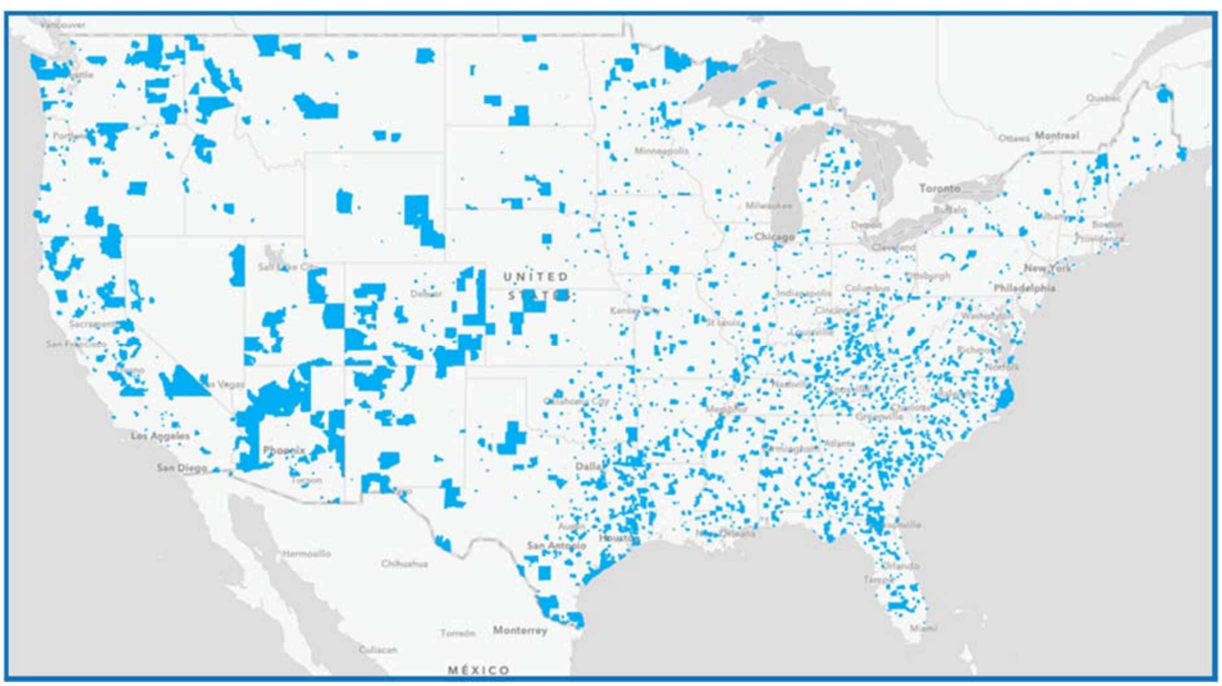
QUALIFIED OPPORTUNITY FUNDS:
A TOOL FOR DE-RISKING PORTFOLIOS



A map of the 8,700 U.S. Treasury certified Opportunity Zones (source: Economic Innovation Group)

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About the author

Brett S. Messing is a Partner and the President and Chief Operating Officer of SkyBridge. He began his career at Goldman Sachs where he held various positions including Vice President and Co-Head of the Restricted Stock Group. Thereafter, he was a partner at Oscar Capital Management, which was acquired by Neuberger Berman, LLC. Following the successful integration of the business, Mr. Messing founded GPS Partners, a $2.5 billion hedge fund at its peak, which focused primarily in the energy infrastructure sector. Mr. Messing was the firm's Managing Partner and Chief Investment Officer. Thereafter, Mr. Messing worked for Los Angeles Mayor Antonio R. Villariagosa as Co-Chief Operating Officer responsible for economic and business policy. Mr. Messing served as a Senior Advisor to Mayor Michael R. Bloomberg at C40 Cities, a joint venture with the Clinton Climate Initiative. Mr. Messing is the Terence M. Considine Visiting Senior Research Fellow in Law, Economics, and Business at Harvard Law School. He is the co-author of *The Forewarned Investor* and contributed to *Learning from the Global Financial Crisis - Creatively, Reliably and Sustainably*, a compendium published by Stanford Business School. Mr. Messing received his A.B. from Brown University, magna cum laude, and his Juris Doctor from Harvard Law School.

About SkyBridge

SkyBridge is global alternative investment manager that provides a range of investment solutions to individuals and institutions. Addressing every type of market participant, SkyBridge's investment offerings include commingled funds of hedge funds products, customized separate account portfolios, hedge fund advisory services, a long-only mutual fund and an Opportunity Zone focused non-traded REIT. The firm is headquartered in New York and has offices in Palm Beach Gardens, London and Seoul.

