FIVE DECISION STEPS FOR PHARMACEUTICAL PROFESSIONALS TO MANAGE EMPLOYEE STOCK INCENTIVES AND REWARDS

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Chapter 1:

Why I Wrote This Ebook

Through years of working as a CERTIFIED FINANCIAL PLANNER™ (CFP®) professional and wealth advisor with clients receiving equity compensation, I realized that many lacked the knowledge and understanding to make the best decisions regarding their stock options and rewards.

Based on Charles Schwab's Equity Compensation Participant Survey,* 85% of employees would like more education to help them understand their benefit programs. The survey also revealed that less than a quarter of employees know how much their equity compensation comprises their investment portfolio.

I specialize in working with pharmaceutical employees. The industry is one of the largest employers in New Jersey and frequently offers equity incentives and rewards. I appreciate that making equity compensation and benefits decisions can be complicated for many people, especially with the lack of education provided by employers.

* Schwab Stock Plan Services, "2020 Equity Compensation Participant Study," October 2020, https://content.schwab.com/web/retail/public/about-schwab/schwab_equity_compensation_survey2020_findings.pdf

If you have ever asked yourself, “Am I maximizing the opportunities available to me?” this ebook is for you. This ebook will outline five decision steps that can get you started. However, you may still want the expertise of a financial advisor to help you put the pieces of the puzzle together.

Chapter 2:

How Do You Reach Your Goals When Your Financial Pieces Aren't Working Together?

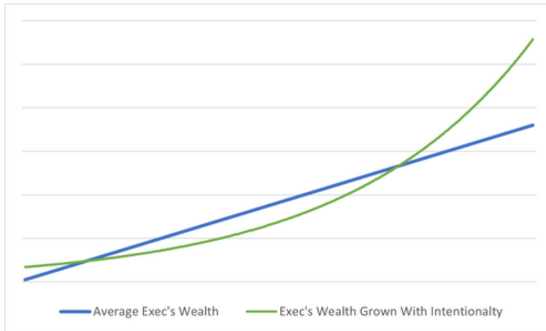
As a successful pharmaceutical employee, you want your financial progress to match your professional advancement.

Your professional progress, or career development, is your human capital. Over your career, your human capital will compound and grow in value. Being intentional with human capital decisions can pay off with higher income, promotions, and benefits. Your income should keep pace with inflation plus a salary scale based on your relationships, advancement in knowledge and skills, and value to the company.

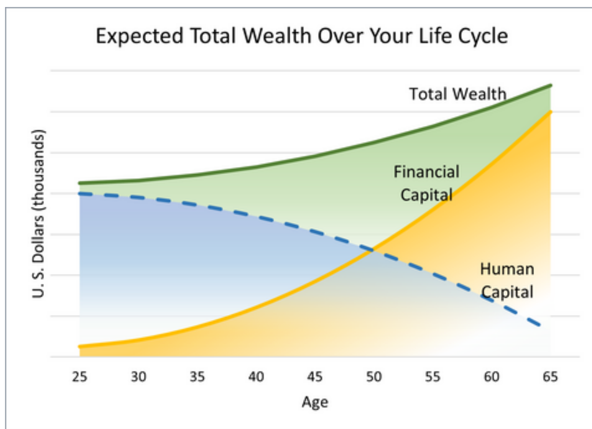
Your financial progress is your investment capital. Over your lifetime, your investment capital will also compound and grow by being intentional with your financial decisions. Your planning for the investment capital should keep pace with inflation and consider factors like taxation, diversification, risk and reward, and liquidity.

Start with a plan in mind that maintains a long-term view. Like your career development over your lifetime, wealth accumulation is not linear.

Your career decisions in the early years can significantly impact your compensation decades later, whereas the same is true for your financial planning decisions. Consistency and patience can pay off in exponential terms many years later. Unlike linear growth, exponential growth increases in magnitude over time.



Over your lifetime, with prudent and consistent planning, you can expect your investment capital to replace your human capital as you approach retirement. Financial planning is making all your financial pieces work together for a common purpose or goal. Your lifetime goal is to achieve independence from your human capital.



