

# How a Variable Forward Works within Equity Risk Management Strategies

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# Summary of a Variable Forward

- A variable forward is designed so you can protect against a decline in the stock at a predetermined price (“Floor”) and participate if the stock increases up to a certain price (“Ceiling”). For example a 90% floor / 150% ceiling.
- You have limited your loss to the floor price and keep the gains up to the ceiling price.
- You can receive cash expressed as a “x”% of the floor price ranging from the high 60’s to low 90’s.
- Normally the maturity ranges from 2 years to 7 years.



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# How a Variable Forward Transaction Works

## What happens in the beginning

- Determine the wants and needs for the client's holding of the concentrated stock.
- Coordinate tax and estate implications at maturity of the variable forward.
- Create a theoretical variable forward.
- Take the theoretical variable forward and price between several counterparties.

## What happens to put on the trade

- Transfer of shares, and signing of the contract
- Cash transfer made to investor.
- Monitor and review every 6 months or more often

## What happens at maturity

- At expiration analyze the best after-tax answer.
- Delivery of stock or cash.

## What have you accomplished



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# What happens in the beginning

## **1. Ask investors questions like this to figure what they want and need**

- Are the shares in a FLP, Trust etc or just held individually by the investor?
- Do they feel bullish or negative on the stock?
- How much do they want to diversify? Do they need cash today or tomorrow?

## **2. Model, create and price the trade**

- You need to review history of the stock, options, interest rates to figure how the pieces fit together.
- Take the history to figure an estimated price, the breakeven points etc.
- Check with the investor on your model and then price the trade.

## **3. Analyze the prices**

- You need to take each price and analyze the components to get a fair comparison.
- Have Ernst & Young analyze the tax effects.

## **4. The contract for gotcha's**

- What happens if the client passes away during the trade?
- What happens if the investment bank goes bankrupt?
- What happens if the stock gets bought?
- Does the investor have choices to cancel the trade anytime?



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# What happens to put on the trade

Once you've chosen to put on a variable forward here is what happens:

- You and the winning bidder (financial institution) agree on downside protection, upside participation, maturity length and amount of cash you receive.
- Contracts are tailored to your specific needs and wants.
- Since you receive the cash, the financial institution needs your stock as a pledge against the cash they sent you. Wall Street expresses the cash you receive as a “x” % of stock value.
- You wire the shares to the financial institution as collateral.
- The financial institution wires the cash to your FROST account.
- With the help of your FROST advisor you can now create a diversified investment portfolio.
- You will not have access to your pledged shares. You will receive a portion or most likely all of the dividends.
- As of the date of this presentation the IRS has not considered executing a variable forward as entering into a constructive sale. Taxes are paid at maturity in most instances.
- It makes sense to review the trade every 6 months or if the stock gets close to the floor or ceiling price.



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# What have you accomplished so far

- You potentially have two pools of money at work:
  1. The cash received from the prepayment. (your upfront payment).
  2. The amount of the upside that you retained on the stock that you have pledged. (50% in the following example. This will decrease your prepaid cash amount).
- At contract maturity, you will have a choice of how to settle the contract.
- The amount of stock and/or cash owed is usually dictated by the current share price of the pledged stock.



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# What happens at Maturity

- You will not owe more than 100% of the shares at maturity.
- If the stock price is below the floor price you would owe 100% of the shares.
- If the stock price is between the floor and the ceiling price, you owe somewhere between 100% to 60% of the shares.
- If the stock price is above the ceiling, you begin to owe more than 60% of the shares but never more than 100% ( since you always get to keep the growth on the stock to the ceiling price).
- The tax issues depend on whether you deliver cash or stock and whether you had a long-term holding period on the stock before they entered into the variable forward. Before maturity of the variable forward you are advised on the best after-tax answer.

ON THE NEXT PAGE IS AN EXAMPLE OF A VARIABLE FORWARD

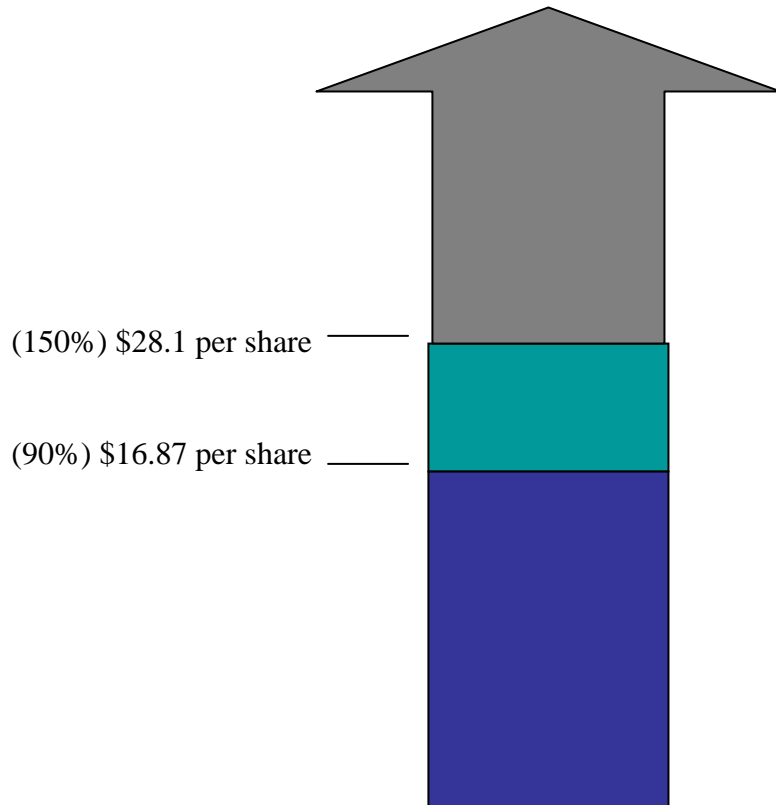


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# An Example of the Effects at Expiration

The example below shows you holding 1 million shares of Southwest Airlines (LUV) with a zero cost basis. You decided to enter into a 4 year variable forward receiving \$13.8 million up-front in cash and having protection if LUV drops below \$16.87 and participate if LUV increases to \$28.11 assuming a stock price of \$18.74 today. The after-tax breakeven point of entering into this transaction versus selling and re-investing is \$21.50 or an annualized after-tax return of 3.5% (excluding dividends).

## Stock Value at Maturity



## At Maturity ( three example scenarios):

This does not include any benefit from reinvesting the \$13,867,600 up-front cash payment.

- ← → You keep \$11.2 million worth of LUV and delivers the balance of the LUV shares
- ← → You deliver \$16.9 million worth of LUV and retain the balance of the shares
- ← → You deliver 100% of the LUV shares



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# What Have you Accomplished

- Diversification
- Significant risk reduction to an investment portfolio from owning one concentrated stock position
- Hedging your downside risk
- Participating in some of the upside in the stock
- Potentially gained an advantage by deferring your tax



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