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Introduction

The Tax Cuts and Jobs Act of 2017 introduced a new federal tax incentive, the Opportunity Zones program, to encourage investors with substantial unrealized gains to sell low-cost basis stock positions and reinvest the proceeds. The tax incentive provides investors with a finite opportunity, with the program expiring in stages beginning in 2019 and ending in 2026, to reduce portfolio risks associated with overconcentration, particularly in large single-stock positions. Investors need to reinvest gains by December 31, 2019 to receive the maximum available tax benefits available via the program. The unlocked and redeployed capital is expected to drive real estate and business development, economic growth, and job creation. Senators Cory Booker (D-NJ) and Tim Scott (R-SC) co-sponsored this bipartisan legislation, which was championed by Sean Parker, the former President of Facebook, and Jamie Dimon, the Chairman and CEO of JP Morgan Chase.

"Investors with unrealized capital gains can receive tax benefits including: 1) deferral of the payment of capital gains taxes until 2027, 2) up to a 15% reduction in their capital gains tax liability, and 3) complete exemption from capital gains taxes for any appreciation on reinvested capital. "

Investors with unrealized capital gains can receive tax benefits including: 1) deferral of the payment of capital gains taxes until 2027, 2) up to a 15% reduction in their capital gains tax liability, and 3) complete exemption from capital gains taxes for any appreciation on reinvested capital. Investors may avail themselves of these generous tax incentives by reinvesting a realized capital gain in a Qualified Opportunity Fund that invests in real estate projects or businesses in newly designated Opportunity Zones. State governors designated more than 8,700 census tracts in the U.S. and Puerto Rico as Opportunity Zones based on criteria established via the Tax Cuts and Jobs Act of 2017. Most major cities have numerous Opportunity Zones, including, among others, New York City, Washington, D.C., Los Angeles, San Francisco, Houston, Chicago, and Atlanta. The U.S. Treasury calculates that there are over $6 trillion[1] in unrealized gains eligible for this program, and it further projects that over $100 billion[2] will be invested in Qualified Opportunity Funds.

Portfolio Concentration Risk

Qualified Opportunity Funds are highly effective, cost-efficient vehicles to mitigate risk confronting individual investors in the United States who hold excess concentration in either a single stock or a group of stocks. Excess portfolio concentration, particularly in equities, has developed for a number of reasons including 1) massive outperformance of a subset of the Standard & Poor's 500 Index, particularly large capitalization technology stocks like Facebook, Apple, Amazon, Netflix, and Google (the "FAANGs"), 2) consolidation in several sectors, like, for example, energy master limited partnerships ("MLPs"), 3) public market exits by private equity and venture capital firms, and 4) initial public offerings in various sectors including FinTech, clean energy, cyber security, and investment advisory and management.

The wealth creation associated with portfolio concentration fosters complacency, which poses an existential risk to the preservation of innumerable family fortunes.

Resistance to Change

Behavioral psychology, in large part, explains why individuals are averse to diversifying large single stock positions. When confronted with uncertainty, individuals have a substantially greater negative emotional reaction to losses suffered by acts of commission than acts of omission. However, status quo bias produces irrational behavior as there is no inherent rational virtue associated with "doing nothing." Inaction, or not diversifying a concentrated stock position, represents a decision that carries the same risks and rewards as taking action. Outcome optimization is achieved through rational decision-making, which is agnostic as between "doing nothing" or taking action.

Ironically, in virtually all contexts other than the portfolio diversification, individuals place a very high value on loss aversion. This bias produces mathematically irrational decisions to avoid potential losses. In a study conducted by Amos Tversky and Daniel Kahneman, a majority of people refused to accept a bet, based on the flip of a coin, whereby they would lose $100 if the coin came up tails and win $150 if the coin came up heads.[3] Despite the bias towards loss aversion, individual investors accept extraordinary and irrational single-stock concentration risk.

Historical Recurrence

Embracing portfolio concentration can be attributed, in part, to a misunderstanding of Warren Buffett's axioms and his portfolio management style. Berkshire Hathaway's largest holding, Apple, represents 25% percent of its stock portfolio, and Berkshire Hathaway presently holds 33% percent in cash.[4] Thus, the Apple position represents 18.7% of the liquid cash and stock portfolio. While 18.7% in a single stock represents significant concentration for an institutional investor, Buffett's portfolio is well diversified and defensive by individual investor standards. Further, notwithstanding Buffett's famous statement that "our favorite holding period is forever," Berkshire Hathaway's portfolio undergoes substantial turnover (Figure 1).