It may be difficult to envision where you want to be in the future compared to where you are now, professionally and financially.

Take a step back and start with the big picture. If you've ever assembled a jigsaw puzzle, recall what the most essential component is. It's the picture on the cover of the box. Without the end picture, you randomly attempt to fit pieces together. Likewise, financial planning starts with the end in mind – where you want to be, not where you came from or even where you are right now.

There are things you can and cannot control. Focus your time and effort on the things that matter and that you can manage and not what's beyond your control. That's the 80/20 rule. Find the 20% of effort that generates 80% of the results. The five decision steps in this ebook are an excellent place to start.

There are factors you cannot influence, like the movement in the stock market, directly impacting your wealth and equity compensation. The stock market is volatile, and without having a defined investment plan that works in tandem with your finances, the risk of loss may cause you to make emotional money decisions.

Your employee stock and benefits come with complexity and tax considerations, which may make you apprehensive about making mistakes or missing out on opportunities. Leaving your employer's equity compensation on autopilot can be tempting because the rules are convoluted. You may not have the time to research, and it's easy to procrastinate since stock options and rewards may not be immediately available or needed.

Your benefits should be a benefit, not a burden.

Chapter 3:

Jack and Jill

HIGHLAND has enjoyed working with a diverse clientele, giving us a unique perspective when solving clients' obstacles. We have partnered with clients for over 30 years, integrating their stock incentives and rewards into a broader financial plan. Consider Jack and Jill's financial journey with us.

Jill was promoted to manager at a global pharmaceutical company and offered a new benefits package. She now had access to different types of long-term stock incentives awarded annually. The total benefits package would become a sizable part of the household net worth for Jill and her husband, Jack. The lack of understanding and fear of making a mistake led her to take no action, although Jill and Jack realized the potential future value.

Talk at the company water cooler gave Jill a case of FOMO, or fear of missing out. She heard varying and confusing viewpoints about the "optimal" treatment of her equity compensation, benefits, and deferred compensation. She was worried about missing out on valuable benefits and when to capitalize on her awarded stock incentives. Jill was unsure how to reduce the noise to feel confident in her decisions.

Jill and Jack wanted to enjoy their money, such as renovating their home and indulging in multiple yearly vacations. However, they also wanted to be financially responsible and understood the value of living below their means to save for their retirement, child's college, and general financial security.

They did not know how to approach the balancing act of enjoying their lifestyle now and properly saving and planning for the future.

Jill and Jack engaged HIGHLAND's services because they wanted objective, fiduciary advice on managing the different types of compensation benefits and how they impacted their larger financial picture on an ongoing basis. They wanted a long-term approach and a process to smooth out cash flow and taxes while coordinating their benefits with their other financial resources.

The initial planning started with discovering and exploring their vision for the future and their goals in life. We then collaborated to create the foundational blueprint of Jill and Jack's financial plan by understanding the quantitative data (compensation – salary composition, stock options, non-cash benefits, retirement plans, cash flow, etc.) and qualitative information (lifestyle, goals, objectives, etc.).

We dissected the RSU and NQSO grants and stock operation agreements to explain the components to Jill and Jack in simple, easy-to-understand terms. Our analyses of the data would guide our recommendations for the current and future awards as we revisited the study multiple times during grants, vesting, and tax season.

The plan also considered how other employer benefits for Jill and Jack might impact their decisions with equity compensation for Jill. Their choices about traditional 401(k) deferrals vs. Roth 401(k) deferrals, medical savings accounts, insurance coverage, and leveraging deferred compensation for additional tax savings were all discussed.

We did not want to lose sight of their short-term goals and experiences while balancing their long-term savings. Although their annual income increased, a significant portion was not received in a predictable monthly cash flow. To make this more manageable, we mapped out their yearly lifestyle, irregular expenses (annual savings and taxes), and net inflows (salary, vested stock, and bonus). Through the planning process, we were able to:

- Create a financial plan that matched their needs
- Identify the timing of vesting stock, when to exercise the NQSOs, and calculate an estimate of taxes by coordinating with a tax professional
- Simplify their daily finances and adequately prepare for expected and unforeseen outflows
- Recognize their ability to maintain their lifestyle while balancing the need to save toward their goals
- Minimize the risk of unexpected life events through proper estate and insurance planning
- Give them peace of mind that they were making the most of the opportunities available to them

After the initial planning was complete, regular and consistent monitoring of their financial plan increased their odds of success over the long term.

