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Managing Concentrated Stock Positions

The goal of this paper is to analyze the risk-return implications of concentrated positions, address common reasons behind investor reluctance to liquidate, and explore ways to employ prudent management of concentrated holdings as part of a larger portfolio.

RISK-RETURN PERSPECTIVE

Many affluent investors may find themselves holding concentrated positions in single securities that represent substantial portions of their overall portfolios. Concentrated positions can develop from a number of sources, such as an equity compensation structure, a sale of a business, high-profile IPOs or an inheritance. It may be tempting to hold onto those shares in a time of consistently bullish equity-market environment, such as that observed in 2017, which was a year of low volatility and a relentless rise in stock prices that led to a number of new highs and milestones in key U.S. market indices. But markets at some point are bound to hit turbulence. Corrections occur, and volatility comes and goes in varying degrees. Given that markets don't move in just one direction, understanding and managing the risks associated with concentrated stock positions become a crucial part in securing one's wealth.

The implications of a concentrated equity position can vary for each investor, depending on factors such as individual risk tolerance, investment horizon, desired and required returns, and any other assets in the portfolio. As such, there is no one-size-fits-all solution in managing concentrated holdings. Each concentrated position and its risk-return implications should be analyzed, understood and managed on an individual basis.

Still, broadly speaking, when a single stock represents a significant share of a portfolio, it would be fair to say that the stock is assigned a disproportionate weight and that the portfolio is not well diversified. In our view, a lack of diversification means the position is more vulnerable to greater volatility than is a diversified portfolio, and, as such, could experience a heavier drag on the position's compounded growth. For an example of what that "drag" could look like, please see the table at the top of the following page.

> *It is common for affluent investors to have concentrated equity positions in their portfolios. Such outsized holdings could expose the investor to undue risk without a guarantee of higher return.*

THE EFFECT OF COMPOUNDING: S&P 500® Index

	S&P 500® Index Annual Return	Growth of $1M Using Arithmetic Mean	Actual Growth of $1M
		$1,000,000	$1,000,000
2008	-37.00%	$1,114,915	$630,000
2009	26.46%	$1,243,036	$796,698
2010	15.06%	$1,385,880	$916,681
2011	2.11%	$1,545,139	$936,023
2012	16.00%	$1,722,700	$1,085,786
2013	32.39%	$1,920,664	$1,437,472
2014	13.69%	$2,141,378	$1,634,262
2015	1.38%	$2,387,455	$1,656,815
2016	11.96%	$2,661,811	$1,854,970
2017	21.83%	$2,967,694	$2,259,910
2018	-4.38%	$3,308,727	$2,160,926
2019	31.49%	$3,688,951	$2,841,402
2020	18.40%	$4,112,868	$3,364,220

Source: FactSet Research Systems. Data is assumed to be reliable. This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only. ***Past performance is no guarantee of future results.***

The table above shows the 13 most recent calendar-year returns of the S&P 500 Index. Simple math (using the arithmetic mean of the returns) would bring the cumulative return to 149.39% and the average to 11.49%. This average, applied across the 13 years, would have brought a $1 million investment at the beginning of the period to $4.11 million by the end of 2020.

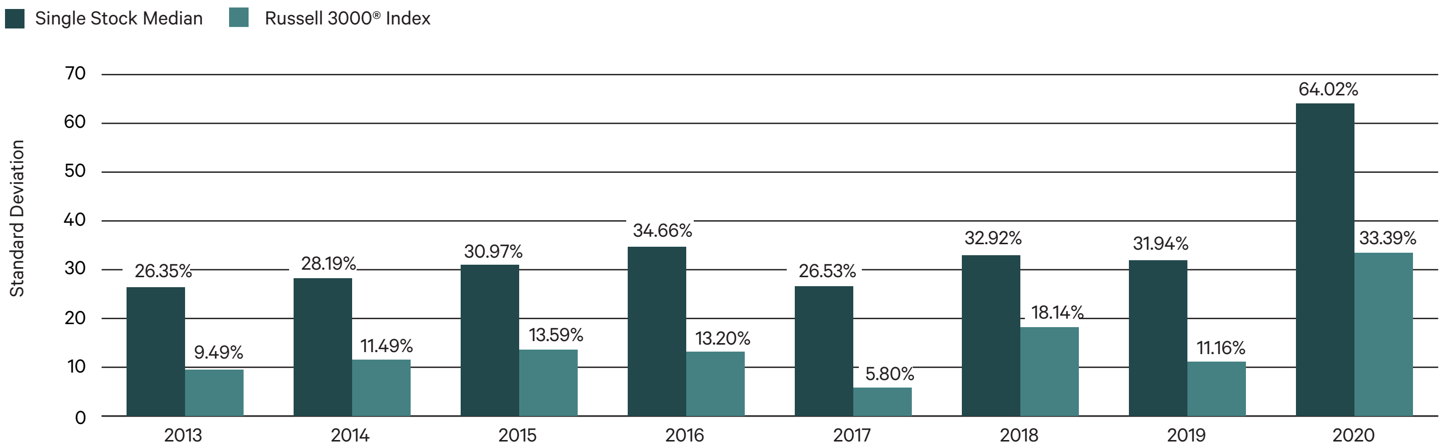
However, in reality, the $1 million investment would have grown to just $3.36 million. This is due to the fact that returns are compounded, meaning each year's return carries over to affect the following year's return. For instance, after the 37% decline in 2008, there is not $1 million anymore to experience the 26% rebound, but $630,000. Then there is not $1 million to experience the 15% gain the next year, but $796,698, and so on.