Figure 1

Berkshire Hathaway Top 10 Public Equity Positions

2008	2018
The Coca-Cola Company	Apple Inc.
Wells Fargo & Co	Bank of America Corp
The Proctor & Gamble Co	Wells Fargo & Co
ConocoPhillips	The Coca-Cola Company
Kraft Foods, Inc.	American Express Company
American Express Company	Kraft Heinz Co
U.S. Bancorp	U.S. Bancorp
Johnson & Johnson	Bank of New York Mellon Corp
Sanofi-Aventis	JP Morgan Chase & Co.
Tesco plc	Moody's Corporation

The idea of a "forever" holding period fails to account for Joseph Schumpeter's theory of creative destruction, which describes the process of "industrial mutation that incessantly revolutionizes the economic structure from within, incessantly destroying the old one, incessantly creating a new one." Said differently, it is a virtual law of nature that new companies will emerge and displace the seemingly indestructible incumbents. Consequently, the potential outcome of a "forever" holding period is substantial, and perhaps total, loss of capital.

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For example, on June 26, 2018, General Electric was removed from the Dow Jones Industrial Average. GE was an original member of the Dow Jones since the index's creation in 1896. However, over the last decade, GE has been a source of tremendous wealth destruction, which materially impacts the financial security and lifestyles of millions of Americans. Strikingly, only four of the thirty companies in the Dow Jones remain since 1975 (Figure 2). Ten companies – or one third of the Dow Jones circa 1975 - subsequently went bankrupt, including Bethlehem Steel, Chrysler, Eastman Kodak, General Motors, Johns-Manville, Owens-Illinois, Sears Roebuck, Westinghouse Electric, U.S. Steel, and F.W. Woolworth. Thus, holders of large single -stock positions should be mindful of Sir John Templeton's warning, "the four most expensive words in the English language are 'this time it's different'."

Figure 2

Dow Jones Members (1975)

Allied Chemical Corp	Esmark Corporation	Owens-Illinois, Inc.
Aluminum Company of America	Exxon Corporation	The Proctor & Gamble Company
American Can Company	General Electric Corporation	Sears Roebuck & Company
American Telephone and Telegraph Company	General Foods Corporation	Standard Oil Co. of California
American Tobacco Company	General Motors Company	Texaco Incorporated
Anaconda Copper Mining Company	Goodyear Tire and Rubber Company	Union Carbide Corporation
Bethlehem Steel Corporation	Inco Limited	United States Steel Corporation
Chrysler Corporation	International Harvester Company	United Technologies Corporation
E.I. du Pont de Nemours & Company	International Paper Company	Westinghouse Electric Corporation
Eastman Kodak	Johns-Manville Corporation	F.W. Woolworth Company

Company remains in Dow Jones: 4
Company not currently in Dow Jones: 16
Company went bankrupt: 10

Relatedly, investors with large low-cost basis stock positions, particularly owners of the FAANGs, ignore the law of large numbers at their peril. Apple presently (March 2019) has a market capitalization of $814 billion. Thus, in order to grow its market capitalization by 10% annually, it needs to grow by $81 billion. To place $81 billion in context, American Express has a $90 billion market capitalization. Thus, while Apple will likely, in the short to intermediate term, avoid the calamitous fate of some of its Dow Jones Industrial Average predecessors, it will, at some point, experience slower growth, and even revenue and profit contraction.

Rational Inertia

According to one application of the Coase theorem, investors will diversify their property, or stock holdings, in the most rational and beneficial manner in the absence of transaction costs.[5] While stock-trading commissions have decreased over time, capital gains taxes represent a substantial disincentive to the efficient allocation of resources. An investor in the highest income tax bracket pays a federal capital gains rate of 23.8%, including the net investment income tax (NIIT). Further, an investor from a state with an average state tax rate will pay an additional 5.5% in state taxes based upon an approximation of the current range of state income tax regimes. Thus, using the average state tax assumption, the combined federal and state capital gains tax associated with the sale of an appreciated stock position is approximately 29.3%. Moreover, because of the new limitation on the deductibility of state income taxes, the aggregate capital gains liability has increased for residents of states with median, or higher, state tax rates. The prospect of paying capital gains taxes adversely impacts investors' willingness to redeploy capital into diversified portfolios with more attractive risk-return profiles.

Traditional Diversification

The most common way to diversify a concentrated low-cost basis stock position is to sell shares and pay the federal and state capital gains taxes. The payment of the capital gains taxes reduces the amount of investable money, which adversely effects the dollar return on future appreciation. As set forth above, the tax liability of an investor who owns $10 million in Google with a zero-cost basis is $2.93 million in federal and state income taxes. If the Google stock position doubles to $20 million, the capital gains liability also doubles to $5.86 million. If the investor sells the Google stock position for $20 million and pays the capital gains taxes, he will have $14.14 million in after tax proceeds.