Chapter 4:

What Steps Should You Take to Shape Your Financial Life Positively?

The following steps can increase your odds of personal and professional success. It is vital to take a strategic approach to regularly review your benefits and incorporate them into a financial plan to make the most out of them, even if it is easier not to act.

Here are five decision steps for your stock incentives and rewards to improve your odds of success.

Step 1: Understand the Types of Compensation
There are three main types of compensation, and it's essential to understand the type, timing, and amount to have a clear picture of your finances, as this provides the capital to grow wealth.

- **Cash compensation:** This includes your base salary and cash bonus. Bonuses are short-term incentives because they are merit-based or depend on company profits. Bonus percentages can vary widely depending on the industry and job level. The bonus is discretionary income because the amount can change, while your salary is fixed.

- **Equity compensation:** Equity compensation is simply non-cash pay, encompassing awarded stock options (NQSOs, SARs, ISOs) and grants (RSUs, ESPPs, PSUs). Options and grants are long-term incentive compensation because they typically vest over three or more years. They encourage employees to contribute to the company's growth and development, hoping their awards grow in value over time. Until the awards vest, there is no tangible value.

- **Benefits:** Non-monetary compensation is compensation rewarded in a non-cash form and can be an essential part of a total compensation package. These benefits can significantly reduce household expenses or offer tax deferrals, like retirement plans, non-qualified savings accounts, health savings accounts, and flexible spending accounts. All benefits deserve careful consideration as part of a financial plan and current lifestyle structure.

Step 2: Learn the Equity Compensation and Benefit Basics

Equity Compensation:

Equity compensation deserves special attention because it involves timing and unique tax considerations as part of your wealth creation. To make the most of your equity compensation, you must account for what you have and how it will affect your income. Doing so will minimize tax surprises and stop reactions based on emotions or "gut feelings."

Terms to Know:

- **Grant:** The date the options are issued or granted at a set price called the strike price.

- **Strike price:** The price paid to purchase the shares. The strike price usually equals the fair market value (FMV) on the grant date. Unlike public companies that use the current trading price, private companies use valuation metrics to determine a fair price as if the stock was available on the open market.

- **Vesting:** The date you have the right to purchase (exercise) the options or own the grants. For grants like RSUs, you receive the shares at the grant date but do not own them until vesting. It is typically based on time but can also be associated with performance milestones. You may forfeit the unvested shares if you leave employment before becoming fully vested.

- **Vesting schedule:** A set time frame dictates when and how many shares the employee will own. Immediate vesting has no waiting periods, so employees fully own the asset at the grant. Cliff vesting provides 100% ownership at a specified date. Graded vesting refers to increasing incremental ownership over time. A four-year graded vesting schedule (25% per year) is most common; however, the vesting schedule can range monthly, quarterly, or annually with set vesting percentages.

- **Exercising:** Allows you to purchase the shares at the strike price – ideally, exercising the options when the fair market value exceeds the strike price. At this point, you will have the opportunity to either sell it immediately or retain the stock. There may be tax implications for exercising depending on the type of award.

- **Alternative minimum tax (AMT):** A separate tax system to calculate your tax obligation based on household income. For some households, the tax liability is calculated based on the ordinary income tax rules and AMT, where the higher amount is paid. Specific stock options and actions may trigger AMT.

Types of Awards:

- **Non-qualified stock option (NQSO):** Type of option where you have the right to exercise the company stock at the strike price after vesting. Ordinary income tax is triggered when exercised, based on the difference between the strike price and stock price on the exercise date.

- **Restricted stock unit (RSU):** Type of grant where ownership of the shares is transferred at vesting, and the market value is realized as ordinary income on your tax return.

