

## Concentrated Portfolios – Not Worth the Risk



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It is quite common to see investors with a substantial portion of their investment portfolios in a single company or industry. Given that Kobren Insight Management builds diversified portfolios, it probably won't surprise many when we say that we believe that the risks of a concentrated portfolio are not worth the potential returns.

Concentration risk is fairly easy to identify and remedy – in an emotionless and tax-free world. The problem with trying to reduce many concentrated positions, however, is that they have low cost bases and/or many investors have an emotional attachment to them.

Reducing a concentrated position for many investors may feel like an act of disloyalty. Oftentimes, the concentrated position is in company stock where an employee can take pride in the growth of the company or it could be in another stock that has treated an investor and/or his or her family well over the years. This is an understandable emotion, but for the financial health of an investor and the investor's interests, we believe that the best course of action moving forward is to diversify, reduce the unnecessary risk, and protect future purchasing power.

Another issue caused by simply reducing a concentrated position usually involves realizing a significant gain and incurring a taxable event. While this may still actually remain the best option in some cases, there are several ways that an investor can reduce concentration risk while attempting to minimize the tax bite. In this article, we will provide a quick overview of some of these techniques.

### What Constitutes a Concentrated Position?

How large should an individual security position be? At Kobren Insight Management, our soft guideline is that no one individual stock position should be more than 10% of an over-all investment portfolio. This can still be a healthy position though, and we often work to reduce positions even more. For a frame of reference, the largest stock in the U.S. market is ExxonMobil. Its current weight is approximately 3% of the total U.S. market.

When it comes to economic sector exposures, we generally attempt to keep sector weightings between one half to two times their over-all stock market weight, though we would relax that a bit for sectors with low over-all market weights (like Media or Utilities) or cap the maximum weight for larger sectors (such as Financials or Energy).

When working to reduce concentration risks in client accounts though, our top consideration at Kobren Insight Management is to get a portfolio to the appropriate asset allocation as quickly as possible (while being sensitive to taxes). Setting up the appropriate asset allocation is of critical importance as asset allocation is in fact the primary driver of a portfolio's long-term return and risk characteristics.

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### How Did the Concentration Occur?

First, let's review how concentration in a portfolio can occur. Concentrated positions can be created in many ways. Usually the concentration was intentional, but sometimes it just sort of happened. Astute investing, of course, can create concentrated positions. Inheritances can create concentration. Avoiding realized gains for tax purposes can create significant positions. Stock option plans and 401(k) matches can also create sizable positions. A long-term investor who never re-balanced may have developed some significant portfolio imbalances.

Another key ingredient — and this is a good reason — is that the concentrated investment has generally had a pretty good run itself. Sometimes though, this can create a false sense of security. While indeed some securities can go on multi-year runs of superior relative performance and successfully compete for long stretches of time, even the most successful companies can eventually languish for long periods of time — if not outright falter entirely. Just think of the technology stocks from last decade. Many have fulfilled their economic promise, yet many are still substantially below their stock price highs — if they are even still around at all.

A special case of concentration risk is concentrating in an employer's stock or even in the same industry as one draws his income. In short, this concentration is even riskier. If significant economic problems in the company or industry occur, not only is income jeopardized, but the investment portfolio may also be impaired rather quickly. In a worst case scenario, not only may a job be lost, but net worth can be significantly reduced if not destroyed. The Bear Stearns debacle from earlier this year is a fairly recent high profile example of how important it is to diversify, especially away from an employer's stock. Many Bear employees lost the bulk of their net worth once the stock plummeted.

The risk of concentrating in an employer's stock is actually quite common though. Stock option plans are one way that many investors build large positions in employer stock. An even more common way for many investors is that nearly a quarter of all public companies use their stock to match contributions to 401(k) plans (according to Hewitt Associates). In plans offering company stock, the average 401(k) participant had 22% of his account in these shares, with about 16% of the participants having at least half of their account in company stock. Again, we believe that this is simply inviting too much risk into a long-term investment plan.

Something about many of the concentrated positions that we see is that remarkably many of them are not in blue chip, large cap companies. It seems like most of the time the accumulated position is in a high volatility sector or industry like technology, biotechnology, or energy service stocks. Needless to say, volatility is much higher in these types of securities. While this sort of volatility can create sharper gains, it can also create more dramatic losses at times as well.

However the concentrated position was accumulated, congratulations to the investor who was fortunate enough to be in such a situation. Nonetheless, we believe the appropriate action to take now is to diversify.

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#### Why Diversify?

There are two big reasons to diversify. First, while a concentrated portfolio is more likely to hit a home run, it is also more likely to strike out. Avoiding the big mistake, however, is the key. Long-term investment success is generally more about avoiding the big losses, than it is about hitting it big with a concentrated position. This is especially so when the time horizon for a portfolio gets shorter and when there is less time to catch up and offset past losses either through additional contributions or investment returns or both.

The second reason is that concentrated portfolios are more volatile. Excess volatility can be disruptive to long-term investment objectives as it often creates an emotional response (greed and fear) in many investors, often leading to undisciplined investor behavior. A diversified portfolio, however, can often remove a lot of the volatility.

Ned Davis Research has done some pretty interesting work on what drives individual stock returns. Approximately 20% is due to the over-all market, roughly 20% is due to the broad economic sector, approximately 30% is due to the industry within the sector, and the remaining 30% or so is due to the specific company itself. Needless to say, an investment portfolio dominated by a single name or two can be quite volatile. Investment theory and practice, however, shows that diversifying a portfolio can reduce (perhaps even significantly, if not entirely, depending on the depth of diversification) stock-specific, industry, and sector-related volatility. In sum, lower portfolio volatility should provide a smoother ride for investors.

