The Hidden Cost of Holding a Concentrated Position

Why diversification can help to protect wealth

By Baird's Private Wealth Management Research

Executive Summary

Family wealth created by holding a single stock that appreciates substantially in value over time is fairly common. For example, senior company executives receive stock or stock options as part of their compensation, investors benefit from superior appreciation of one stock relative to the rest of their portfolio or family members inherit a large position in a single stock. Regardless of how the concentrated position is acquired, it results in a disproportionate allocation of wealth, which exposes the family to undue risk that should be understood and managed.

Whether investors understand the risks of holding a concentrated position or not, there is a tendency to hold onto these positions. Corporate executives may face insider selling constraints or concerns about how a sale would affect the market price of their company's stock. Other investors simply have an emotional attachment to the stock. Many investors are concerned about the tax implications of selling.

Despite these seemingly valid reasons, there is a critical point for most investors and families where the desire for wealth, income and lifestyle preservation outweighs the need for further wealth creation. This is especially true when investors approach retirement or life events during which they will more heavily rely on their accumulated wealth.

The goals of this paper are to educate investors about the hidden risks associated with holding significant wealth in concentrated positions and to suggest strategies to help mitigate and manage those risks.

Defining a Concentrated Position

A concentrated position occurs when an investor owns shares of a stock (or other security type) that represent a large percentage of his or her overall portfolio. The investor's wealth becomes concentrated in the single position. Depending on the volatility of the stock and the size of the client's portfolio, a position is often considered to be concentrated when it represents 10% or more of one's portfolio.

The Risk/Reward Implications of a Concentrated Position

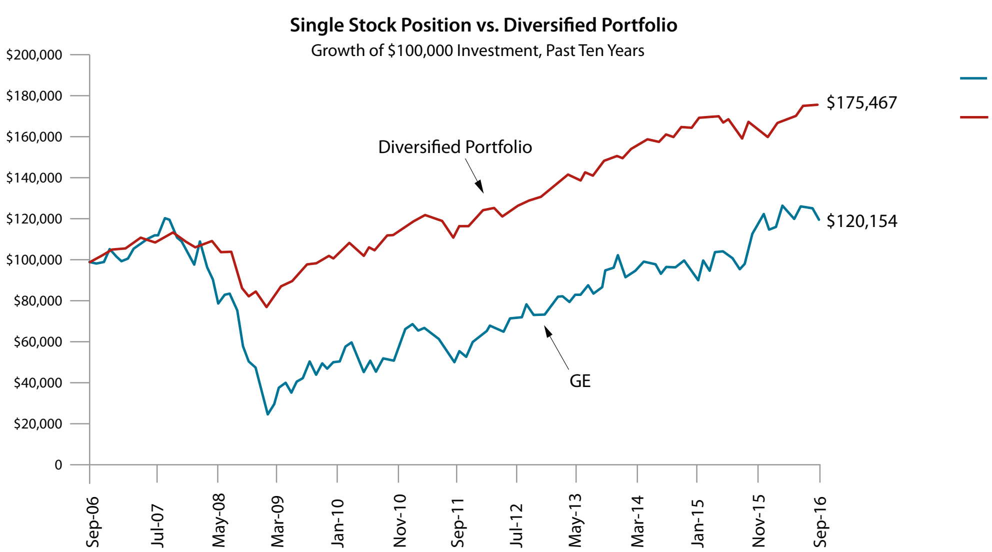
Investors who have benefited from holding a concentrated position often believe that past performance will continue indefinitely, and may find it difficult to imagine a downside. While it's tempting to believe a stock's market outperformance will continue, studies show that investments in a diversified portfolio can produce greater long-term wealth than investments in a concentrated position, with significantly less risk.

In order to better understand the risk/reward trade-off of holding a concentrated stock position, Baird constructed a hypothetical diversified portfolio consisting of 60% equities and 40% fixed income and compared it with the 309 individual stocks that remained consistently in the S&P 500 Index for the 10-year period of September 30, 2006, to September 30, 2016.

