



Net Worth Strategies, Inc.  
presents...

# THE PLANNER

## Inside this issue:

|   |            |
|---|------------|
| <b>Building Your Practice Through Stock</b>   | <b>1</b>   |
| <b>Planning Article of the Month: The Importance of Planning for Underwater Stock Options</b> | <b>2-4</b> |
| <b>StockOpter Tip of the Month</b>  | <b>4</b>   |
| <b>What's New at Net Worth Strategies</b>   | <b>4</b>   |

Welcome to the launch of a new newsletter designed especially for financial planners and advisors — *The Planner*

It's a free, bimonthly newsletter that promises to keep you on the leading edge of high-value financial planning – including technique and knowledge-building discussions, answers to FAQs, articles, tips and insights from Net Worth Strategies and guest financial planning and taxation experts. *The Planner's* initial content will focus on four categories:

**1) Building Your Practice through Stock Option Planning:** (the strategies and building blocks necessary to create a successful stock option planning niche)

**2) Planning Article of the Month:** (where we take you inside the minds of guest and Net Worth Strategies' financial planning and taxation experts as they look at timely industry subjects impacting planning professionals today)

**3) StockOpter Tip of the Month:** (new approaches, shortcuts and techniques that will enable you to maximize StockOpter's functions and capabilities)

**4) What's new at Net Worth Strategies:** (you'll be the first to hear about new developments, web site enhancements, discounts and more).

If you are interested in subscribing to *The Planner* newsletter, please subscribe at:  
[www.networthstrategies.com/StockOpter/docs/requestform.htm](http://www.networthstrategies.com/StockOpter/docs/requestform.htm)

We hope you enjoy this new service and that it will help you develop more prosperous and satisfied clients. Please let us know if you have any questions or suggestions for *The Planner*.

Sincerely,

Adam Renfrow  
*The Planner* Editor  
Net Worth Strategies, Inc.  
[arenfrow@networthstrategies.com](mailto:arenfrow@networthstrategies.com)  
(541) 383-3899

## Building Your Practice Through Stock Option Planning

As we've crisscrossed the country meeting and talking with financial planners at our Net Worth Institute's StockOpter training seminars, we continually run into a common question:

**“How do you charge for stock option planning services?”**

There is a wide range of pricing strategies that seem to be prevalent from \$200 per hour to \$2,000 per engagement, to \$5,000 flat fees, to \$10,000 annual retainers. In this month's newsletter, we invite you to discuss stock option planning pricing structures via our web site.

First, we've set-up a forum where planners are currently discussing how to charge at:

[www.NetWorthStrategies.com/StockOpter/docs/userforum.asp](http://www.NetWorthStrategies.com/StockOpter/docs/userforum.asp)

Second, we want to survey planners and advisors on their own practices. The survey can be answered on our web site at:

[www.NetWorthStrategies.com/StockOpter/docs/feestrategies.htm](http://www.NetWorthStrategies.com/StockOpter/docs/feestrategies.htm)

Results will be posted in our next newsletter.

## Planning Article of the Month: The Importance of Planning for Underwater Stock Options

**By: Greg Fowler, CPA**  
**Financial Planning and Taxation Consultant**  
**Net Worth Strategies**

**Underwater (Out-of-the-money):** A term that refers to employee stock options when the stock's current market price is below the option's grant price. "Underwater" is the unpopular buzzword of the year for both financial planning professionals and their option-holding clients. Buzzword or not, the fact remains that millions in one time highly valued options have now plunged underwater and become seemingly worthless as a result of a bearish market. Many option holders who have endured the decline of their company's stock price have become complacent about planning related to this important asset class – making the planner's job of recommending a course of action more difficult. The purpose of this article is to help financial planners develop a compelling argument for the importance of option planning when a bear market holds their client's options underwater. In order to successfully do so, a client needs to have a clear understanding of this often-confusing asset. The key to client understanding is to help them recognize the true value of their employee stock options, model "what-if" scenarios, and demonstrate how planning today can better prepare an option-holder to take advantage of the bull market's return.

### RECOGNIZING AN UNDERWATER OPTION'S VALUE

The first key to helping option-holding clients understand the importance of planning for underwater options is to help them recognize their options' true value. Underwater options have a potential for future and conceivably large gains – a fact that makes planning for this asset an integral part of developing the client's overall financial plan.