As an alternative, let's assume an investor sells $10 million in Google stock and pays $2.93 million in federal and state income taxes. After paying the taxes, the investor has $7.07 million to re-invest in a diversified portfolio. Let's further assume that, like Google in the example above, the diversified portfolio doubles in value to $14.14 million. Thereafter, the investor sells the appreciated diversified portfolio. The investor owes capital gains of $2.07 million on the $7.07 million portfolio gain, and thus he will have $12.07 million in after tax proceeds.

Consequently, if Google and the diversified portfolio generate the same investment return, the investor will be $2.07 million worse off financially by virtue of having sold his Google shares and reducing the amount of his investable capital. However, given the substantially greater risk associated with holding a single stock position (as opposed to a diversified portfolio), the investor's return per unit of risk will be substantially enhanced through diversification. Individual investors often evaluate stock trading decisions based solely on the resulting dollar return without giving sufficient weight to the value of risk mitigation.

In certain respects, investors should analogize diversification to the purchase of insurance. Whether or not a claim is submitted, people do not question the wisdom of buying home, auto, or disability insurance. Insurance is bought to provide protection against calamities. Given the recurrences of "100-year storms" like the 1987 crash, the Mexican debt crisis in 1994, the Russian bond default in 1998, 9/11, and the financial crisis of 2008, the purchase of insurance through portfolio diversification represents a prudent course of action to protect wealth.

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Exchange Funds – a Niche Product

Exchange funds represent vehicles for holders of low-cost basis stock positions to diversify without paying capital gains taxes and reducing the amount of their investable capital. Exchange funds enable a group of investors to swap their ownership in shares of a single stock position for shares, or partnership interests, in a diversified fund without triggering a taxable capital gain. The diversification is achieved because investors contribute different stocks to the exchange fund.

Exchange fund investors are locked up for several years, usually five or more, and redemptions are met with in-kind distributions of shares from the underlying portfolio. The investor's basis in the original stock positions transfers to his interest in the exchange fund and, upon redemption, to the portfolio of shares received in fulfillment of the redemption request. Redeeming from the fund does not trigger a taxable event. Importantly, the capital gains taxes on the stock position are deferred, but the liability endures.

Exchange funds are a niche product for a variety of reasons. The components of the diversified portfolio are limited by the manager's ability to attract willing participants. Thus, the manager might want the fund to hold certain stock positions, but he might not attract investors who own shares of the desired stock positions to contribute. The manager might also reject prospective investors who hold stock positions that the manager believes are unattractive. Relatedly, the manager will usually limit the number of shares that investors in a specific stock or a specific sector can contribute in order to meet the diversification mandate. As a consequence, some investors are unable to access exchange funds or are only permitted to contribute a very small portion of their holdings. Finally, for tax reasons, the portfolio is static rather than actively managed. Exchange funds are generally effective at providing diversification to their participants. However, because of the limitations set forth above, the funds have historically underperformed, in many cases by substantial margins, the broader equity market as measured by the S&P 500 index.[6]

Derivative Securities – a Time Bridge

Derivative securities (i.e. puts and calls) can be utilized to manage the risk associated with a large single-stock position. The most common strategy, a costless collar, combines the purchase of over-the-counter puts and the sale of calls. In an over-the-counter transaction, an investor privately negotiates the terms of the transaction with a counterparty bank. This protects the investor against an early option exercise, which occurs in the listed options market and which would generate a premature, tax-triggering stock sale.

A costless collar is characterized as costless because the premium, or cash received, by the sale of out-of-the-money calls finances the purchase out-of-the-money puts. However, the collar is not actually costless. Creating asymmetry between the strike prices for the put and the call produces profits for the counterparty bank. For example, for a stock selling at $100, an investor might sell calls with a strike of $105 to finance the purchase of puts with a strike of $90. Thus, in this "costless" transaction, the investor is limited to five percent of appreciation while bearing exposure to ten percent of stock price decline. Importantly, puts and calls must be out-of-the-money and expose the investor to a modest degree of risk or the IRS will deem the transaction to be a disguised sale, which triggers a capital gains tax liability.

While derivative securities are used to hedge the risk associated with a single-stock position without triggering a tax liability, these strategies do not unlock capital for reinvestment except by borrowing against the stock position with a margin loan. Borrowing against a hedged stock position is most appealing in a low interest rate environment. However, many investors are uncomfortable with introducing portfolio leverage into their investment strategies even in the pursuit of diversification.

Consequently, the use of derivative securities to hedge a single stock position, with or without an associated margin loan, is a sensible strategy for a short period of time. For example, it is an effective way to defer the recognition of a gain into the next tax year while immediately eliminating much of the downside price risk associated with holding the stock. Similarly, if an investor faces imminent death because of a terminal illness, derivative securities are a smart way to preserve the step up in tax basis for the investor's heirs while concurrently protecting the stock position from downside decline. In summary, derivative securities are tools with limited utility. They do not facilitate the redeployment of capital from concentrated single stock positions into a less risky diversified portfolio.