The results of this study showed that over one-third of the individual stocks underperformed our 60/40 diversified portfolio, and that all of the individual stocks showed much higher volatility. The average stock's volatility was more than three times that of the diversified portfolio. There is no perfect way to know which stocks will be the winners over the long term, and the cost for being wrong can be high. For example, the return of 55 stocks failed to keep pace with inflation over the period, and 37 of the 309 stocks had a negative return for the decade.

A good example is General Electric. The chart below compares the performance of General Electric's stock to the diversified portfolio over this 10-year period. GE experienced a 1.9% annual rate with 28.9% volatility, while the diversified portfolio generated a positive annual return of 5.8% with much less

Concentrated Equity Position: "What If" Analysis



	GE	Diversified Portfolio	
10-Year Annualized Return	1.9%	5.8%	Higher Return
10-Year Annual Volatility	28.9%	9.2%	Less Volatility

Diversified Portfolio (total=100%)

Equity	
Large-Cap Value	14.0%
Large-Cap Growth	12.0%
Mid-Cap	8.0%
Small-Cap	4.0%
International	14.0%
Taxable Fixed Income	40.0%
Satellite	8.0%

Source: FactSet Research Systems; Baird analysis.

The following indices are used to represent the diversified portfolio: Large-Cap Growth: Russell 1000® Growth Index; Large-Cap Value: Russell 1000® Value Index; Mid-Cap: Russell Midcap® Index; Small-Cap: Russell 2000® Index; International: MSCI EAFE; Taxable Fixed Income: Barclays Capital Intermediate US Govt/Credit Index; Satellite: MSCI Emerging Markets Index, Barclays Capital US Corporate High Yield Bond Index, DJ UBS Commodity Index, DJ US Select REIT Index. Russell® is a trademark of the Frank Russell Company. Indices are unmanaged and a direct investment can not be made into an index. The analysis was performed by Baird's Private Wealth Management Research department.

volatility (9.2%). Importantly, this is not an isolated case. Baird has calculated similar results for dozens of companies, including US Bank, Cisco Systems, Exxon Mobil and FedEx. In many of the "what-if" analyses we conducted, the diversified portfolio outperformed the single stock position, and in all cases the diversified portfolio had lower volatility.

So why does a diversified portfolio often outperform a single stock position? The answer lies in the lower volatility. As our study and others like it have indicated, greater volatility in a portfolio reduces compounded growth rates and future wealth. The example in the tables below illustrates this point through two hypothetical investments that generate the same average annual return of 10%, but with varying levels of volatility. In Table A, Investment I averages a 10% return but is the more volatile investment, increasing 50% one year and decreasing 30% the next. Investment II also averages a 10% return; however, it is less volatile, up 15% and 5% in the two years, respectively.

TABLE A:

Averages Can Be Misleading

Investment	Year 1	Year 2	Average	Volatility
I	50%	-30%	10%	40%
II	15%	5%	10%	5%

TABLE B:

Why Volatility Matters

Investment	Original Investment	Year 1	Year 2	Compounded Growth Rate
I	$1,000,000	$1,500,000	$1,050,000	2.50%
II	$1,000,000	$1,150,000	$1,207,500	9.90%

As Table B shows, Investment II, the less volatile of the investments, generates a much higher compounded growth rate of 9.9%, compared with 2.5% for Investment I. As a result, a $1,000,000 investment in Investment II grows to $1,207,500 in two years. That's over $150,000 more than Investment I simply because of the investment's lower volatility. In summary, the more an investment's return fluctuates year by year (i.e., the higher the volatility), the greater the drag on the compounded growth rate and the lower the future wealth. Thus, controlling volatility and risk through proper diversification does matter in portfolio management.

