Managing the risks and rewards of concentrated stock positions

Many wealthy individuals made their fortunes by concentrating investments in a single company, especially in recent years. In fact, concentration can be an effective tool in wealth creation. However, it can endanger wealth preservation.

Owning a concentrated stock position presents significant single-stock risk. Investors typically recognize this risk, but find that reducing it is not always easy. Stock owners often face barriers – both psychological and monetary – that impede their ability to take action. Fortunately, there are several techniques available to help owners manage this challenge. While reducing single-stock risk can be complex, several solutions are available to help investors preserve their portfolios for the long-term.

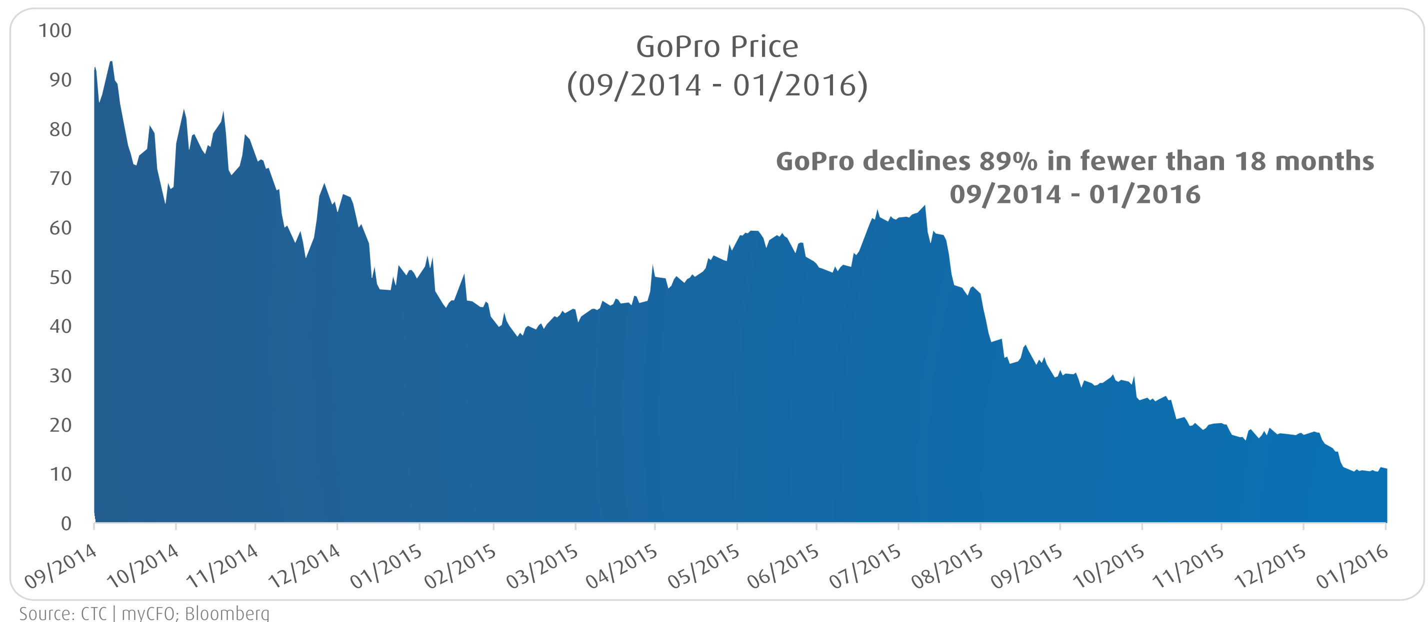
Reducing Single-Stock Risk: Easier Said Than Done

When owning a concentrated holding, the primary risk is a major, permanent loss of capital. But offsetting this risk is complex, due to issues ranging from the psychological challenge of selling a "winner" and potential family connections to a company, to potential regulatory constraints and the ever present tax consequences.

Fear of missing future appreciation: Behavioral finance experts have identified the fear of regret as a strong impulse among investors – even stronger than the satisfaction of making a profitable investment. This psychological bias may help explain why many investors put off selling concentrated positions, which requires forfeiting the opportunity to benefit from future appreciation, despite compelling reasons to diversify their holdings.

Negative market impact: For low volume traded stocks, the sale of a large position could put downward pressure on the price of the stock, thus reducing the value of the seller's proceeds.

Psychological Stress: Often, an investor's loyalty to the company may make it difficult to part with a stock that has generated significant wealth for the investor. This attachment is particularly strong when the investor founded or helped build the company.



Source: CTC | myCFO; Bloomberg

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Children and grandchildren may feel it would be inconsistent with the family legacy to divest stock of a company that is so closely tied to the family's identity.

