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Strategies for Concentrated Stock Positions

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Executive compensation plans often include awards and grants of company stock. Or an investor may have bought a position that grew to be a large percentage of a portfolio. From a personal financial perspective, it can present the challenge of “having your eggs in one basket.”

Prospect theory in behavioral finance teaches us that investor losses hurt more than gains feel good. One might be optimistic about the company’s prospects and the stock price. Yet, the volatility of a single stock and potential downside risks may be too much for a portfolio and individual to handle.

Single stocks can be much more volatile than the overall market. According to a JPMorgan study, nearly 60% of all public companies underperformed cash returns

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since 1920. In addition, from 1980 to 2020, 44% of all companies comprising the Russell 3000 Index experienced a loss of at least 70%, which was never recovered.

Diversifying makes sense in theory, but many factors must be considered in execution. First, there is the potential opportunity cost and familiarity of a holding that may make it challenging to address. Second, taxes need to be considered. Third, the implementation and timing of transactions can play a large role in how much an investor ultimately keeps.

As a rule of thumb, we prefer a maximum of 10% in any single holding and ideally under 5%. This way, even if one investment does not work out, it is unlikely to derail the financial plan.

Before we dive in, here are a few simple approaches:

1. Systematic Selling—Many are likely familiar with dollar cost averaging, which involves investing the same defined amount in the market each month. We can flip this in reverse and average out of a position each month.

2. A 10b5-1 Plan – For executives with access to material non-public information, setting up a periodic plan to sell securities at price limits can be a way to stay within the many trading rules.

3. Gifting—Whether it's shares to a charity, a donor-advised fund, or a family member, gifting can reduce the capital gains taxes owed, though one gives up control of the asset.

Taking it to the next level while keeping control of the assets, let's assume taxes are a key consideration we would like to avoid. We are willing to add complexity and time to potentially save and diversify to broad market exposure.

1. Direct Indexing – While we talked about the potential tax benefits before, this can also be used in strategic liquidation. It starts with selling a concentrated position alongside an account designed to track the broader market. While attempting to get closer to the index each year, the manager generates tax losses from those names that go down any given year. These losses can be used to offset capital gains from the concentrated position. This potentially saves on taxes and creates a portfolio with many holdings, ideally tracking a broad market index. The risk of the strategy is being sure the holdings track the market index appropriately.

2. Exchange Fund – This is where one has a nontaxable exchange of shares in a single stock for interests in a limited partnership that tracks a broad public index. There are a few catches: the manager needs to accept the stock, the lock-up is lengthy – usually 7 years, and at the end, one inherits a basket of stocks with the original cost

basis. [We recently came across an ETF doing something similar: taking shares in-kind instead of a normal buy with cash. The offering purports to offer diversified exposure; while it's still in the early days, we like the innovation.]

3. Options – There is a variation of the exchange fund strategy on the option side. This attempts to use options to hedge a portion of the single stock risk while providing broad market exposure for the majority of the portfolio. Another option strategy is an equity collar. The objective is to cap the upside and downside of single stock risk while being low cost (since the option premium of selling a call option offsets the premium of buying a put). Collars are usually used when one thinks a stock will have short-term volatility. Finally, selling calls is a way to generate income. However, this caps the stock's upside for an investor since it may get called away.

Strategies to reduce risk, save on taxes, and fit within a well-defined financial plan are available. Building knowledge around these areas can help one address concentration risk in single stocks to protect and grow capital.

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