- **Employee stock purchase plan (ESPP):** This is a program to purchase shares of company stock, usually at a discounted price or even with an employer match. This is usually a voluntary program where you can specify the amount of capital.

- **Stock appreciation right (SAR):** Option type with no upfront cost from exercising. Instead, the difference is received in cash or, rarely, as company stock. There are no tax consequences at the grant or vest, but the spread between the fair market value and grant price may be taxed as ordinary income.

- **Incentive stock option (ISO):** Type of option where you have the right to buy company shares at the strike price with special tax treatment. Exercising the options once vested may trigger alternative minimum tax based on your situation. Once exercised, you can either sell the stock immediately, taxed as ordinary income (disqualifying event), or sell two years after the grant date and at least one year after exercising to be taxed at capital gains (qualifying event).

Non-Qualified Deferred Compensation (NQDC):

This type of benefit is also called a 457(f) plan and is offered to higher-level executives. Deferred compensation usually provides immediate tax benefits as taxes are postponed until the income is paid out, often at retirement age. There are no caps on contributions, and these plans are a way to reduce the tax burden in the short term and provide additional retirement savings on top of the 401(k) plan. NQDCs have excess risk because they do not have the same protection under federal regulations as traditional retirement plans and can be seized if the company goes bankrupt.

Non-Compensation Benefits:

Non-monetary compensation is simply compensation rewarded in a non-cash form. These benefits can significantly reduce household expenses or offer tax deferrals.

- **Insurance:** Group benefits can be an inexpensive way to ensure you and your family are adequately covered and minimize the risk of unexpected out-of-pocket expenses.

- Medical: There are several types of medical insurance, but picking the right one is based on your utilization. Do not focus on the deductible or premium figure alone. A lower deductible typically translates into a higher premium and more robust coverage. While a higher deductible plan has a lower premium, it gives you access to a health savings account (HSA). HSAs offer "triple tax savings" because contributions are tax-deductible, and earnings and withdrawals are tax-free if used for qualified medical expenses.

- Disability: This provides a stream of income if something unexpected happens to you and you cannot work in some capacity. There are important terms to know, like the definition of disability, elimination period, benefit payment, and benefit period. Employers may offer basic disability insurance for little to no cost.

- Life insurance: This provides a death benefit when the employee (insured) passes away. The coverage is relatively inexpensive, and your employer may even cover the premiums. Typically, life insurance is not portable, meaning you forfeit the coverage if you leave your employer.

- **Retirement plans:** The most common plan is a 401(k), which allows you to defer a portion of your income into the plan on a per-paycheck basis. The deferral is limited to the amount the IRS sets annually. Depending on the plan, you may be offered a traditional 401(k) funded with pre-tax money and a Roth 401(k) funded with after-tax money. Your employer may also contribute money to your account based on a set percentage of your salary or a matching contribution up to a determined threshold.

- **Additional fringe benefits:** These encompass items like tuition reimbursements, pet insurance, and gym memberships.

- **Miscellaneous benefits:** These include paid time off (PTO), career development opportunities, and work-life benefits/flextime.

All benefits deserve careful consideration as part of your financial plan and current lifestyle structure.

Step 3. Define a Purpose for the Equity Compensation Through Goal Exploration

Many people lose momentum over time and make ad hoc decisions about one goal without considering the impact on other goals. This often leads to making short-term financial decisions for long-term goals or ignoring the liquidity requirements for short-term goals. Start with goal setting, and then follow this simple method for matching financial assets with goals. Being mindful of the trade-offs allows adjustments to expectations and behaviors to maintain progress on your financial plan.

Defining a purpose for equity compensation is a shift in perspective regarding work and payment. Understanding your goals, objectives, and timing will help you decide where equity compensation assets should fit. For instance, your employer's retirement plan and your 401(k) salary deferrals should be dedicated to your most long-term retirement goal with a time horizon of your life expectancy.

Employees must consider their stock incentives and rewards regarding their time horizon, matching goals, and investment considerations like diversification and asset allocation.

