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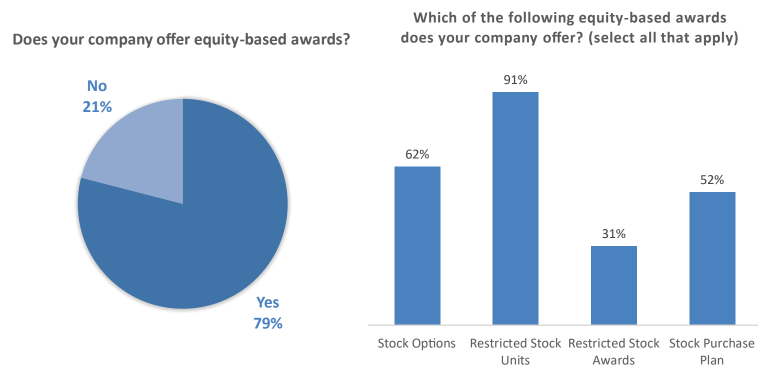
Markets have largely rebounded from the big downturn in the fourth quarter and so has the climate for initial public offerings. Levi Strauss, Lyft, and Tradeweb have already gone public this year, and investors are eagerly anticipating IPOs from Uber and Pinterest. IPOs like these have the potential to make employees of these firms wealthy but it's not just technology companies that reward employees with equity compensation. Today, almost all companies around the globe offer some sort of stock-based incentives to attract and retain talent.

Stock options have been an important part of executive pay at major U.S. companies since the 1950s. Their popularity has gone up and down with the general market performance because stock option grants have high upside if the company's stock price rises.

Deloitte 2018 Global Tax Equalization Survey



A stock option gives an employee the right to purchase a certain number of shares of a company's stock at a fixed exercise price over a specified time period. The option has value if the stock price is higher than the exercise price in the future.

Because a stock option grant does not require the outlay of cash by the employee, it is like getting an interest-free loan, which creates a leverage effect much like getting a mortgage on a house. The return on a home with a mortgage is amplified because the house appreciates or depreciates based on the full market value of the property, but the investment return is a percentage of the equity value of the owner. For example, if you put 50% down on a home that appreciates by 10%, the return on your investment is 2x or 20%. The same holds true if one margins a brokerage account.

As a result, stock options can be a way to build quick wealth but only if the stock price goes up. Options are worth nothing if the stock price goes down because the right to buy a stock at a price above market has no value at expiration. This extreme risk-return trade-off is part of the reason Microsoft shifted away from options to giving shares of stock, called Restricted Stock Units, in 2003. They were the first big company to make this shift, which has since been widely followed.

Restricted Stock Units are "restricted" because they are subject to a vesting schedule, which can be based on length of employment or employee performance, and because they can be controlled by other limits on transfers or sales by the issuing company.

Here's an example to compare the two approaches. Let's assume a company expects its stock price to go from $75 to $100. A grant of 400 options at $75 would be worth $10,000. To deliver that same incentive compensation to an employee, the company would only have to issue 100 Restricted Stock Units. However, if the price were to rise to $200, the option value would be worth $50,000 while the Restricted Stock Units would only be worth $20,000. But here's the rub on options, if the stock price were to go down to $50 the options would be worthless while the Restricted Stock Units would still be worth $5,000.

What's important to know is that Restricted Stock Units—the most common type of equity compensation for public companies and larger, late-stage private companies—are very different than stock options. They have less upside potential and more downside protection. They are also taxed differently for both the issuing company and its employees.

"When you win [with options], you win the lottery. And when you don't win, you still want it. The fact is that the variation in the value of an option is just too great. I can imagine an employee going home at night and considering two wildly different possibilities with his compensation program. Either he can buy six summer homes or no summer homes. Either he can send his kids to college 50 times, or no times. The variation is huge; much greater than most employees have an appetite for. And so as soon as they see that options could go both ways, we proposed an economic equivalent. So what we do now is give shares, not options."

— Bill Gates (2003)

Stock options are taxed when they are exercised rather than when they are granted. Restricted Stock Units, on the other hand, are taxed as ordinary income soon as they vest. This means there is no tax advantage to holding shares after they vest. Not surprisingly, we read regular accounts of people making this mistake.

For diversification reasons, selling the shares immediately and allocating the money to a diversified portfolio is a prudent course of action. It's important to not make the mistake of holding the shares, thinking they will qualify for long-term capital gain treatment like certain stock options. (Incentive Stock Options qualify for long-term gains if you hold them for at least one year from the date of exercise and two years from the date of grant.)

As investment advisors, we favor the shift from options to shares as it is less risky for employees. However, not everyone agrees. Some question whether it will hurt the competitiveness of American companies and therefore the economy. Can companies continue to attract high risk takers who would otherwise be willing to sacrifice cash for the opportunity to hit a home run with stock options? Will companies be able to innovate and perform at the same level as the past?

We suspect it will not be a problem. Companies adopting this approach think that share grants are sufficient to motivate people, and there are ways to increase incentives such as speeding up vesting and offering more shares. Early stage start-up companies still favor options, and these are the firms that are most interesting to high risk takers anyway.

As always, thank you for you continued trust and confidence.

Warm regards,

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