Opportunity Zone Tax Benefits Provide a Compelling Incentive to Diversify Concentrated Stock Positions[7]

The Tax Cuts and Jobs Act of 2017 provides a powerful tax incentive for investors with capital gains in single-stock positions to diversify their holdings. Investors must realize capital gains and reinvest the gains in a Qualified Opportunity Fund by December 31, 2019 to take advantage of the full tax benefit. The tax incentives take three different forms: 1) deferral of the payment of capital gains taxes until 2027, 2) an up to 15% reduction in the capital gains tax liability, and 3) a full exemption from capital gains taxes for any appreciation on the reinvested capital, subject to a ten-year holding period.

The following example provides a helpful tool to illustrate the economic value of the tax benefits as well as timing and logistical issues. For simplicity's sake, the example will describe the steps required to access the maximum tax benefits provided by the Opportunity Zones program. Let's assume that Mary purchased $1,000,000 of Amazon stock following the financial crisis, and the position has grown in value to $11,000,000. Mary wants to diversify her Amazon position because it represents an outsized percentage of her net worth. On December 1, 2018, Mary sells the Amazon stock. Thereafter, she invests $10,000,000 in a Qualified Opportunity Fund that will invest its capital in a diversified real estate portfolio. Importantly, Mary only invests her capital gain, the $10,000,000, in the Qualified Opportunity Fund. While the Opportunity Zones program requires the capital gain to be reinvested in a Qualified Opportunity Fund within 180 days of sale, this requirement does not apply to the cost basis. Mary may redeploy her $1,000,000 cost basis without restriction.

Because Mary reinvested her $10,000,000 capital gain in a Qualified Opportunity Fund, she does not owe an assumed $2,930,000 in federal and state capital gains on April 15, 2019. Rather, this liability is deferred until April 15, 2027. There is a substantial economic value associated with deferring the payment of $2,930,000 for eight years. Assuming a 6% net annualized return on the Qualified Opportunity Fund investment, the value of the deferring the tax liability is $1,739,975. (Figure 3)

Figure 3

Value of Gain Deferral	
Initial Capital Gain Liability	**$2,930.000**
Total Value at Payment (6% net return)	**$4,669,975**
Payment of Initial Capital Gain Liability	**($2,930,000)**
Value of Deferral	**$1,739,975**

***Assumes 8 year investment period**

However, Mary will not owe $2,930,000 in 2027. Rather, her actual capital gains tax liability is reduced by 15% to $2,490,500 (assuming she holds her interest in a Qualified Opportunity Fund for at least seven years). This represents a tax savings of $439,500 ($2,930,000 - $2,490,500) excluding the benefit of deferring the payment of the tax for eight years.

Based on historic return assumptions, the most mathematically powerful tax benefit of the Opportunity Zones program is the complete exemption from capital gains taxes on appreciation of the investment in a Qualified Opportunity Fund (subject to a ten year holding period). If Mary's Qualified Opportunity Fund investment produces a 6% net annualized return, her $10,000,000 investment will grow to $17,908,477. Absent the Opportunity Zone tax benefit, she would owe capital gains taxes of $2,317,184 on her $7,908,477 gain. However, because Mary invested her Amazon capital gain in a Qualified Opportunity Fund, she owes zero taxes on the resulting $7,908,477 capital gain. Thus, Mary's tax benefit is the capital gains taxes that she does not have to pay, $2,317,184. Essentially, the Qualified Opportunity Fund, if held for ten years, represents a tax-free investment.

"Based on historic return assumptions, the most mathematically powerful tax benefit of the Opportunity Zones program is the complete exemption from capital gains taxes on appreciation of the investment in a Qualified Opportunity Fund (subject to a ten year holding period). "

The scope of the various Opportunity Zone tax benefits is extraordinary. Mary receives a deferral benefit of $1,739,975 (assuming a 6% net return on the Qualified Opportunity Fund), a capital gains reduction benefit of $439,500 (maximized because she invested prior to December 31, 2019), and a capital gains exemption of $2,317,184 (assuming a 6% return on the Qualified Opportunity Fund). The sum total of her benefits is $4,496,659 on a $10,000,000 capital gain.