Public perception: Officers and directors of public companies and anyone owning more than 10% of a public company's stock are required to report their holdings and transactions involving the stocks. When senior executives announce plans to sell their shares in a company, the stock market may perceive this as a bearish signal for the company's prospects, and the stock price may drop.

SEC restrictions: The Securities and Exchange Commission places significant restrictions on the sale of securities owned by corporate insiders, such as senior executives and directors, as well as those who may have received securities in a transaction that did not involve a public offering. Although there are numerous restrictions on the sale of these "Restricted" and "Control" securities, there are exemptions that permit these securities to be sold under certain circumstances (Rules 144/145).

Investing in what you know: Many corporate executives hold onto large positions of company stock because they feel comfortable investing in a company and industry they know intimately. Outside investors may feel similarly, having gained extensive knowledge of the firm's management and business model through years of owning the stock. That said, regardless of how well an investor understands the company, unpredictable macroeconomic events beyond the company's control can negatively impact the stock price.

Taxes: Selling a large position of highly appreciated stock creates a significant tax liability. Given the current 20% tax rate on long-term gains and 3.8% net investment income tax, selling $11 million of stock that was acquired for $1 million could result in a federal tax bill of $2.6 million.

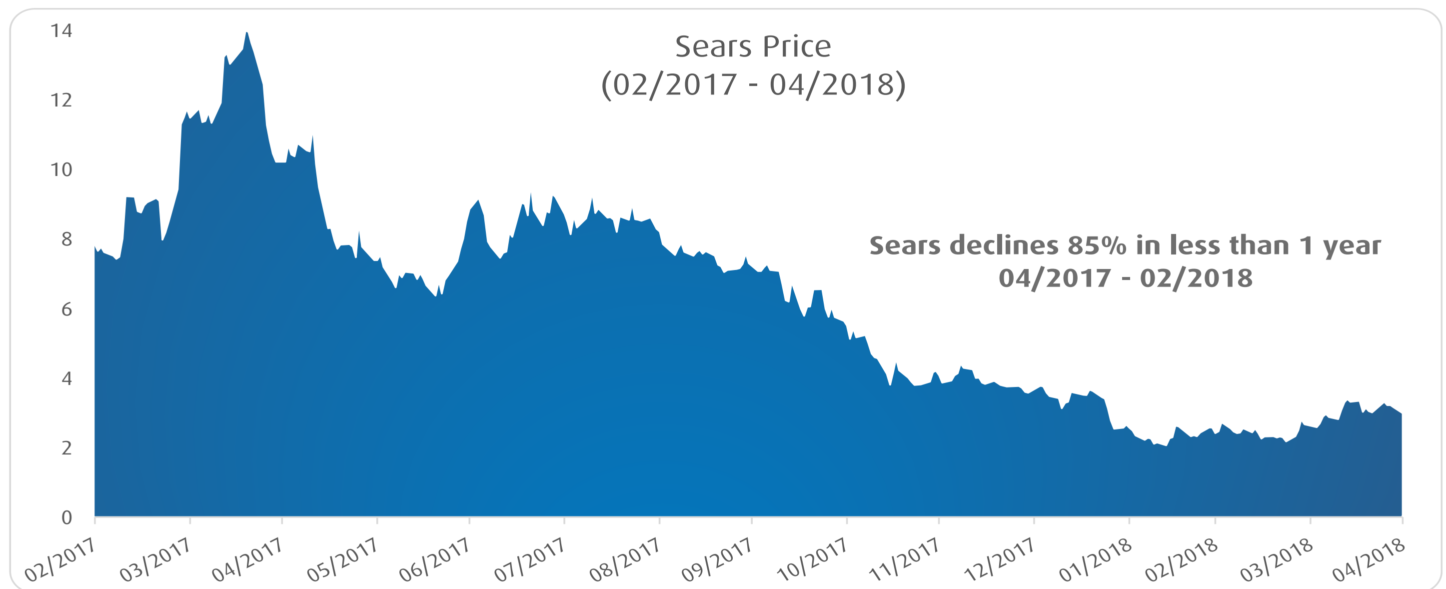
Concentrated Stock Solutions

Investors seeking to diversify single-stock risk have options available to them. We can help with concentrated stock positions using one or a combination of these solutions.

Sell immediately: The most straightforward solution to eliminate single-stock risk is to liquidate the position and reinvest the proceeds into a diversified portfolio. Doing so would immediately protect the investor from the downside risk of the individual stock but could limit growth potential. Selling the entire position frequently results in a large tax bill that may create cash flow problems. With tax rates on long-term capital gains at 23.8% currently (20% capital gains + 3.8% net investment income tax), but having been both higher and lower in the past, future tax rates should be a major factor in deciding when to sell highly appreciated stock.