An option's true value is not limited to the intrinsic value of the option (Current price – Strike price = Intrinsic value). Nobel laureates Fischer Black and Myron Scholes demonstrated this with their model developed in 1973 (<http://bradley.bradley.edu/~arr/bsm/pg04.html>). Based on their ground-breaking work, we are able to quantify the true value of stock options. Today, planners can use a simplified version of Black-Scholes' complex stock option

pricing formula to demonstrate to clients the value of their underwater employee stock options. The formula reduces the Black-Scholes model to three basic components: Current price, Strike price, and Time to expiration.

$$\begin{aligned} &(\text{Current price} - \text{Strike price}) + \\ &\text{Time to expiration (Time value)} \\ &= \text{Underwater option's value} \end{aligned}$$

To explain the underwater option value equation, let's begin with the first component: Current price – Strike price (Intrinsic value). It is important to stress to the client the tenuous nature of this component. An underwater option today can become a windfall profit tomorrow. By the same token a large paper profit can quickly evaporate in today's fickle markets – a fact many option holders refused to believe until the recent bear market offered a dose of reality. As a result of the market decline, many of these option holders are now holding options with zero intrinsic value. In other words, the intrinsic value is zero because the current price is less than the strike price.

Time-to-expiration or time value comprises the second component of our simplified option value calculation. An option's time value is directly related to the expiration dates outlined in the option grant – often lasting up to ten years. Because many of today's underwater options were likely granted in the past 24-36 months, millions of dollars in time value stands to be realized in the next seven to eight years. Unlike the intrinsic value, which can be zero, time value is always greater than zero prior to the expiration date. In other words, during the time prior to its expiration, an option always has the potential to generate a positive intrinsic value. In many cases, the time value will very likely transform these underwater options back into a significant asset within the next couple years.

Now that the client understands the hidden value, the importance of having a plan becomes more evident. With proactive stock option planning, the client and planner are prepared to react at the ideal time when the options' intrinsic value recovers. By planning now, the option holder can implement a plan that will ensure the client avoids the frustrating and often disastrous results of executing tax-inefficient exercise and sales strategies, allowing in-the-money options to expire or disqualifying options early to pay for exercise liabilities.

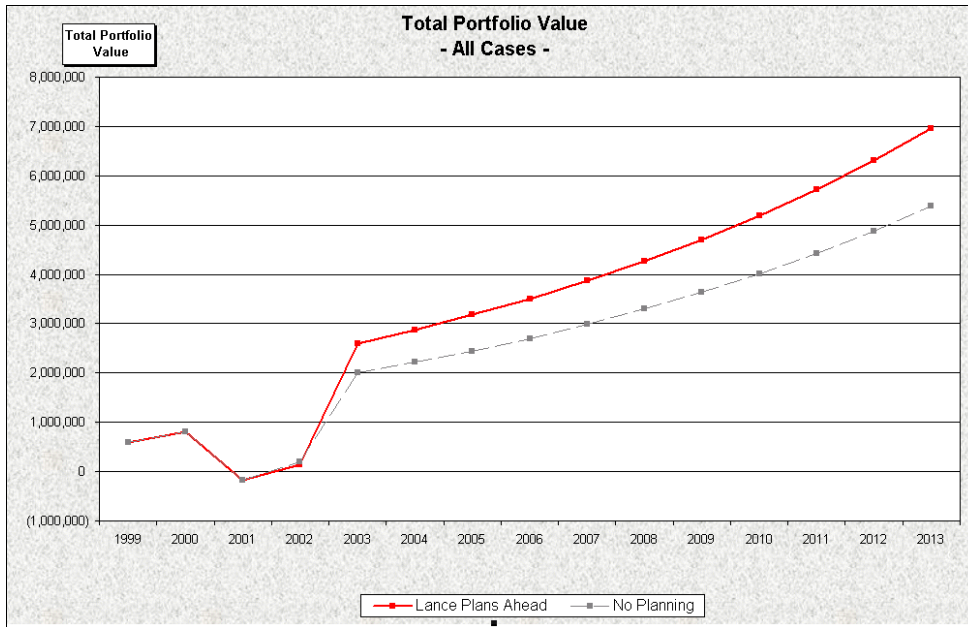
### THE POWER OF MODELING SCENARIOS

After the client has understood that underwater options hold promising future wealth, it's important to demonstrate various "what-if" scenarios to the option holder to make the argument for option planning today even more compelling. By using the StockOpter® modeling tool, a planner can easily illustrate what-if scenarios to the client, including: "What if you would have used a planner and diversified your option holdings? What would your net worth be today?" Such an analysis makes a compelling argument. See figure 1 from just such a scenario modeled using StockOpter.

Figure one shows a typical scenario from 1999-2001. In one instance, the client did not plan and simply exercised as late as possible and sold. In the other scenario, the client began diversifying in 1999 and continued once the options began to recover until he was diversified out 75% (Diversify 75% ASAP). The diversified total portfolio value (TPV) in 2013 is \$4,260,763 compared to the TPV without a plan of \$892,328.