Mary began the diversification process with $11,000,000 in Amazon stock and a $2,930,000 capital gains tax liability. Thus, the net after-tax value of her Amazon position was $8,070,000 ($11,000,000 - $2,930,000). After investing $10,000,000 in a Qualified Opportunity Fund, her $11,000,000, assuming no return on the reinvestment of her $1,000,000 cost basis, will be $16,417,977 ($17,908,477 from the Qualified Opportunity Fund - $2,490,500 in capital gains taxes + $1,000,000 in original cost basis). To appreciate the magnitude of the Opportunity Zones program tax benefits, it is helpful to compare Mary's Qualified Opportunity Fund experience with a traditional strategy of selling stock, paying capital gains taxes, reinvesting in a diversified portfolio, and paying capital gains taxes again on the sale of the diversified portfolio.

For example, if Mary sold her $11,000,000 in Amazon and did not invest in a Qualified Opportunity Fund, she would pay a $2,939,000 capital gains tax on April 15, 2019. Excluding her cost basis of $1,000,000, Mary is left with $7,070,000 to reinvest in a diversified portfolio, instead of reinvesting $10,000,000 in a Qualified Opportunity Fund. This represents $2,930,000 ($10,000,000 - $7,070,000), or 29.3%, less investable capital for her diversified portfolio. If Mary generates a 6% net annualized return on her diversified portfolio, her $7,070,000 would grow to $12,661,293 over ten years. Unlike the capital gains on a Qualified Opportunity Fund, which are exempted from taxation, Mary pays capital gains taxes of $1,638,249 on the $5,591,293 of appreciation on her diversified portfolio. After paying the tax, Mary will have $12,023,044 which includes her original $1,000,000 cost basis.

Thus, by taking advantage of the trifecta of tax benefits offered by the Opportunity Zone program, Mary converts her $8,070,000 Amazon position ($11,000,000 - $2,930,000 tax liability) into $16,417,977 of after-tax dollars with no tax liability. The identical diversification strategy without the Opportunity Zone tax benefits produces only $12,023,044 (Figure 4). Thus, the tax benefits generate an additional 37%, or $4,394,933 for Mary. The trifecta of tax benefits are only powerful, of course, if the Qualified Opportunity Fund generates returns.

Figure 4

Sell Amazon and Invest in Diversified Portfolio	
Capital Gain	**$10,000,000**
Initial Capital Gains Tax	**-$2,930,000**
Initial Investment	**$7,070,000**
Payment of Deferred and Reduced Cap Gains Tax (2027)	**N/A**
Investment Gains (6% net return)	**$5,591,293**
Gross Proceeds at Liquidation	**$12,661,293**
Second Capital Gains Tax on Liquidation	**-$1,638,249**
Ending Capital (including original basis)	**$12,023,044**

Sell Amazon and Invest in Qualified Opportunity Fund	
Capital Gain	**$10,000,000**
Initial Capital Gains Tax	**-**
Initial Investment	**$10,000,000**
Payment of Deferred and Reduced Cap Gains Tax (2027)	**-$2,490,500**
Investment Gains (6% net return)	**$7,908,477**
Gross Proceeds at Liquidation	**$17,908,477**
Second Capital Gains Tax on Liquidation	**N/A**
Ending Capital (including original basis)	**$16,417,977**

As this example illustrates, the Opportunity Zones programs offers compelling incentives to sell a concentrated, low-cost basis stock position and reinvest the proceeds into a diversified real estate portfolio via a Qualified Opportunity Fund.

A Portfolio Management Tool

In addition to diversifying large single-stock positions, a Qualified Opportunity Fund can be used to reduce the portfolio concentration, or lumpiness, that develops because of disparate performance from various stock positions. Importantly, all capital gains, both long-term and short-term, are eligible for the Opportunity Zone tax benefits.

For example, over time, a diversified equity portfolio of twenty-five equally-sized stock positions that is not periodically rebalanced will likely develop significant position size disparity. The portfolio's top five positions could, with significant relative outperformance, come to represent over half of the portfolio's value. While this portfolio imbalance generally represents a high -class problem (as it is usually a function of owning top performing stocks), it is a problem nonetheless.

"The risk management benefits of creating a diversified portfolio diminish as performance variance produces greater concentration. "

The risk management benefits of creating a diversified portfolio diminish as performance variance produces greater concentration. At certain levels of portfolio concentration, the risk-return profile becomes inappropriate for the average investor. However, the same risk aversion biases and economic disincentives causing holders of large single-stock positions to "do nothing" afflicts owners of overly-concentrated stock portfolios as well. Consequently, portfolio overconcentration pervades portfolios throughout the nation and is a risk to wealth preservation.

