MANAGING CONCENTRATED STOCK RISK

One of the largest risks in a portfolio is having a significant percentage of capital allocated to one holding. It may seem obvious, and usually the reason behind the concentration of a position in a portfolio is strong long-term returns. An asset that has grown considerably over time can become a disproportionate amount of either an individual's wealth or investment portfolio.

The most common example of a highly concentrated position is owning a substantial number of shares in a single stock. By continuing to hold this position and refusing to diversify, there is a greater risk of not only additional volatility, but also the threat of not meeting the long-term return objectives of the portfolio.

Therefore, it is important to find ways to minimize a concentrated portfolio position over time, while understanding the potential pitfalls that may come with each approach.

Methods to reduce concentrations include:

1. Tax-Managed Separate Account – An investor could transfer the concentrated position and other portfolio securities to the manager of a separate account, who then reduces the concentration over time within a specific budget of annual realized gains, as directed by the owner of the assets.

The manager would also realize losses in other portfolio holdings to help offset the gains in the concentrated position. The proceeds from partial sales in the concentrated position and other securities sold at a loss would provide the capital to diversify the holdings and reduce portfolio risk. The longer it takes to reduce the concentration, pay capital gains taxes, and diversify the overall portfolio, the greater the risk of large portfolio losses.

2. Prepaid Variable Forward – A prepaid variable forward is an agreement to sell a variable number of shares at a specified future date in exchange for a cash payment, which is typically 75% and 90% of the stock's current market value, as noted in the article "Variable Prepaid Forward Contract," by the Corporate Finance Institute.

This strategy is commonly used when trying to receive the necessary liquidity from a concentrated stock position without having to deal with the immediate tax implications of selling the actual stock. However, the tax treatment of this transaction is still quite uncertain, and it may breach regulatory rules, such as the stock lending provision noted in the article "Prepaid Variable Forwards: Hedging Risk and Deferring Taxes," by the CFA Institute.

3. Exchange Fund - With an exchange fund, an investor contributes shares of the concentrated stock into a diversified fund without having to sell the position. In addition to increased diversification, an investor does not have to pay capital gains taxes when contributing the security to the fund. Exchange funds are offered as private placements with certain net-worth requirements. Also, some stocks may not be eligible for an exchange fund, and the liquidity of an exchange fund is low.

4. Gifts to Charities – An additional way to reduce a concentrated personal investment is to donate a portion of the stock to a charitable organization or charitable trust, such as a Charitable Remainder Trust. Donating stock to charities provides the opportunity for a tax deduction based on an individual's adjusted gross income, and the charitable entity would not pay capital gains taxes on the sale. The donor relinquishes all control of the shares donated.

5. Gifting to Family Members - The annual gift exclusion rule allows individuals to gift up to a predefined maximum value (up to $15,000 in value in 2021) per beneficiary, free of any gift tax. While the cost basis in the stock carries over to the beneficiary, he or she also receives the potential benefits of future income and appreciation. Gifts of securities to an individual in excess of the exclusion in a single calendar year may trigger gift taxes and potentially generation-skipping transfer taxes, however.

6. Annual Realizations – The most seamless route to reducing the risk of a concentrated position is simply to liquidate a portion of the stock and use the proceeds to invest in other areas of the portfolio. However, selling the concentrated position could result in significant capital gains taxes due to the low cost basis of the security. In this scenario, it may make sense to create an annual capital gains or tax budget for this position to determine how much of the stock should be sold on a yearly basis. A long-term approach to reducing a position can expose the investor to significant risk.

While a concentrated stock position may build substantial wealth through compounding gains over time, it can also inflict significant damage on a person's portfolio and net worth. Stocks of seemingly invincible companies can fall substantially in value or become worthless in bankruptcy.

Companies whose shares have become worthless (or nearly so) include Pacific Gas & Electric (2019), Theranos (2018), Chrysler (2009), Washington Mutual (2008), and Arthur Andersen (2002). Implementing one, or more commonly a combination of the aforementioned strategies, can help to diminish risks, in ways that not only provide diversification, but also liquidity and reduced tax impacts. As always, Innovest advises that you consult with both your tax advisor and investment advisor on the strategies appropriate for your particular situation while continuing to meet your long-term objectives.

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Sloan is a Principal & Director at Innovest and member of the Investment Committee, which drives the firm's investment related research and due diligence. He serves as a consultant working primarily with institutions and families. He is the Director of the Due Diligence Group, responsible for independently sourcing investment managers, as well as monitoring recommended products and strategies.