In 2000, planners were having a very difficult time making recommendations to option holders because many were confident that their company's stock would return 150%. (**cont'd on page 3**)

Figure 1



Why would Lance want to do this? By exercising options near the grant price versus a much higher price (i.e., \$100), Lance will minimize the bargain element thereby mitigating the resultant alternative minimum tax (AMT) impacts often associated with exercising ISOs. In addition, by exercising earlier, he also begins his one-year holding period mandatory for ISOs.

Let's assume Lance listens to your advice and allows you to develop an option plan for him to exercise his ISOs when STL's stock price reaches \$35. By setting up a plan to exercise when the bargain element is only \$5, a relatively small AMT adjustment is created. At the same time, Lance begins the holding period for preferential capital gains treatment.

It's nearly identical to today as planners are again struggling to convince clients to do option planning with so many grants being underwater. Last year many option holders believed planners were a bit off their rocker for suggesting clients diversify. Today many option holders wished they had asked a planner to develop a diversification strategy for their stock options because their TPV would likely be more substantial. By modeling what-if scenarios a planner can use the disaster of 2000 to illustrate the need for ongoing planning services. This will quickly impress upon clients and prospective clients the critical need for proactive, ongoing planning for greater peace of mind as net worth goals are met with less risk through diversification.

has a grant for 40,000 incentive stock options (ISOs) that are currently underwater. The strike price is \$30, while the FMV is holding at about \$18. Because STL is a well-established company, and you as Lance's trusted financial planner have a long-term outlook, you assume the stock price will recover above \$30 by late February of 2002.

After Lance understands that his underwater options aren't worthless, the next step is to develop a strategy to exercise Lance's underwater ISOs once the stock price begins to recover.

The year following Lance's exercise, STL's stock price rises to \$122.50 per share. Lance decides the opportunity to lock in the gain is too much to pass up – he sells all his STL stock. By planning ahead, Lance was able to avoid over \$600,000 in taxes. Figure 2 below demonstrates the results under both the plan and assuming Lance waited until the stock price rose to \$122.50, exercised and then sold the shares as a disqualifying disposition.

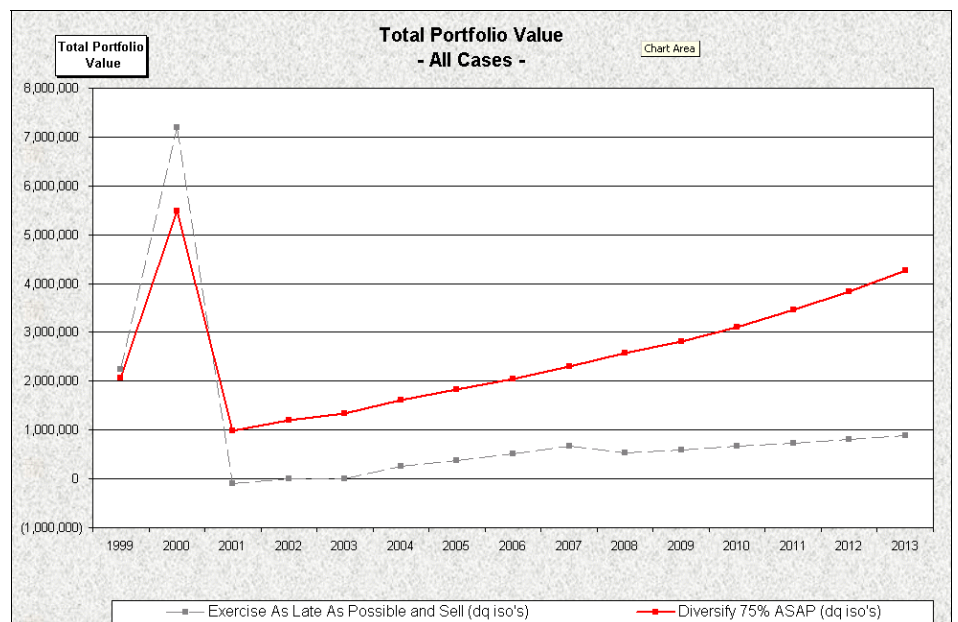
(cont'd on page 4)

**HOW UNDERWATER PLANNING OPTIMIZES OPTION WEALTH**

After the planner has modeled what-if scenarios to help the client understand the need for planning, he or she must also demonstrate how planning for underwater options today can maximize their option wealth.

