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FEBRUARY 1, 2021

YOUR GUIDE TO CONCENTRATED STOCK POSITIONS

AND STRATEGIES TO HELP DIVERSIFY YOUR PORTFOLIO

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In our roles at Creative Planning, we often work with investors who have accumulated significant wealth through the growth of one or a few individual stocks. Their most common question is, "Should I continue to hold this stock, or sell?" The answer often depends on whether or not the stock represents a concentrated position.

What is a concentrated stock position?

A concentrated stock position is an investment that represents a significant percentage of an investor's overall portfolio. There is no set dollar amount that defines a concentrated position, as the percentage will vary based on the portfolio's size. For example, if you have a $3 million portfolio and want to buy a $10,000 interest in a start-up company, this investment would not be viewed as a concentrated position. However, if your portfolio is valued at $50,000, a $10,000 investment would be considered a concentrated position because it represents a significant percentage of your overall assets.

How does someone end up with a concentrated stock position?

There are several ways an investor may end up with a concentrated stock position. As in the example above, an investor may choose to over allocate to a specific stock, betting on big returns. There are also other, less obvious ways investors can find themselves concentrated in a particular holding.

1. **Company stock** – Some employers offer company stock or stock options as part of an overall compensation plan. Others allow employees to purchase stock at a reduced price. Over time, these stock positions can add up to comprise a significant percentage of your portfolio.
2. **Inheritance** – You may receive concentrated holdings as part of an inheritance of in-kind shares.
3. **Business sale** – If your business is purchased by a public company, you may receive compensation in the form of publicly traded shares of the purchasing firm.
4. **Tremendous growth** – Some investors have the insight to purchase stock

in rapidly growing companies at a very low price. (Think Apple in 2007/2008.) If you've experienced tremendous growth over time, these holdings may represent a significant percentage of your portfolio.

The risks of holding a concentrated stock position

If you've been investing long enough, you're likely familiar with infamous story of Enron's stock. In 2001, many employees who held concentrated positions lost all of their retirement savings when the company's stock value tanked following the company's disclosure of serious financial problems. As a result of the scandal, more than 4,500 employees lost their jobs, their income and their benefits, in addition to their life savings.[1] While this is an extreme example, it's a good reminder of the importance of diversifying your investments and income whenever possible.

Behavioral biases play a role

Most financial advisors preach the wisdom of portfolio diversification. Having a concentrated stock position can put you at significant risk in an unexpected situation. Yet, there are several behavioral biases that can prevent investors from diversifying their holdings, including:

1. **Recency bias** – This is the tendency to believe that recent trends will continue into the future. For example, the belief that because Apple stock has performed well since 2008, it will continue to perform well long into the future. This bias exists even with investors who understand that companies face the threat of constant competition and industry disruption that can cause unexpected drops in a stock's value.
2. **Familiarity bias** – Investors are more likely to invest in companies that are well known to them. For example, if you use Apple's products, you may be more likely to invest in its stock, regardless of other performance indicators.
3. **Overconfidence** – Being too confident in a company can prevent an investor from seeing a situation for what it really is.
4. **Confirmation bias** – Investors have been known to seek information that aligns with their own pre-conceptions, and disregard information that does not.
5. **Anchoring bias** – This is when an investor relies too heavily on a single piece of information, which is often the first thing he or she learned about a specific stock or company.

What's the best way to manage concentrated positions?

The following strategies can help reduce your holdings in a concentrated position. Because they can have an impact on your taxes and other portfolio holdings, it's always wise to consult with a

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financial advisor prior to implementing any changes.

1. **Diversify –** Selling out of all or a portion of your concentrated position allows you to invest in a diversified mix of mutual funds or exchange-traded funds (ETFs). If you have reached age 55 or 59 ½ (depending on plan rules) and have significant company stock within your employer-sponsored retirement plan, you may be eligible to diversify your investments, without triggering a taxable event, by completing an in-service rollover to an IRA.

2. **Options –** By using a sophisticated option strategy called an equity collar, you can purchase puts and calls on your concentrated position. This strategy is best implemented by an experienced professional.

3. **Exchange fund –** If you are concerned about the potential tax implications of selling an appreciated stock position, you may want to consider an exchange fund. Different from an exchange-traded fund, this is an option offered by firms willing to exchange your shares for a diversified basket of holdings that track an index, such as the Russell 1000. The benefit to you is portfolio diversification and the ability to defer capital gains taxes. The benefit to the exchange fund provider is it can create a diversified basket of holdings and exchange them with other investors in similar situations.

4. **Charitable donations –** You may wish to consider donating appreciated shares of stock to a qualified non-profit organization. The charity will receive the current value of the stock without triggering a taxable event for you or the organization. If you use a donor-advised fund (DAF) to make your charitable contributions, you can "bunch" your donations in years when you have a significant taxable event and allocate to charities of your choice in future years.

5. **Trusts –** Another gifting strategy is the use of a charitable remainder trust (CRT). When you make a donation of appreciated stock to a CRT, it is considered an irrevocable gift and no taxes are due. As the donor, you may be eligible to receive an income stream if certain requirements are met. Whatever remains in the trust after your death passes to a charitable organization of your choice.

   For example, if you donate $100,000 to a CRT and withdraw 5 percent each year, you will receive $5,000 per year. If, on the other hand, the same $100,000 is subject to taxes at 25 percent, you would be left with $75,000, and a 5 percent withdrawal would equal only $3,750 per year.

6. **Borrow against the stock –** Margin works in a similar manner to the leverage you use when

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you buy a home – you borrow from the bank, using your home as collateral. When you use margin on your account, you borrow against the value of your portfolio, using your stock and bond holdings as collateral. You can use the borrowed funds to purchase other holdings and diversify your portfolio while gradually selling out of your concentrated position.

As with most investment-related decisions, it's wise to consult with your financial advisor prior to making any changes to your concentrated stock positions.

At Creative Planning, we work with clients to develop diversified investment portfolios that help them achieve their long-term goals. We have experience helping clients diversify their concentrated stock holdings with minimal tax ramifications. If would like to speak with one of our qualified advisors about how we can help you implement a diversified portfolio to meet your needs, or for any other financial matter, please contact us.

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[1] https://www.cbsnews.com/news/enron-by-the-numbers/

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