes?" – How concentration risk and additional tax can impact your wealth
- Part 4 – "Who you 'gonna call?" – The right solution is not the same one as your neighbor's

For those who would like more information on any of the topics covered in this series, please give us a call at 312-736-8567 or email jmariscalco@103advisory.com. When you're ready, we're here to help.

P.S. Do you have friends or colleagues who also wrestle with how to handle their stock compensation? If so, please share this series with them. Below is a link to our website that you can copy and paste.
https://103advisory.com/our-thinking/

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Citations

1. Morningstar Direct
   - Tickers: AAPL and SIVBQ – Returns assumes the reinvestment of all dividends
2. FactSet, Goldman Sachs Asset Management as of 12/31/2022
   - Volatility is defined as one standard deviation of annual returns
   - Permanent capital impairment is defined as a stock that loses more than 75% of its value and does not recover 50% of its original value. Diversification does not protect an investor from market risk and does not ensure a profit.
   - These examples are for illustrative purposes only and are not actual results. If any assumptions used do not prove to be true, results may vary substantially.
3. https://thedecisionlab.com/biases/loss-aversion
   - Tversky, A., & Kahneman, D. (2000). Advances in Prospect Theory: Cumulative Representation of Uncertainty. Choices, Values, and Frames, 44-66. doi:10.1017/cbo9780511803475.004