The following case study will demonstrate how planning proactively for underwater options can lead to better client satisfaction. Let's consider Lance Williams, the CEO for a fictitious blue-chip company called STALWART (STL). Lance

Figure 2



# Planning for Underwater Stock Options...(cont'd)

Page 4

Clearly, StockOpter can powerfully demonstrate multiple what-if scenarios, such as how failing to take advantage of ISO's preferential capital gains tax treatment can have an adverse impact on an option holder's TPV. Clearly, planning ahead can provide significant value to the client and having StockOpter makes it easy to provide that value.

This past year has been difficult for everybody with financial ties to equity markets. However, it's during a bear market that a skilled planner can help complacent clients look beyond the current malaise, see the value in underwater options and the importance of planning for them. Teaching the client to adopt a realistic perspective and leveraging the power of a modeling tool to demonstrate what-if scenarios, enables the planner to provide high value to their clients by being prepared to capitalize on options' future potential.

## ABOUT THE AUTHOR

Greg Fowler, CPA is part of the Planning and Taxation group of Net Worth Strategies, Inc. He serves as an instructor for the Net Worth Institute and delivers the taxation content for the Stock Option Planning seminar. He is also involved in product development and enhancing new software products for future releases of the company's stock option modeling software, StockOpter. He has a Bachelors of Science degree in accounting from the University of Colorado at Boulder. He can be contacted via email at [gfwolder@networthstrategies.com](mailto:gfwolder@networthstrategies.com).

## StockOpter Tip of the Month: How to Disqualify ISOs to Cover

**Question:** My client has an ISO grant that expires this year. Her options are currently "in the money." She would like to exercise all the options in this grant in order to avoid letting them expire. However, she doesn't have enough money to cover the exercise price and resulting taxes, and doesn't want to take out a margin loan to cover those costs. As a result, she needs to make a disqualifying disposition to cover the cost of the exercise. How can I use StockOpter to calculate the exact number of ISOs that she must disqualify to cover costs so that she can hold the remaining number and sell them later as qualified?

**Answer:** Disqualifying ISOs to cover is a two-part process. First, type a formula in the row "**Qualified options to exercise**" to calculate the number of shares to exercise and hold. Then, use the Goal Seek tool to calculate the number of shares to sell as a disqualifying disposition. Part I - Identify shares to exercise: To identify the number of shares to exercise, create an Excel formula that calculates the number of qualified options to exercise. In column C on the row "**# of qualified options to exercise,**" type =C11-C14. **Note:** This assumes that you want to exercise all the available options, have only one ISO, and are doing this calculation for the first year. Part II - Calculate number of shares to sell as a disqualifying disposition: Use "**Goal Seek**" to calculate the number of ISOs to disqualify in order to have enough cash to buy the stock and pay taxes on the sale. **Tip:** Open the "**Bottom Lines Window**" to see the row "**Total after tax cash flow from all stock option activity.**" To do this, on the "**SO Views**" menu click **Bottom Lines Window**.

1. On the "**SO Tools**" menu click "**Goal Seek.**" The "**Goal Seek**" box displays.
2. In the row "**Total after tax cash flow from all stock option activity,**" click to select the cell that corresponds to the year in which you want to sell the options. The cell location displays in the "**Set cell**" box.
3. In the "**To value**" box type the numeral "0".
4. Click the "**By changing**" box and select the corresponding cell in the row "**Disqualifying disposition.**"
5. Click **OK**. Goal Seek calculates the answer and displays it in cells C13 and C14.
6. Round the number in the row "**Disqualifying disposition**" up to the next whole number.

In the "**Bottom Lines Window,**" the row "**Total after tax cash flow from all stock option activity**" should be a number equal to or greater than zero.

## What's New at Net Worth Strategies, Inc.

During the past several months, Net Worth Strategies has been enhancing our web site's financial planning resources. June marks the month we launch our site's "Planner's Resources" – a continually updated library of articles (like the one above), past eNewsletters, interviews with financial planners, FAQs, a glossary of terms, discussion/user forum, practice-enhancing materials you can download and other useful information.

The Planner's Resources information will help you sharpen your skills, keep you abreast of trends and help you and your clients avoid pitfalls. The resources can be accessed for free through our web site at:

[www.NetWorthStrategies.com/StockOpter/docs/resources.asp](http://www.NetWorthStrategies.com/StockOpter/docs/resources.asp)



960 SW Disk Drive, Suite B  
Bend, OR 97702  
Phone: (541) 383-3899  
Fax: (541) 388-0308  
Email: [Info@NetWorthStrategies.com](mailto:Info@NetWorthStrategies.com)

We're on the Web!  
[www.NetWorthStrategies.com](http://www.NetWorthStrategies.com)  
[www.StockOpter.com](http://www.StockOpter.com)