Staged selling: Selling a large block of stock through a staged process allows investors to gradually convert a concentrated equity position into a diversified portfolio. This strategy lets the investor temporarily retain some of the upside potential while achieving some diversification. In addition, if staged selling occurs over several years, it spreads the capital gains liability across multiple tax years. As discussed above, this could also be a drawback or benefit depending on changes in tax rates.

Staged selling is often the most viable option for corporate insiders, who face significant SEC restrictions on the sale of company stock. Rule 10b5-1 trading plans allow officers and directors of public



Source: CTC | myCFO; Bloomberg

Advantages of Donating Low Basis Stock to Charity*							
		Example: cash gift (value $1,000,000)		Example: sell appreciated shares and donate the proceeds (value $1,000,000 / cost basis $0)		Example: gift of appreciated shares (value $1,000,000 / cost basis $0)	
Charitable gift	$	(1,000,000)	$	(762,000)	$	(1,000,000)	
				proceeds after paying capital gains & medicare tax			
Embedded capital gains tax liability	$	-	$	(200,000)	$	200,000	*avoided*
Medicare tax on unearned income	$	-	$	(38,000)	$	38,000	*avoided*
Income tax deduction	$	370,000	$	281,940	$	370,000	
Net cost to donor of gift	$	(630,000)	$	(718,060)	$	(392,000)	
						Anticipated federal tax rates	
Income tax						37.00%	
Capital gains tax						20.00%	
Medicare tax on unearned income						3.80%	

For illustrative purposes only; this information is not intended to serve as tax advice. For any questions regarding your unique tax situation, please consult a qualified tax professional.

companies to sell company stock according to predetermined schedules, which are created during periods when no material, nonpublic information is available to the insider. When executed properly, 10b5-1 plans provide corporate insiders flexibility and an affirmative defense against insider-trading allegations.

Portfolio Construction: To mitigate the risk of concentration, we can customize an investor's portfolio construction. For example, when there is a concentrated stock position, we can prevent additional investment in that company. If the stock correlates highly with its industry (e.g. pharmaceuticals, semiconductors) or its geography/market cap segment (e.g. U.S. large cap stocks), we can take this a step further and avoid stocks or strategies that invest heavily in that industry or segment. We might also consider adjusting weighting to non-correlated asset classes to help reduce overall risk. The degree to which adjustments are made to the portfolio construction should be commensurate with the concentrated stock's volatility, the percentage of stock concentration relative to the investor's overall portfolio and/or personal net worth, and the degree of correlation between the stock and its industry geography/market cap segment.

Hedging: For investors who are either unable or unwilling to sell the concentrated position, hedging can be an effective risk-management tool. Hedging choices include: protective puts, covered calls, zero-premium collars, prepaid variable forward sales, and monetizing hedging positions – for those with protective put or zero-premium collars. A portfolio-level hedge, such as a structured note, is another risk-reduction tool to consider. Another option is to borrow, using the concentrated stock as collateral, and use these proceeds to invest in a diversified portfolio. An experienced investment advisor can assist you with exploring effective hedging strategies and an experienced banker can help you consider a leveraged hedging strategy.

Exchange funds: for qualified investors, an exchange fund provides a way to achieve diversification while deferring capital gains taxes. Individuals contribute shares of highly appreciated securities in exchange for interests in a limited partnership made up of investors who have contributed shares of other companies. Investors must keep their share of the diversified portfolio for a predetermined number of years. Exchange funds can charge relatively high fees.

Charitable and wealth transfer planning: Charitable and wealth-transfer strategies may mitigate a stockholder's capital gains tax impact as well as reduce concentration risk and allow for a charitable deduction (see illustration). Giving appreciated stock provides for leveraged charitable giving in contrast to cash contributions.* In the illustration, we compare giving $1 million of zero basis stock versus $1 million cash to charity. The example shows the potential benefit of giving stock to charity by eliminating the embedded capital gains and medicare tax cost otherwise owed upon sale of the stock. The combination of capital gains tax savings and medicare savings, in addition to the tax savings from the charitable deduction, would mean the stock gift has an out of pocket cost of only $392,000. In comparison, the $1 million cash gift represents an out of pocket cost of $630,000 (cost of the donation less the income tax deduction). The gift of stock in this illustration would provide an out of pocket cost savings of $238,000 compared to a cash gift. The direct donation of stock is especially advantageous when compared to selling the stock and donating the proceeds, which is the least favorable option.

Conclusion

Whether the stock is received through executive compensation, inheritance, or opportune investing, large positions of individual securities have created tremendous wealth for countless investors. But with the opportunity for growth in concentrated holdings, so too comes significant risks. CTC | myCFO can help!

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