#### How to Reduce Concentration

There are several possible strategies to deal with a concentrated portfolio, with the strategies either being financial or charitable in nature.

First, there are financial strategies such as:

- **Completion Strategies:** In this strategy, a plan is established to reduce a concentrated position in a disciplined manner and re-invest the proceeds into assets which are the most uncorrelated to the remaining concentrated position. The most common example would be to sell a highly appreciated equity (usually from a portfolio with a heavy allocation to equities) and re-invest the proceeds into a non-equity exposure such as fixed income.

Reductions in the concentrated position can be set up either on a calendar basis and spread out over a period ranging from several months to a few years (the determined time period is heavily influenced by the client's tax situation) or on market weakness (to take advantage of potentially matching up tax losses from other positions in the portfolio) or both.

- **Hedging Strategies:** These are typically option-based strategies where an investor purchases a put option for protection and pays for this (partially or in full) by selling a call option. This

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protected position can then be borrowed against, where the new funds could be used to invest in securities that will diversify the portfolio.

A couple ways to do this are through Equity Collars and Variable Prepaid Forwards (VPF). One difference between these two methods is how much liquidity can be created from each. Generally speaking, the amount is usually higher with a VPF if the purpose is to reinvest in the marginable securities. What these strategies do is basically protect the value of the concentrated position, diversify the portfolio to some extent, and if everything is executed properly, taxes will be deferred on the sale of the stock until the maturity of the VPF or collar.

- **Exchange Funds:** An Exchange Fund (sometimes called a Swap Fund) can allow stockholders of a significant amount of a single stock to diversify into a larger, more diversified pool of stocks (coming from other investors doing the same thing) by swapping their stock for a *pro rata* position in the larger pool. The goal is to diversify holdings without triggering a taxable event. The tax is then postponed (due on the difference between the sales price of the exchange fund and the original cost basis of the contributed stock).

Public exchange funds hold stocks while private exchange funds own privately-owned stock (pre-IPO). There are unique features regarding exchange funds, including the requirement that at least seven years has to elapse before an investor can sell without realizing a step up in basis and pay taxes. In addition, public exchange funds are generally not marginable.

There are also charitable strategies:

- **Charitable Remainder Trusts:** CRTs offer the benefits of income and estate tax deductibility, the ability to plan annual cash flow, and ultimately a gift to a charity. The way a CRT works is that an investor gifts the stock to a pre-established Trust (a current year income tax deduction for the client), which in turn sells the stock and re-invests in a diversified portfolio. The trust will then pay out a taxable, pre-specified amount (could be fixed or based off percentage of CRT's net assets) each year to a beneficiary. The beneficiary is typically the donor. At the end of the donor's or Trust's life, the remaining assets will be gifted to charity (an estate tax deduction).
- **Private Foundations and Donor Advised Funds:** Private Foundations and Donor Advised Funds are another option to gift low cost basis assets. In both cases, an investor will receive a charitable deduction for the gift to be used to offset income taxes. There are, however, no other economic benefits. Both Private Foundations and Donor Advised Funds are tax-exempt entities supporting qualified charitable organizations.

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In Donor Advisor Funds, a donor gifts to a “host organization” which is established to accept gifts from multiple donors. The Donor Advised Fund then sells the gifted security and places the money in a co-mingled pool of the gifts from multiple donors. The donor then advises the fund to make charitable gifts out of the pool. Technically, while the Donor Advised Fund does not have to follow the donor’s wishes, it is rare that the trustees of the fund do not make the gift as long as it goes to a legally organized public charity. Generally speaking, Donor Advised Funds are more flexible than Private Foundations, less expensive to establish and maintain, and typically require less of time commitment for investors who still want to make charitable gifting a part of their lives.

Private Foundations meanwhile, are often better vehicles for those who want to devote a significant amount of time to a charitable cause. Private Foundations are often family-specific where a donor is frequently trying to put his or her own personal touch or lasting legacy on a specific charitable venture. Private foundations offer the advantages of more control over the gifting process, but the cost (if it is considered such) is the amount of time in the management of the foundation.

### What is the Best Strategy to Use?

What is the best way to reduce concentration risks? The answer, like many investment solutions, is that it depends on the particular investor. Different investors have different investment and charitable objectives, risk tolerances, tax sensitivities and other personal considerations.

Future tax policy is another consideration. Currently, many people believe that regardless of the outcome of the next election, most investors are in for higher taxes. Utilizing tax deferral strategies now may result in deferring taxes into a future where the tax bite will be even larger. Given this expectation, the preferred approach for most investors is to consider a completion strategy first. If there are compelling reasons why a completion strategy doesn’t meet investor objectives, then the consideration of other strategies makes sense. Working with an advisor can often help with this process

Regardless of potential changes in tax policy, our portfolio preferences at Kobren Insight Management typically default to the simpler solutions. Whether one wants to refer to Occam’s razor (“All other things being equal, the simplest solution is the best”) or even the KISS Principle (“Keep it simple and short”), there is no reason to introduce unnecessary complexity. As a result of this philosophy, our preference is typically the completion strategy where we work with a client to establish a disciplined plan to reduce concentration risks in a tax-aware manner as quickly as possible.