Step 4. Create a Plan for Your Investment Assets, Equity Compensation, and Benefits

With your goals in mind, define your buckets, match your assets to your time horizons, and create a plan to achieve and fund them. The financial plan is a blueprint guiding your decisions over time. It's a working document you will intentionally modify over time as your life evolves. A financial plan starts with an inventory of your net worth and a clear picture of your current cash flow.

Think about booking a trip. To create your itinerary, you must know the location, airports, time frame, and dollar amount. Without that information, the trip wouldn't happen. The same applies to your financial plan.

No business can succeed without clearly understanding its cash flow – the income and expenses – and a household is no different. Many consumer-based apps can help you budget and manage expenses. Still, you can start with a spreadsheet snapshot of your net worth (assets and liabilities) and cash flow (income and expenses). You should note the timing of any irregular income and expense items within your cash flow. The next step is to project these components over five years to start forecasting.

You will also need to establish a system for tracking the underlying investments compared to an appropriate benchmark for your equity compensation and investment accounts. You can do this online using Yahoo or Google finance charting functions.

Once you have completed the initial steps and defined how you will treat your equity compensation and investment accounts, deviating during periods of uncertainty may be tempting. Whether there is stock market volatility, unexpected expenses, or a spouse's job loss, refer to your financial plan when you feel uncomfortable.

There is never a shortage of risk in global equity markets. It can seem like a roller-coaster ride. A steep drop in stock prices scares investors and heightens their senses to pay attention to avoid making mistakes.

However, this fear can lead to indecision or making irrational decisions. No one can consistently predict stock prices or how long it may take to recover from a market drawdown, so a long-term strategy is critical.

The decision to sell or not to sell when the markets are distressed is based on a few factors:

- The fundamentals and price trend of your company's stock and the industry: What happened in the past does not guarantee the future but indicates a possible outcome.

- Your unique financial plan: What works for someone else may not be your optimal solution.

- Your need for cash in the short term: Using the sold stock to fund a goal may be better than relying on debt.

Step 5. Monitor and Stick to the Plan

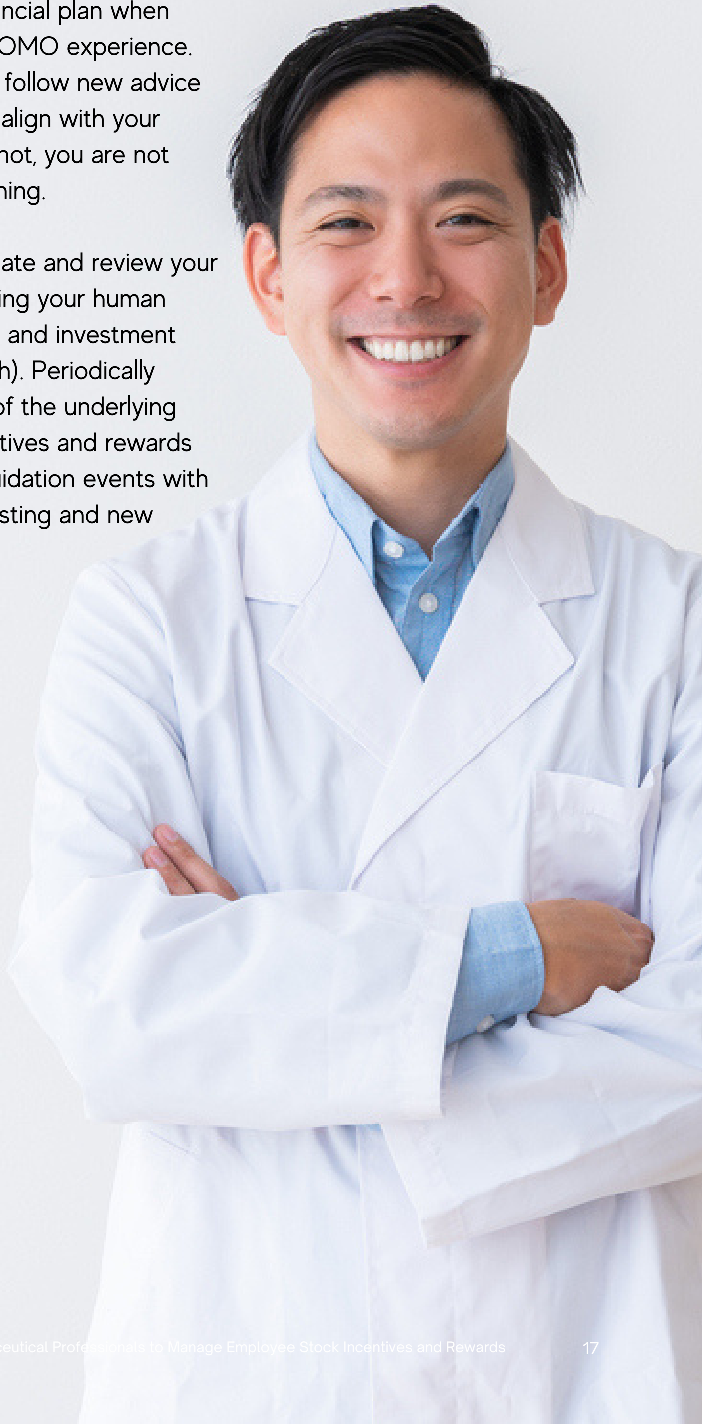
This step is the most critical. Financial planning is not a set-it-and-forget-it process; it is very dynamic. A financial plan does not need to be complicated and should provide a starting point for measuring your long-term success.

