

The risk involved in owning too much (usually defined as 30% or more) of one stock, what's known as concentrated equity, is pretty apparent – too many eggs in one basket. What's trickier is why some investors have such difficulty remedying a situation that can pose a real threat to their long-term financial security.



Concentrated equity can arise in many ways. Investors sometimes inherit large amounts of a single stock. They may have sold their business to a publicly traded company in return for substantial amounts of stock, or accumulated a sizeable position through stock and option incentives from a current or previous employer. In some cases, they've become enamored with a specific company and acquired an overly large stake. Whatever the particular case, concentrated equity can become an issue investors know they should address but often ignore. Why? Primarily, it's because of the enemy between our ears – all the emotions that money generates, including the market mainstays of fear, hope and greed but also more subtle issues that usually revolve around how the concentrated equity occurred in the first place.

The psychological barriers to diversification

For example, let's say you inherited a large amount of a single stock. While that's nice, you may also have inherited an emotional attachment to the stock which, by the way, the stock doesn't feel in return. Grandpa may have left you the reward he received from selling the company he built over a lifetime, but that doesn't mean the stock is a promising investment today, or that it should dominate your overall portfolio. Perhaps the stock was in the family for many years and has appreciated significantly. That can lead to what's called "anchoring" – believing the future will be like the past. But, as the fine print says, "Past performance is no guarantee of future results." Investors who cashed out after working at a company for many years – or still work there – may believe they understand the business very well and will recognize when it's time to sell part or all of their substantial position. Slimming down a big holding might mean tax liabilities, or a reduction in dividend income. In other words, rationalizations abound.

In these instances, and many others, what's really at work is fear of regret. Behavioral finance experts say that fear of doing something we might regret is stronger than the satisfaction of doing something profitable. Overconfidence is often a factor – many of us trust ourselves, and for good reason. We think we know what we know. But in the investing world, that could lead to overweighting a stock we believe has upside potential, while discounting the potential downside. Investors may double-down on a particular security that could throw their asset allocation

out of whack and possibly add more risk and volatility. Tax aversion sometimes leads investors to take outsized risks rather than diversify sensibly. Plain old inertia plays a role too. When something has worked – “XYZ has been very good to me” – it’s easy to do nothing.

Strategies to reduce concentrated equity risk

No matter what the cause, it’s wise to take a step back and acknowledge that successful investing requires elevating reason over emotion. While that takes some effort, as usual, knowledge is power. Although every individual’s situation is different, if you have concentrated equity, there are a number of ways to reduce your risk. Here are some strategies to discuss with your advisor:

Hedging

Using various types of securities, a comprehensive hedging strategy can enable investors to retain their stock positions while also setting limits on the amount of risk they are willing to accept. Hedging strategies generally will involve paying a fixed premium in return for reducing risk.

Monetization

Investors who want to tap into some of the cash represented by a sizeable stock holding can do so in several ways without an outright sale. Borrowing against the stock in a margin account is the simplest example, but your advisor can explain other strategies that may be preferable for you.

Tax-efficient diversification

While diversifying away from a concentrated equity situation can reduce overall portfolio risk, there’s often a price to pay in terms of taxes. Structuring a plan to mitigate any associated tax liabilities in advance may make it easier to overcome a lingering aversion to potentially higher taxes.


Income enhancement

Investors accustomed to a regular income stream in the form of dividends from a large stock position may be more willing to reduce that position if another income source can be created. There are a number of income enhancement strategies for concentrated equity that can accomplish this goal – your advisor can tell you more.

Tax-efficient gifting

Investors with philanthropic or generational transfer goals may be able to reduce their concentrated equity risk while also furthering their individual legacy and tax minimization objectives. Tax-efficient gifting strategies can be complex, so be sure to consult estate planning and tax professionals before making any moves.

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Bottom line? If you have concentrated equity and really want to avoid regrets, talk to your advisor about a personalized diversification strategy. 

Why concentrated equity can be so dangerous

There’s a reason Warren Buffett says the first rule of investing is: “Never lose money.” (His Rule No. 2 is: See Rule No. 1.) A quick look at the cruel math of loss shows why. Let’s say that Investor A has a third or even more of his or her net worth tied up in Wonderful Inc. If the stock declines 40% in price, it has to then gain 67% just to get back to even. If the stock drops 50%, it has to double in price to return to where it started. In other words, if an overly large position goes south, the odds of making up the loss – and the resulting damage to your overall portfolio – are not good.

Asset allocation and diversification do not guarantee a profit nor protect against a loss. | A Margin account may not be suitable for all investors. Borrowing on Margin and using securities as collateral may involve a high degree of risk including unintended tax consequences and the possible need to sell your holdings, which may lead to a significant impact on long-term investment goals. An investor can lose more funds than he or she deposited in the account. Market conditions can magnify any potential for loss. If the market turns against the client, he or she may be required to quickly deposit additional securities and/or cash in the account(s) or pay down the loan to avoid liquidation. The securities in the Pledged Account(s) may be sold to meet the Margin Call, and the firm can sell the client’s securities without contacting them. An investor is not entitled to choose which securities or other assets in his or her account are liquidated or sold to meet a margin call. The firm can increase its maintenance margin requirements at any time and is not required to provide an investor advance written notice. An investor is not entitled to an extension of time on a margin call. Increased interest rates could also affect LIBOR rates that apply to your Margin account causing the cost of the credit line to increase significantly. The interest rates charged are determined by the amount borrowed. Please visit sec.gov/investor/pubs/margin.htm for additional information.

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