# STOCK CONCENTRATIONS

## *Too Much of a Good Thing?*

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The bull market over the last 25 years has presented a potential problem for many investors. What if the vast bulk of their gains derive from a sizable concentration in one or two investments, acquired at a fraction of today's market value, perhaps through a shrewd investment made years ago, through executive compensation or through the tax-free sale of a closely held business in exchange for stock in a public company? On the one hand, sitting on such a highly concentrated portfolio is very risky. On the other hand, the stock could go on to post stellar returns. And of course, if the stock is sold, the transaction will generate a tax bill. How should investors evaluate these trade-offs? They can choose a prudent course of action appropriate to their circumstances, aided by a cool look at the facts.

**Stars Fade**

The first fact is that the concentrated portfolio is even riskier than most think. While single stocks can do extraordinarily well if they "win", chances are they will underperform. Even great companies may not always be great investments. And in some cases, betting on a single stock can be disastrous. Companies that appear solid but have gone bankrupt can be hazardous to one's *wealth*, especially if there is an emotional attachment to the company. And of course, no matter how high a stock climbs initially, a 100% decline always leaves you with nothing.

**Odds Are Against The Average Stock**

But you don't have to focus on "stars" or extreme cases to appreciate the virtue of diversification. Because the second fact is that volatility erodes any stock's compounding rate—the true measure of wealth accumulation. The dynamic is illustrated at Table 1, which traces the performance of three different stocks over two years. Even though Stock "A" has the highest average return, it grows the slowest because it moves up and down the most. Conversely, Stock "C," with the lowest average return, grows the fastest because it has a much steadier rise.

**Table 1**
**Growth of $100**

| | Year 1 Return | Year 2 Return | Arithmetic Average | Ending Value |
|---|---|---|---|---|
| **Stock A** | 45% | (20%) | 12.5% | $116 |
| **Stock B** | (12%) | 35% | 11.5% | $119 |
| **Stock C** | 10% | 10% | 10.0% | $121 |

Since even a "typical" stock - stock with an average arithmetic return close to the market's - misses out on the smoothing effect of diversification, it's likely to underperform the market as a whole. Furthermore, this heightened volatility is exacerbated when the investment environment is more difficult than usual. The longer the bad patch, the more poorly the average stock is likely to perform relative to the market. In other words, diversification is prudent insurance against the extreme unpredictability of any one stock.

**Longer Time Horizon Favors Selling**

The presumption, of course, is that investors will be able to recoup the tax costs they'll incur in diversifying. Their success is primarily a function of their time horizons: The longer until they expect to pass the stock on to heirs with a step-up in basis, the greater the chance a diversified portfolio will justify paying the capital-gains tax up front. The more limited the horizon, the less attractive selling becomes.

With a short time frame, it may be better not to sell. The more time is on your side; however, the less incremental return is needed to make divestment worthwhile. For investors with at least a 20-year horizon (which includes most people in their 60s or younger) selling most of a concentrated position up front is recommended.

**How Much Should Be Sold?**

Even for investors with long time horizons, holding or selling is rarely an all-or-nothing proposition. As a general rule, the longer the time horizon, the more of the concentrated position should be divested at the outset. But "optimal solutions" reflect not facts but forecasts and trade-offs, based on each investor's asset allocation, embedded tax liability, and risk tolerance. And every solution entails giving up some good things in exchange for others.

**Suppose the Investor Doesn't Want to Sell?**

So, suppose selling isn’t an option. For most investors, it’s often a mistake to hold a highly concentrated portfolio. But there are alternatives to selling that can make sense, especially over short time horizons. Using options-based hedging strategies can work in the investor’s favor, but can be costly. Other tactics using different types of accounts such as limited partnerships, charitable remainder trusts (CRTs), and other tax-advantaged vehicles for divesting appreciated stock can also be used. Of course, whether its illiquidity, higher fees, or lack of control of the investment, there is always a price to pay and so this strategy may not be the best alternative.

In summary, diversification strategies are complex and full of uncertainties. But the fact remains that for most investors; it's unwise to concentrate wealth in a few large investments – or in employee options in one stock – where additional complications require rigorous analysis. Deciding how to fix the problem, with one or a variety of approaches, is an area where tax, legal, and investment advisors can work together efficaciously in the investor's best interest.