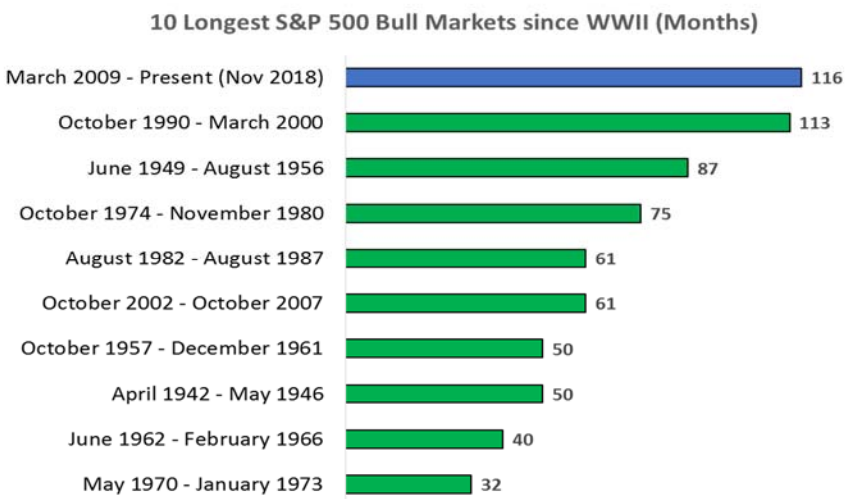
Investing in a Qualified Opportunity Fund provides tax benefits that are specifically designed to motivate investors, whether large or small, with gains to realize those gains and reinvest the capital. The U.S. government is constructively subsidizing portfolio diversification across asset classes (i.e. from equities into real estate). Portfolio managers may take advantage of the program to de-risk portfolios by reducing oversized stock positions and reinvesting the proceeds in a Qualified Opportunity Fund.

As an example, let's assume an investor starts with a \$10 million portfolio consisting of \$5 million in equities and \$5 million in bonds. Let's further assume that, after five years of equity market outperformance, the equities portfolio appreciates by \$2 million (while bonds remain flat) and five of the twenty-five equities positions grow to represent 40% of the equity portfolio. A prudent investor will reduce the five largest positions by fifty percent, or \$1.4 million, and reinvest the proceeds, assuming the proceeds represent capital gains, in a Qualified Opportunity Fund. The reallocated portfolio would look as follows: \$5.6 in equities, \$5 million in bonds, and \$1.4 million in real estate. Moreover, the equity portfolio will, after the reallocation, consist of relatively equally sized stock positions (Figure 5).

Figure 5

Given the expiration of the first stage of the Opportunity Zone tax incentive program on December 31, 2019, investors and portfolio managers should carefully examine the risk profile of their portfolios, and, where appropriate, use this short-lived tool to diversify and optimize their portfolios. Moreover, given that the U.S. equity bull market, which began on March 9, 2009, has become the longest bull market on record since World War II (Figure 6), investors' portfolios carry a historically high proportion of capital gains. Thus, serendipitously, from a probabilistic standpoint given where we are in the business cycle, it appears to be a wise time to harvest capital gains and enhance portfolio diversification with a Qualified Opportunity Fund.

Figure 6



Arguments Against Investing in a Qualified Opportunity Fund

As discussed earlier in this paper, inertia is the biggest obstacle to portfolio diversification, particularly when inertia has been richly rewarded. When presented with a Qualified Opportunity Fund investment, a subset of investors with large concentrated positions will remark that they have been advised to sell stock for the last five years by so-called investment experts. Some will concurrently calculate the increase in their wealth associated with rejecting diversification proposals. This outcome-driven analysis is backward-looking and inherently flawed. Nevertheless, it poses the most common, if not rationally persuasive, argument against diversifying into a Qualified Opportunity Fund.

The best argument against investing in a Qualified Opportunity Fund is a strongly bearish outlook for the real estate market. The tax benefit associated with the exemption of the gain on the Qualified Opportunity Fund after a ten-year holding period is extremely powerful. However, the value of the tax exemption depends on the return for the Qualified Opportunity Fund. If the Qualified Opportunity Fund fails to generate any capital gains, the tax exemption holds zero value.

Another reasonable argument against investing in a Qualified Opportunity Fund is illiquidity. Investors of large concentrated stock position can, with very few exceptions, sell the entirety of their stock positions in a single day and thus immediately convert the stock positions into cash. The Opportunity Zones program requires investment in real estate or start-up business ventures, which are considerably less liquid than equities. This illiquidity is compounded by the requirement to invest in a Qualified Opportunity Fund, which will generally offer little to no liquidity for ten years. There is a true economic cost, generally in the form of an opportunity cost, associated with illiquidity, and thus illiquid assets require a greater expected return relative to liquid assets. The Opportunity Zones tax benefits provide meaningful, and arguably excess, compensation for the greater illiquidity. However, the subset of investors constitutionally opposed to illiquid investments will likely not elect to invest in a Qualified Opportunity Fund.