While investors may be tempted to hold a concentrated stock position in the hope of greater profit, they may fail to understand that they are not being compensated for taking this risk. In theory, stocks are riskier investments that should provide higher returns than less risky investments like Treasury securities.

However, the risk/reward premium turns against the investor when too few stocks are owned, and especially when the investor holds a single or large, dominant position. Returns become too reliant on the fortunes of one company (exposing the investor to significant company-specific fundamental risks) and to a single industry (exposing the investor to sector-specific risks). As a result, it is clear that investors should choose to diversify a concentrated stock position whenever possible.

Today's Capital Gains Rate Environment

It's widely agreed that tax considerations, while important, should not be the only reason for making an investment decision. The investment merits of owning the stock should supersede the tax considerations of selling. Nevertheless, investors who currently own a large stock position should consider the impact of capital gains tax rates when contemplating a sale.

While higher than they were in the early 2000s, long-term capital gains rates are still at or near historical lows for most taxpayers. Those paying the top federal (and possibly state) capital gains rates may want to be more diligent in managing their tax liability. A qualified tax advisor may be able to offer strategies that reduce, or in some cases eliminate, the tax impact of the sale with certain tax-planning techniques.

If a taxpayer's capital gains rate is expected to rise in the future, either due to higher income or anticipated tax law changes, a greater tax burden could exist for those who sell large concentrated positions. Under this scenario, investors should be aware that they will likely need more time in the future to recoup the tax expense of the sale – all else being equal, suggesting a sale sooner rather than later.

Why Are Some Investors Reluctant to Sell?

Despite this compelling argument, we have found many investors are reluctant to sell concentrated positions. A few of the most common reasons investors don't sell are summarized in Table C below. Although many of these reasons are valid in the eyes of the investor, the logic supporting diversification is compelling. We will now turn to some ways an investor can successfully diversify and minimize the risk of a concentrated position.

The True Tax Consequences of Selling

One of the biggest objections to selling a large appreciated stock position is the need to pay income tax on the gain. With a cost basis that can be as low as zero, the tax implications in dollar terms of a sale can seem significant. However, we have already shown how a diversified portfolio can build greater wealth with less risk than a single-stock position. In the study referenced, even in a decade when the S&P 500 was up 5.3%, 25 stocks were down 20% or more in value at the end of 10 years – roughly equivalent to a payment of 15%

TABLE C:

Why Investors Don't Sell

The Rationale for Holding	The Logic of Diversifying
They want to avoid a "certain loss" due to the tax consequences of selling.	This is perhaps the most prevalent of all reasons to hold, yet often, over longer time horizons, an investor can recoup the tax cost and continue to build wealth with a lower risk portfolio.
They assume the future will be like the past.	Even if the stock has been successful in the past, no one can predict the future.
They are overconfident in the stock's prospects (especially if it is their employer).	There is a misperception that can occur when an investor works for a company and has been very successful there. Again, no one can predict the future.
They are lured by the possibility of a big win and feel their stock is immune from a significant downfall.	While one may view situations like Enron and WorldCom–where stocks totally collapsed–as isolated events, owners of these equities never anticipated what happened to them.
They fear they will regret selling the stock if the price continues to rise.	By focusing on the long-term potential and lower risk of the new, diversified portfolio, an investor can overcome these regrets.
They cannot bring themselves to sell the stock at a price below its former high. They are waiting for the stock to "come back."	The stock may never reach those levels again; it's better to put the money to work in a more prudent, diversified strategy.
They feel loyal to a stock they inherited from a trusted family member.	In fact, diversifying that position may be a wiser way to maintain that legacy.
They are legally restricted from selling.	Even when selling the stock outright is not an option, there can be other alternatives. For more information see sidebar, "Solutions for Restricted Stock Holders."

