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MAKE
The Wild Ride of Mouse McCoy; Bob Simond's Bold New Hollywood Studio; 12 Top Media Innovators

GROW
Wealth Management's Digital Frontier; Nine Robo Advisors to Watch; Entertainment's Emerging Markets

LIVE
10 Fantastic Fall Weekends; Bill Harlan's Extraordinary New Wine; How Stem Cells Can Help You

CURATOR
Men's Fall Fashion; Vertu's Breakthrough Phone; Skeleton Watches from Vacheron Constantin and More

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31

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LLBH Private Wealth Management LLC
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"How do you effectively hedge a locked-up position?"

By Kevin Burns

Creating opportunities that make a difference in our clients' lives is central to our mission, and last fall we had one such occasion. While in Hollywood for a movie premiere, we sat down with wonderful clients of ours, a married couple with two young children. They had built a comfortable net worth, including a well-diversified portfolio and a beautiful home. Additionally, the husband had a long-term investment of about $500,000 in a private equity fund that was a significant shareholder of a major social media company that had gone public the very same week.

This new Wall Street darling immediately went to a valuation reminiscent of the heady internet bubble days of the late 1990s. Advisors with experience recognize this scenario as reminiscent of a recurring phenomenon where greed trumps common sense. Invariably, these situations don't end well for the investor.

Our clients were simultaneously excited and nervous: Their $500,000 investment had turned into almost 600,000 shares of a $45 stock totaling $27 million dollars! But they were also nervous because the PE fund had a 180-day lock-up during which they couldn't distribute or liquidate the shares. They were well aware of how the internet bubble had ended, so they anticipated a long six months. Given the absurd valuation the market had given this over-concentrated position, the couple watched with mixed emotions as their stock rose to $50 a share.

That's when we went to work. After reviewing the PE agreement, we determined there were no prohibitions on limited partners' ability to engage in hedging transactions. We looked at the public market, but shorting the stock was not possible; it was already over-borrowed, and Wall Street banks wanted over 70 percent interest to carry the position. Instead, we contacted several large banks to see if we could protect this position for the duration of the lock-up, using a zero cost collar, purchasing a put option to protect any downside while selling a call option to provide appreciation over a certain price to the buyer.

Two banks bid for the business, but the challenge became collateral as we could not use the PE fund position for this purpose. Meanwhile, the stock continued to rise to over $60 a share. The banks wanted 75 percent cash collateral to do the trade, requiring over $27 million in cash. This was an obvious deal breaker so we tweaked the collar by purchasing a call option and securing an offer of 25 percent cash collateral, about $9 million. Timing was of the essence as the position was now worth over $36 million, essentially tripling our clients' net worth. So, we leveraged their current diversified portfolio, lending them $6 million at the current interest rate of 1 percent and we obtained a mortgage on their house for an additional $3 million at a 2.5 percent interest rate. With the $9 million in place, we were able to secure the hedge. The first leg was executed on Christmas Eve, a mere ten minutes before the market closed. The stock ticked at $70 per share.

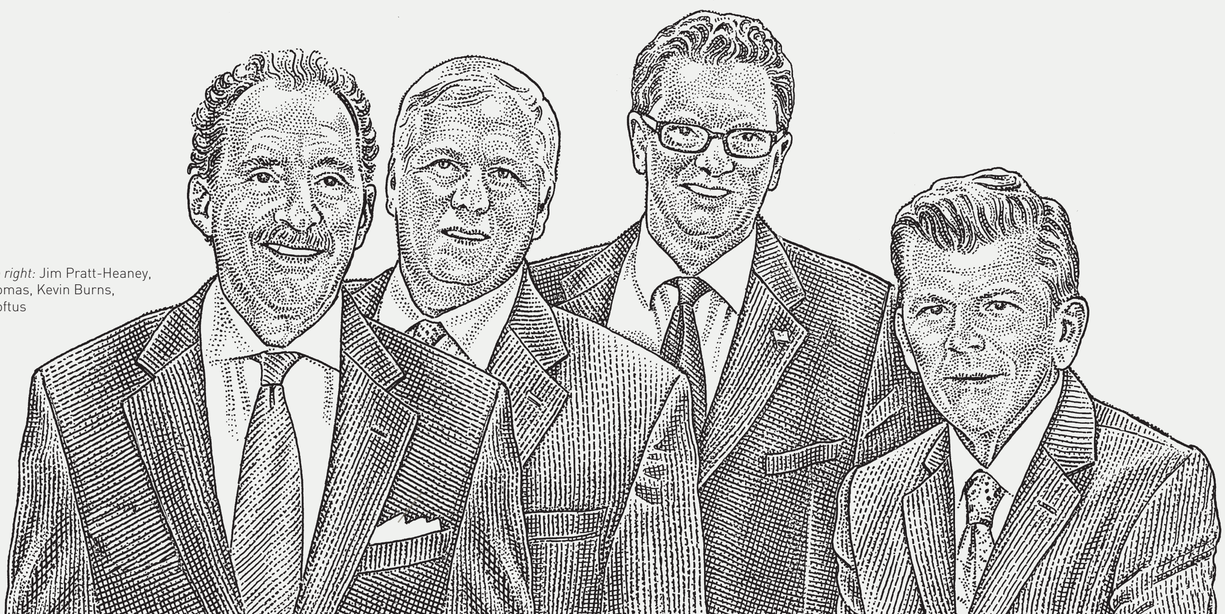
Suffice it to say, the holidays were especially joyous for this family even as the social media darling reported a lack of earnings; the stock had collapsed. The day the lock-up ended, the stock broke $30, and we closed the trade. The loans and taxes were paid, and our clients decided to retire and plan a relaxing summer, as their portfolio was now established in a diversified income-producing allocation with moderate risk. We were thrilled to hear how our creative solution "changed their lives."

"The day the lock-up ended, the stock broke $30, we closed the trade and the loans and taxes were paid. More importantly, our clients took the opportunity to decide it was time to retire."

—Kevin Burns

How to reach Kevin Burns

I look forward to discussing how LLBH can help you reach your financial goals. I can be reached directly at 203.683.1525.



Left to right: Jim Pratt-Heaney, Bill Lomas, Kevin Burns, Bill Loftus

ILLUSTRATION BY NANCY JANUZZI

About LLBH Private Wealth Management LLC

LLBH Private Wealth Management, LLC is an independent Registered Investment Advisor offering a full range of wealth management and family office services including financial planning, asset management, concentrated stock hedging, lending, cash management and alternative investment due diligence. Often referred to as a Virtual Family Office, LLBH delivers these myriad solutions to its clientele to help bring clarity and control to their financial lives. From its base in Westport, Connecticut, LLBH provides these services to wealthy families across the country including its significant West Coast presence focused on the entertainment industry. LLBH works with approximately 140 families approaching $1.6 billion in assets under advisory.

Assets Under Management
$1.6 billion (as of 7/31/14)

Minimum Fee for Initial Meeting
None required

Minimum Net Worth Requirement
$10 million (investment services)

Largest Client Net Worth
$1 billion

Financial Services Experience
200 years (combined)

Compensation Method
Asset-based

Primary Custodian for Investor Assets Pershing, A BNY Mellon Company

Professional Services Provided
Financial planning, asset management, concentrated stock hedging, lending, cash management, alternative investment due diligence and family office services

Association Membership Financial Planning Association, Investment Management Consultants Association

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