Another argument against investing in a Qualified Opportunity Fund is an aversion to the program's newness. The Tax Cuts and Jobs Act of 2017, which was signed into law on December 22, 2017, established the Opportunity Zones program. The U.S. Treasury announced final round Opportunity Zone designations on June 14, 2018 and issued preliminary regulations on October 19, 2018. It was rational for investors to wait for the issuance of U.S. Treasury regulations before investing in a Qualified Opportunity Fund.

As the proverbial green light was provided by the U.S. Treasury relatively recently (October 19, 2018), there has been very little money raised into Qualified Opportunity Funds. Thus, the comfort level associated with pattern recognition is absent. Investors do not know other investors who have invested in Qualified Opportunity Funds. While U.S. Treasury Secretary Steven Mnuchin expects investors to deploy over $100 billion in Qualified Opportunity Funds[8], the program will likely retain its newness attribute even through December 31, 2019 (when certain tax benefits begin to decline). However, an aversion to newness is an emotional, rather than rational, argument against Qualified Opportunity Funds.

The final argument against investing in a Qualified Opportunity Fund revolves around uncertainty, specifically the few open questions that remain regarding the program's mechanics. While preliminary regulations issued on October 19, 2018 addressed most major issues, a few details still need to be clarified. The U.S. Treasury is expected to issue final regulations in the second quarter of 2019, which will address open questions.

Additional Issues to Consider

This paper provides a detailed description of tax benefits associated with investing in Opportunity Zones and outlines the significant potential benefits for holders of concentrated stock positions. However, because of the paper's limited scope, there are additional issues that investors should explore including, but not limited to, the investment expertise of the manager of the Qualified Opportunity Fund, timing considerations, state tax consequences, and tax filing mechanics.

Notes

[1]EIG estimates based on the Federal Reserve's Survey of Consumer Finances and Financial Accounts of the United States data (https://eig.org/news/opportunity-zones-tapping-6-trillion-market)

[2]Treasury Releases Proposed Regulations on Opportunity Zones Designed to Incentivize Investment in American Communities (https://home.treasury.gov/news/press-releases/sm530)

[3]Kahneman, D., & Tversky, A. (1979). Prospect Theory: An Analysis of Decision under Risk. Econometrica, (www.jstor.org/stable/1914185)

[4]"Berkshire Hathaway Inc. Form 10-Q For Quarterly Period Ended September 30, 2018" (https://www.sec.gov/Archives/edgar/data/1067983/000119312518317734/d636103d10q.htm)

[5]Coase, R. (1960). The Problem of Social Cost. The Journal of Law & Economics (www.jstor.org/stable/724810)

[6]Invesco and Chestnut Exchange Fund have both underperformed the benchmark over the last decade
(https://www.morningstar.com/funds/XNAS/ACEHX/quote.html)
(https://funds.eatonvance.com/includes/loadDocument.php?fn=29218.pdf&dt=%27fundpdfs%27)

[7]For this discussion, it is assumed that Mary files her taxes as Married Filing Jointly and has an annual taxable income of $1,000,000. Mary purchased Amazon stock during the financial crisis for $1,000,000 and sells it for $11,000,000 resulting in a $10,000,000 long-term capital gain. Thus, in the year of the Amazon stock sale, she would report taxable income of $$11,000,000 (her annual taxable income + the Amazon capital gain) resulting in an estimated cumulative tax rate of 29.30% on the capital gain. Regarding the 29.30% rate, the federal components are the current long term capital gains and net investment income tax rates of 20% and 3.8%, respectively, which would apply to this hypothetical taxpayer, given her income level. For illustration purposes only, based upon an approximation of the current range of state income tax regimes, Mary's state income tax rate is assumed to be 5.50%. For reference, the marginal or flat state tax rates on capital gains vary by tax filer and can range from zero to 13.30%. Mary's taxable income is assumed to be stable at $1,000,000 for illustration purposes. Different cities, states and municipalities have varying rates of taxation and benefits afforded from the Qualified Opportunity Zone program, which would reduce the tax savings presented herein from an investment in a Qualified Opportunity Fund, in some cases substantially. This example assumes that current rates of taxation apply in the future; there can be no guarantee that current rates of taxation are not reduced in the future, thus reducing the illustrative tax savings. Investors should note that taxes under the Opportunity Zone Program shall become due with an investor's 2026 tax return, which date shall be prior to the expiration of the 10 year hold required for an investor to remain in a QOF and receive the full tax benefits from the investment. Therefore, the QOF investment may not be used as a source of liquidity for the 2026 tax liability.

[8]Treasury Releases Proposed Regulations on Opportunity Zones Designed to Incentivize Investment in American Communities (https://home.treasury.gov/news/press-releases/sm530)

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- loss of all or a substantial portion of investment;
- lack of liquidity;
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