Solutions for Restricted Stock Holders

In some cases, corporate insiders may be prevented from selling due to regulatory constraints, such as prohibition from selling during blackout periods or when in possession of material nonpublic information. The Securities and Exchange Commission (SEC), recognizing that corporate insiders were greatly restricted by these rules, created a preplanned sell program under Rule 10b5-1. By adhering to strict SEC guidelines, insiders entering into 10b5-1 programs are allowed to execute pre-programmed sales when they would not otherwise be allowed to do so. In all cases, owners of stock they cannot readily sell should take a careful look at how the stock position fits into their overall portfolio strategy, and make sure they diversify around the position. For example, if an executive has 10% of his portfolio in company stock, the remaining 90% can be invested in a way that helps counterbalance the additional risk of that position – perhaps with more low-risk securities like Treasury bills. The goal is to minimize the portfolio's overall volatility level in order to preserve as much wealth as possible. In these cases, a personal Investment Policy Statement can also be a valuable tool in defining risk parameters and establishing investment guidelines.

federal and 5% state long-term capital gains. Hypothetically, had an investor sold a position in one of those names at the beginning of the decade and lost 20% to long-term capital gains taxes, they would have been no worse off had they placed the proceeds under a mattress for the 10 years, and would have been considerably better off had they invested the proceeds in a diversified portfolio despite the significant up-front tax bill.

The longer an investor's time horizon, the more likely he or she will be able to recoup the entire tax cost. Much depends on the size of the tax bill, which in turn is a function of capital gains tax rates. Investors should keep in mind that current long-term capital gains tax rates are still at or near their historical lows for most taxpayers. (See sidebar, "Today's Capital Gains Rate Environment" on page 4.)

Some of the factors to consider when deciding whether to sell include age and health, current portfolio assets and how well these assets are diversified, cash flow requirements, and expected portfolio contributions and withdrawals. The optimal sale amount increases with longer time horizons, lower risk tolerances, greater volatility in that single stock, lower tax costs and higher lifestyle spending needs.

Selling and Diversifying

Diversifying a concentrated position doesn't mean making a minor adjustment to the portfolio. After all, the goal is to significantly reduce the volatility caused by a concentrated position, so the diversification will need to be meaningful. Selling a portion (i.e., partial sale) of a concentrated position is better than doing nothing. However, investors must remember the end goal of reducing volatility and risk to their wealth, which will often require a significant, if not total, reduction of the concentrated position.

Determining how much, if any, to continue holding requires a thoughtful, unbiased review of the investment prospects for the stock. It may be that the best approach for a portfolio is a complete liquidation – and given the potential influence of emotion, a trusted outside advisor may need to assist an investor in making this decision.

If the investor is not restricted from selling, the fastest way to reduce the volatility and risk in the portfolio is to execute the sale in one transaction and reinvest the proceeds to create a balanced portfolio. This is a good way to bring the risk level of the portfolio down quickly and efficiently. However, for a variety of reasons, this isn't always feasible, so a staged sale may need to be considered.

Staged Sales

Selling a large position at one time can sometimes lead to downward pressure on the stock price, further reducing the portfolio's value. At other times, it may be too difficult emotionally for the investor to sell in one large transaction. In these cases, a staged sale may be most appropriate. In a staged sale, the investor sets a goal of selling a certain number of shares of the stock by a certain date. For example, the investor wishes to sell 12,000 shares of the stock over the

Special Considerations for Stock Options

Quite often, investors mentally account for stock options differently than stocks. In reality, stock options are equity holdings and can constitute a concentrated position. However, they present special considerations that require additional planning.

There are unique tax consequences to exercising both incentive stock options (ISOs) and non-qualified stock options (NQSOs). One of the greatest is a tax trap that can occur when ISOs are exercised. When the stock is exercised, no regular tax is due, but the taxpayer may have to pay AMT. However, the stock cannot be sold for at least one year to achieve this usually favorable tax treatment. Later, if the stock is sold for a gain, things are good. However, if the stock suffers a large decline in value before it is sold, the previously determined AMT liability is still due even though the stock is worth much less then it was when the ISO was exercised. The taxpayer ends up paying tax on the previously much higher value, even though the stock is not worth that amount today. Sometimes, this is referred to as paying tax on "phantom income." The more volatile the stock price, the greater the possibility an investor might get caught in this trap.

