

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.

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 environments, 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 below.

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%)	\$1,147,893	\$630,000
2009	26.46%	\$1,317,659	\$796,698
2010	15.06%	\$1,512,532	\$916,681
2011	2.11%	\$1,736,226	\$936,023
2012	16.00%	\$1,993,002	\$1,085,786
2013	32.39%	\$2,287,753	\$1,437,472
2014	13.69%	\$2,626,097	\$1,634,262
2015	1.38%	\$3,014,479	\$1,656,815
2016	11.96%	\$3,460,300	\$1,854,970
2017	21.83%	\$3,972,056	\$2,259,910
2018	(4.38%)	\$4,559,496	\$2,160,926
2019	31.49%	\$5,233,815	\$2,841,402
2020	18.40%	\$6,007,862	\$3,364,220
2021	28.71%	\$6,896,385	\$4,330,088
2022	(18.11%)	\$7,916,314	\$3,545,909
2023	26.29%	\$9,087,084	\$4,478,128
2024	25.02%	\$10,431,003	\$5,598,556

*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. The S&P 500® Index is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. **Past performance is no guarantee of future results.** Returns could be reduced, or losses incurred, due to currency fluctuations.*

The table above shows the 17 most recent calendar-year returns of the S&P 500 Index. To illustrate this point, we apply simple math (using the arithmetic mean of the returns), which brings the cumulative return to

211.30% and the average to 12.43%. Applied across the 17 years, this average brings a \$1 million investment at the beginning of the period to \$10.43 million by the end of 2024.

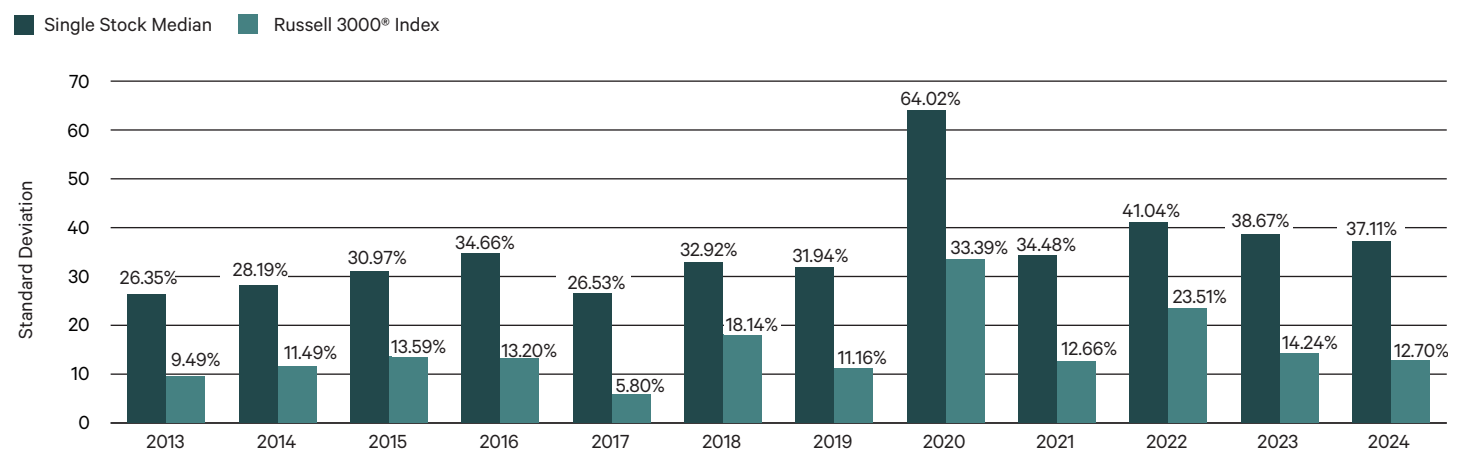
However, in reality, the \$1 million investment grows to just \$5.60 million. This is due to the fact that returns are compounded, meaning each year's return carries over to affect the following year's return. For instance, after the 37% decline in 2008, there is not \$1 million anymore to experience 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 \$10.43 million and the \$5.60 million at the end of 2024 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. Russell 3000® Index is a market capitalization-weighted index that measures the performance of the 3,000 largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The index is unmanaged, its returns do not reflect any fees, expenses, or sales charges, and is not available for direct investment. **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

Managing A Concentrated Position

While the concentration of one's wealth in a single holding or small group of holdings could potentially provide outsized rewards in the right market conditions, holding concentrated stock positions also comes with substantial risk that may be mitigated with portfolio diversification. When looking to further diversify one's portfolio, there are multiple ways and solutions that may help clients make that transition away from a concentrated stock position. Here are our views on different courses of action that an investor might take:

Outright liquidation: This applies only to unrestricted shares and is not always the best answer, though investors can direct proceeds into other investment opportunities for greater diversification.

Staggered selling: Gradually winnowing down a concentrated stock position can spread out any capital-gains tax liability over time.

Charitable giving: 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.

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.

Option collars: Option collars allow clients to generally keep their stock and from selling by incorporating strategies that create downside protection while limiting unrealized gains on the upside.

Call option transition plan: Some investors may want to use the sale of call options on a concentrated stock to provide them with defined dates/outcomes as to when the stock will be sold while also providing the opportunity to collect income on their concentrated position.

Direct indexing: Direct indexing involves taking proceeds from the sale of a concentrated stock, which will then be invested in an index and tax loss harvested to offset the gains.

Hedged Equity Exchange: A hedged equity exchange refers to maintaining a concentrated stock position but transferring one's risk from a single stock (idiosyncratic risk) to a broad index (market risk).

From our perspective, the benefit to these various solutions is that they are all highly customizable and can be tailored to meet the income needs, risk tolerance, and tax situations of each individual client.

For additional information about managing concentrated stock positions, consult with a Kayne Anderson Rudnick [Wealth Management advisor](#) today.



Kayne Anderson Rudnick is an investment firm specializing in high-quality investment and wealth management strategies. The firm has an over 40-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.

*This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only. Information contained in this article is not intended by KAR to be interpreted as investment advice, a recommendation or solicitation to purchase securities, or a recommendation of a particular course of action and has not been updated since the date of the material, and KAR does not undertake to update the information presented should it change. This information is based on KAR's opinions at the time of the publication of this material and are subject to change based on market activity. There is no guarantee that any forecasts made will come to pass. KAR makes no warranty as to the accuracy or reliability of the information contained herein. The information provided here should not be considered to be insurance, legal, or tax advice and all investors should consult their insurance, legal, and tax professionals about the specifics of their own insurance, estate, and tax situations to determine any proper course of action for them. KAR does not provide insurance, legal, or tax advice, and information presented here may not be true or applicable for all investor situations. Investors should consult their tax and legal advisors to determine if the strategies make sense for their own financial and tax situations. **Past performance is no guarantee of future results.***