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Managing Embedded Gains with *Intention*

Embedded Gains



By Chris Boyd

Most investors eventually face a familiar dilemma: an investment that has grown so much that it now dominates their financial picture. It might be employer stock, a long-held equity position, a rental property, or even a business interest. While the growth is a sign of success, the embedded capital gains can make selling—and diversifying—feel prohibitively expensive.

The challenge is simple: selling triggers taxes. For many, that tax cost becomes a psychological and financial barrier, leading to inaction even when concentration risk becomes uncomfortably high. What begins as a smart long-term investment can slowly become a source of vulnerability.

Embedded gains represent the appreciation that hasn't yet been taxed. Whether the holding has doubled or increased tenfold, the IRS waits patiently. This tax reality often creates decision paralysis: investors feel trapped between maintaining excessive risk or realizing a large tax bill.

Concentration risk is especially problematic when one asset starts dictating your financial outcomes. A single stock or property can balloon from 10% of your net worth to 40% or more. At that point, your financial wellbeing becomes tied to the fate of one investment—and that's rarely a comfortable place to be.

Fortunately, tax-aware strategies can help investors reduce concentration without incurring the full tax cost all at once. One of the most effective tools is a long/short separately managed account (SMA) designed specifically to generate realized losses. These losses can help offset gains triggered when diversifying a concentrated position.

A long/short SMA seeks to remain largely market-neutral by pairing long positions (stocks expected to appreciate) with short positions (stocks expected to decline). As markets fluctuate, positions naturally generate gains and losses. Skilled

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managers harvest the losses systematically, creating a pool of realized losses that investors can use to offset gains elsewhere.

The benefit is twofold: investors stay invested in the market while simultaneously building tax flexibility. This differs from selling investments solely to create losses, which takes investors out of the market and potentially compromises their long-term strategy.

Direct indexing offers a related approach, allowing investors to own individual stocks that mirror an index. This structure provides more frequent opportunities for tax-loss harvesting, especially during periods of market volatility. While typically less aggressive than long/short strategies in generating losses, direct indexing remains a valuable tool for ongoing tax management.

For investors anticipating major taxable events—such as selling a business, liquidating real estate, or reducing a large stock position—planning ahead is crucial. By building a bank of losses before the liquidity event occurs, investors can significantly soften the tax blow.

As with all tax planning, a thoughtful, multi-year strategy tends to be the most effective. Setting clear objectives, understanding cost-basis details, modeling tax outcomes, and coordinating with tax professionals are essential steps. With the right tools and planning, investors can unwind concentrated positions in a tax-efficient manner—without sacrificing long-term investment potential.

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