As a result, advance planning is crucial. Investors should consult their investment and tax advisors before taking action to diversify a concentrated stock option position.

next 18 months. The investor is willing to sell shares every quarter, meaning there will be six sales during this period. At the end of each quarter, the investor then would commit to selling 2,000 shares. By making this commitment, the investor has set the schedule and won't be swayed by emotion, market fluctuations or other events that otherwise might keep him or her from selling. The emotion has been removed from the transactions with a set plan, agreed to by all involved, that every three months 2,000 shares will be liquidated.

In some cases, executives may be prevented from selling at certain times because they possess insider information such as knowledge of corporate strategy, earnings reports or other non-public information. Timing sales between these events (known as "open window" periods) can be difficult and leaves insiders open to regulatory scrutiny. In this circumstance, staged selling through a 10b5-1 plan is one solution. These plans specify how much and when a stock will be sold. The sales are executed automatically, with no further investor involvement.

As a result, open window periods are not an issue and regulatory oversight is greatly reduced. These arrangements are binding and will often require the approval of the company, so they're not for everyone, but they can be a valuable strategy. (See "Solutions for Restricted Stock Holders" on page 5.)

Other Ways to Diversify

For stock owners unable to divest, there are several alternatives that may be appropriate:

- **Exchange funds** allow qualified investors to exchange a concentrated position for a more broadly diversified portfolio of stocks without incurring an immediate tax liability. Essentially, investors contribute their appreciated stock to a limited partnership in exchange for an interest in a diversified portfolio. After a period of time, generally seven years, the investor can withdraw a pro rata share of the portfolio. Exchange funds may have limited liquidity, defer rather than eliminate capital gains and be costly, but they can help work toward a more diversified portfolio.
- **Charitable Remainder Trusts (CRTs)** help further an investor's philanthropic goals while providing an immediate tax deduction. The investor transfers the appreciated stock to the trust, and in return receives an annual income stream from the trust. The trust can diversify the portfolio, but any taxes on the gain are deferred until the income stream is passed to the donor. At the trust's termination, the remaining assets pass to a charity the investor chooses. The investor cannot reverse the transfer once it's done. And, the income stream will not generate as much wealth as selling the stock and keeping the proceeds. Therefore, the CRT may be most appropriate for an investor with charitable intentions.
- **Hedging alternatives** are most often used by individuals who are restricted from selling their shares, or whose short time horizon makes selling an unattractive option. A common hedging technique involves the use of "collars" or collar-like

strategies. Hedging strategies are complex and can have tax implications for the investor. Therefore, we encourage clients to work carefully with their investment and tax advisors to evaluate how these strategies fit in the context of their overall wealth management plans.

When *Not* to Sell

Selling usually doesn't make sense for those investors who expect to bequeath their assets in the near term. Upon an investor's death, the heirs (including the spouse, children and others) may be entitled to step-up the cost basis of the stock, meaning they could sell and owe little or no capital gains taxes. In this case, hedging the position may be a better alternative. (See "Other Ways to Diversify" on page 6.)

It's All About Protecting the Wealth

A large stock position acquired through years of executive compensation, superior price appreciation or an inheritance can produce significant family wealth. At the same time, that wealth may become dangerously concentrated, presenting considerable risks.

As we have discussed throughout this paper, there are several thoughtful approaches investors can consider to reduce their concentrated position and diversify their portfolio. We encourage any client who holds concentrated positions to speak with an advisor about the available options. Families with concentrated positions should set and execute a professionally prepared plan to help retain and protect their family's future wealth.

Diversification does not assure a profit or protect against loss.

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