The difference between the $4.11 million and the $3.36 million at the end of 2020 is what's known as "volatility drag." Note that this kind of discrepancy—where the compounded average lags its arithmetic counterpart—will occur with any level of volatility present in the market, not just in environments with larger swings.

VOLATILITY: SINGLE STOCK VS. DIVERSIFIED PORTFOLIO

Furthermore, all equity investors face market risk, but we find that those with concentrated positions also face idiosyncratic risk, challenges unique to that single stock that could hurt its performance. The graph below shows that volatility, measured by standard deviations of stock returns, is greater for single stocks than for a diversified portfolio of stocks.

VOLATILITY OF RETURNS: Standard Deviations



Source: FactSet Research Systems. Data is assumed to be reliable. This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only. ***Past performance is no guarantee of future results.*** *Single-stock volatility is the median value of standard deviation of all securities in the Russell 3000® Index at the beginning of each year observed.*

INVESTOR TENDENCY TO HOLD ONTO POSITIONS

Whether they are aware of the risks involved, investors with concentrated positions may have a tendency to hold onto those positions. In our view, it would serve investors well to take a strategic approach to their concentrated positions and consider the various methods they could employ to diversify. Here, we offer a few possible reasons behind their reluctance to sell:

- A belief that the stock will continue to outperform
- A desire to defer capital gains for tax implications, especially if the cost basis is low
- Restrictions on selling
- An emotional tie to the security

A CASE TO DIVERSIFY

Diversification is no guarantee for higher returns but we believe it can help reduce overall risk. Here are our views on different courses of action that an investor might take:

- **Outright liquidation:** This is applicable only if the shares are unrestricted. The investor could sell the positions, pay taxes and reinvest or keep the cash. While an outright liquidation of the entire holding is an option, this sort of an all-or-nothing approach may not be feasible for many investors, and we do not readily suggest that an immediate sale is the best or only option available.
- **Staged selling:** This is a strategy for gradually unwinding a concentrated position so as to spread out the capital-gains tax liability over time. The sell-down can be arranged for a number of years. This may be appealing to an investor who wishes to diversify while avoiding a large tax bill in the shorter term.

- **Charitable techniques:** Making charitable gifts during an investor's lifetime can be a way to diversify a concentrated position without incurring significant taxes. The investor would transfer the value of the asset to a recipient of choice, often a tax-exempt organization, and is usually eligible to receive a tax deduction.
  - ✓ In the case a charitable remainder trust is used, an investor would make contributions to the trust and be eligible for a partial tax deduction and a potential income stream for a specified term. At the end of the term, the remaining assets in the trust are distributed to the beneficiaries.[1]
  - ✓ A donor-advised fund may also be utilized. In using this philanthropic vehicle, the donor makes a contribution, receives an immediate tax benefit and recommends grants from the fund. The contribution in the donor-advised fund can be invested and grow tax free.[1]

CONCLUSION

Investors might worry that selling portions of their concentrated positions means the proceeds will be held in cash or something unlikely to yield a meaningful return. That's not necessarily true. In certain circumstances, we believe it could make sense to redirect the liquid money into portfolios of quality stocks with strong track records that would provide investing opportunities across styles and geography for diversified exposure.

In sum, there is little certainty regarding the future of an individual stock, and the risk imposed on concentrated positions can be substantial. We believe it would serve investors well to consider the risk-reward dynamics of their investments and be open to allocating their assets differently to accomplish their financial objectives over the long term.

KAYNE ANDERSON RUDNICK

Kayne Anderson Rudnick is an investment firm specializing in high-quality investment and wealth management strategies. The firm has over a 30-year history serving a diverse client base that includes high-net-worth individuals, corporations, endowments, foundations, public entities, taft-hartley clients, and mutual funds. Kayne Anderson Rudnick is known for its commitment to high-quality investment strategies and business practices. For more information, please visit www.kayne.com.

1. Investors should consult their tax and legal advisors to determine if this is ultimately a strategy that makes sense for their own financial and tax situation.