The Wilson Group at Morgan Stanley

Eric S. Wilson, CIMC®, Family Wealth Director

"How can exchange funds be useful for diversifying a concentrated stock position?"

By Eric S. Wilson

There are multiple effective strategies for dealing with concentrated, low-cost basis stock positions and creating a diversified portfolio. Strategies can include selling some shares and investing elsewhere, implementing a philanthropic plan using a charitable remainder trust (CRT) or investing in an exchange fund.

Exchange funds have been in existence since 1961 and are typically offered through private-placement vehicles (usually limited partnerships or a limited liability company). Investors agree to swap their exposure in a single security for shares in a diversified portfolio, managed by a portfolio manager. Exchange funds are a tax-efficient solution for suitable long-term investors in that the swap of the securities does not cause an immediate capital gains tax. It is important to note that not all stocks are accepted in an exchange fund and that the portfolio manager has ultimate authority over which stocks are added to the exchange fund. The composition and investment objectives of exchange funds are varied.

To attain the tax-efficient benefits of exchange funds, shareholders must remain in the fund for at least seven years. If a situation requires the fund to sell or distribute a contributed security prior to that time, a taxable event will be triggered, primarily for the contributing shareholder, but all shareholders will bear a proportionate tax liability for the stock's appreciation from the time of contribution. At the end of seven years, a shareholder generally may redeem all or a portion of his or her share of the fund without incurring a capital gains tax liability. Some funds may offer limited liquidity during the seven years, but early redemption can be costly. Those who remain in the fund for at least seven years will usually be offered the choice of requesting: 1) their own stock back; 2) a diversified basket of securities; or 3) a pro rata piece of the entire portfolio.

In most cases, entering into an exchange fund is limited to qualified purchasers, meaning those individuals with $5 million or more in investable assets. So, imagine high net worth qualified purchaser holders of some of the great American companies all contributing their varied individual, low-cost basis, single-stock positions to a common holding account (the exchange fund) so that their investment experience is that of the fund and not the individual stock. Why would they do this?

There are several possible reasons. First and foremost, the stock may represent a disproportionately large part of investors' net worth, and they want to protect themselves from a major net worth reduction in the event of a falling stock price. **It makes sense, then, for them to contribute to an exchange fund so they can still have the opportunity for further appreciation while avoiding the capital gains tax triggered were they to sell and diversify on their own.** Second, for estate-planning purposes, the exchange fund can potentially moderate the volatility of a single stock position until the death of the owner, when a step-up in cost basis occurs and the heirs can sell the stock and diversify with minimal capital gains tax. Third, because some exchange funds can accept restricted securities, some owners of restricted securities have contributed these to the exchange fund in order to moderate the potential downside of a stock they cannot touch.

Exchange funds offer potential benefits to suitable investors as one component of a diversification strategy for a concentrated stock position. They are not recommended for use as a stand-alone solution. The strategies that can be extracted by using an exchange fund are numerous, and any investor considering contributing to one should consult with his or her legal and tax professionals.

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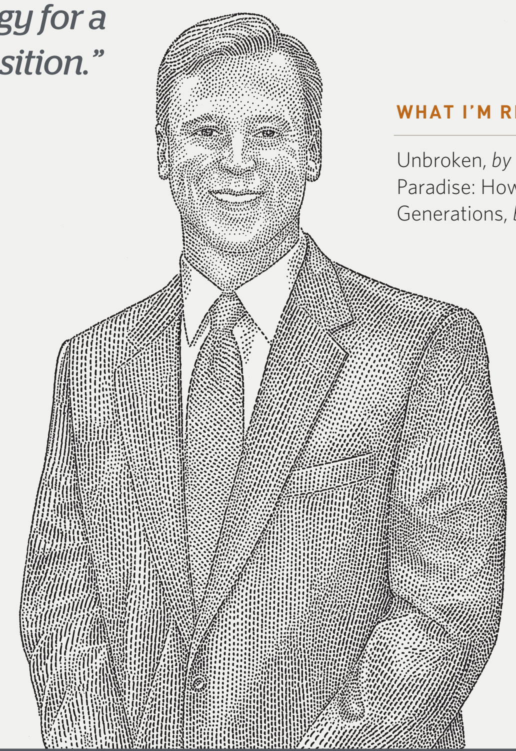

ILLUSTRATION BY KEVIN SPROULS

How to reach Eric S. Wilson

Families may reach me with questions or with interest at 877.442.5445 *or* eric.s.wilson@morganstanley.com.

WHAT I'M READING NOW…

Unbroken, *by Laura Hillenbrand and* Strangers in Paradise: How Families Adapt to Wealth Across Generations, *by James Grubman*

WHAT MAKES A GOOD CLIENT…

A first or second generation family of wealth that desires to improve the odds of the successful transition of their wealth to subsequent generations

MY HOBBIES ARE…

Being a husband and a father, playing tennis, upland hunting and reading

About Eric S. Wilson

Eric S. Wilson is a wealth advisor and senior vice president at Morgan Stanley, and for the past 20 years he has served the varied needs of families whose wealth has the potential to change the essential nature of their descendants' lives. Mr. Wilson began his career at Merrill Lynch in 1994, where he served until joining Morgan Stanley in 2010. For his work with affluent and high net worth families throughout the southeastern United States, he has been specially designated at Morgan Stanley as a family wealth director. Achieving this prestigious designation meant adhering to stringent quantitative and qualitative requirements set forth by Morgan Stanley and now provides him with specialized and dedicated resources from around the firm, which benefits his clients by providing them with many of the same services offered by family offices. Mr. Wilson is a Certified Investment Management Consultant℠ (CIMC®), an Accredited Investment Fiduciary Analyst (AIFA®) and is a member of the Association of Professional Investment Consultants. He serves on the advisory boards of the Community Foundation of Central Georgia and Children's Hospital of Central Georgia. He and his wife, Cindy, are proud parents of four sons, ages 13, 13, 13 and 6.

Assets Under Management
$2 trillion (Morgan Stanley Wealth Management, as of 8/31/14)

Minimum Fee for Initial Meeting
None required

Minimum Net Worth Requirement
$5 million (planning services); $2 million in investable assets (investment services)

Largest Client Net Worth
$25 million+ (as of 7/31/14)

Financial Services Experience
20 years

Compensation Method
Asset-based fees and commissions (investment and insurance products)

Primary Custodian for Investor Assets
Morgan Stanley Smith Barney LLC

Professional Services Provided
Planning, investment advisory and money management services, advanced wealth transfer planning and liability management

Association Memberships
IMCA, Fiduciary 360 (www.fi360.com)

Website www.morganstanleyfa.com/thewilsongroup

Email eric.s.wilson@morganstanley.com

The Wilson Group at Morgan Stanley | 5444 Riverside Drive, 2nd Floor, Macon, GA 31210 | 478.471.2266 | 877.442.5445