Financial planning is like building a home, as both take time and preparation. Constructing a home is done with the help of an architect and general contractor to create a blueprint capturing your vision. The construction stage brings the blueprint to life, but modifications to the building process and materials will need to be made along the way. Once the property is built, ongoing repairs and maintenance are necessary to preserve the value of your investment.

Financial planning is as unique as you are, so a solution for one person may not be appropriate for another. Although it may be tempting to take what someone else is doing as advice for yourself, this common mistake can lead to costly setbacks and emotional stress if it doesn't work out.

This is commonly called FOMO or the fear of missing out on something. Stop and review your financial plan when confronted with a FOMO experience. Does your desire to follow new advice or to buy a product align with your long-term goals? If not, you are not missing out on anything.

Once a quarter, update and review your financial plan, including your human capital (career path) and investment capital (financial path). Periodically check the tracking of the underlying stock for your incentives and rewards and plan for any liquidation events with the timing of any vesting and new grants.



Chapter 5:

Why the Hesitation to Get Started?

According to the Charles Schwab Equity Compensation Participant Survey, three out of five employees have never exercised or sold any equity compensation. Why not? Fear of missing out, waiting to see if there are more favorable market conditions, is the number one reason for not acting. Other causes include fear of making mistakes or a lack of knowledge in managing equity compensation.

Many people put off decisions with equity compensation due to uncertainty around the taxation of any action. Equity compensation tax planning may require an investment of your time, but the process is crucial to saving money in the short term and building wealth over the long term. All types of employer stock options and grants come with some sort of tax liability, whether when it vests or at exercise, but there are strategies to implement, like using the liquidity of one grant to pay for the cost of the next.

Although you may feel confident managing your equity compensation and benefits, seeking expert advice from your CPA or CERTIFIED FINANCIAL PLANNER™ professional can help you avoid costly mistakes. We can all produce behavioral responses that short-circuit our rational brain, causing us to buy or sell at the wrong time.

Having a long-term strategy as part of your financial plan can help you stay objective in times of market stress, and working with a knowledgeable advisor can free up time to pursue life's passions.

How Can We Help You Succeed?

Based on the Charles Schwab Equity Compensation Participant Survey, 83% of employees are more confident in making the right decisions about their equity compensation when working with an advisor.

Our mission is to improve people's lives through competent, objective financial advisory services. As an independent fiduciary, HIGHLAND will always act with a duty of loyalty and a duty of care and always in the client's best interest. For over 30 years, we have helped people with equity compensation solutions.

If you want to learn more and schedule an introductory call with me to learn how we can help, click here: https://www.highlandplanning.com/pharmaceutical-professionals

All my best on your path to financial freedom!

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