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What to do with a Concentrated Portfolio

Introduction

Located as we are in Silicon Valley, we have many clients and friends who are successful entrepreneurs. As a result of their success they often have much of their wealth in a single stock. It's usually either the stock of a company they started from scratch, or shares of a company to which they sold their business. If they had founder's shares or some type of incentive stock option, these investors also have a very low tax basis.

Basic investment principles suggest that investors with concentrated portfolios should diversify, diversify, diversify. Experience dictates the same. We know too many people who, either against advice or on bad advice, kept portfolio concentrations and then needlessly suffered large losses. Their losses had less in common than you might think. They had different causes — the dot-com bust, accounting fraud, too much leverage, real or potential product liability — and occurred in various market conditions. But investors often ignore the danger. They are reluctant to sell the stock that brought them wealth, make a large tax payment, and invest in an "ordinary," diversified portfolio.

I've observed four common reasons that investors hold on to concentrated positions. The first is tax. Selling a low-basis position means paying capital gains taxes, and people just don't like to do that. Second comes loyalty. This stock has done well for so long, and made us so much money (or made our parents so much money before we inherited it) that it just doesn't seem right to part with it. The third motivation, oddly, is a big loss. When a high-flying stock comes down to earth, many holders hang on, hoping to recoup their lost paper wealth. The fourth reason is involvement. If you are an executive or major shareholder of a company, you may face legal or investor relations impediments to selling your stock. While every investor's situation is distinct, the conclusions are uniform. It's important to respect the constraints, legal and otherwise, in your circumstances, but within the bounds of those constraints, diversification is the best policy.

The Tax Motivation

If you have a big position with a low tax basis, you face an unpleasant choice. If you sell your stock, you'll have a capital gains tax bill. If you hold it, you'll have a concentrated portfolio. But unless you want to look at mere paper wealth all your life, sooner or later you will have to sell some of your stock, and in all likelihood that sale will be taxable. In most cases you can only defer, rather than avoid, capital gains tax. This deferral has value, but maybe not as much as you think. You only get to keep the amount that the deferred tax earns in the market — the interest on it, so to speak, but not the tax itself. If you lose money on the investment, the tax deferral actually magnifies your loss.

To make a big difference, you would have to reduce or avoid, and not just defer, taxes. To reduce or avoid tax, you need to dispose of the shares in a way that reduces the *rate* of tax. Charitable giving can fit this description, so long as you have genuine charitable intent. If you live in a high tax state and are about to move to a lower-tax state, then it may be worth waiting until you move to sell your concentrated shares, though you should check state tax rules before you decide. You could simply bet that Congress will further reduce the capital gains tax rate, or that your state will improve the tax treatment of long-term gains. And ultimately, if you hold a concentrated position for the rest of your life, your heirs would enjoy the step-up in basis that goes with the tax treatment of inheritance, and they could then sell your stock without paying any capital gains tax. Before you take any type of step aimed at reducing the *rate* of tax on the disposal of your concentrated position, consult your tax advisor.

For most investors, it may be difficult to do much better than the current federal long-term capital gains tax rate of 15%. So the decision is really whether to defer taxes by holding the stock. The trouble is that for as long as you have the concentrated position, you also have concentrated risk. That works out fine if your stock doubles, but as experience shows, any stock that seems to have the potential to double, triple, or more — and many that don't — also has the potential to collapse. If you have $10 million worth of a stock, it's tempting to bet that it will become $20 million worth, but it just isn't prudent to make that bet when it exposes you to the chance that your $10 million will become $100,000.

Loyalty

Even without a strong tax motivation, many investors feel a natural attachment to holdings that have done well for them over a long period of time. It's certainly sensible enough to reason that a company whose stock has grown over the years is a solid company. Sentiment can play a role, too. It's hard to sell a legacy from a beloved grandparent. But yesterday' great companies aren't necessarily today's. Fast growers slow down, steady performers sometimes stagnate, and seemingly timeless institutions sometimes fade away or occasionally collapse. And great companies aren't necessarily high-returning stocks.

It can be especially hard to sell a successful stock while it is rising. After all, it's natural to worry that if you sell now, you'll miss some of the ride. But the danger of selling too late is far greater than that of selling too early. The early 20th Century financier Bernard Baruch is often quoted as having said, "I made my money by selling too soon."[1] If you do sell too early and diversify, the risk reduction alone can be worth it.

Gotta Make it Back

Ironically, as hard as it can be to sell a stock on the way up, many people find it even harder to sell on the way down. The problem may be a determination to recoup the loss, refusal to admit a mistake, or a conviction that the market has mispriced the stock. In any case, it's just as natural to hope for a bounce in a fallen stock as to hope for continued performance from a rising one. It's also just as questionable.

Would You Buy this Portfolio if you had Cash?

Let's say you have $5 million in a concentrated position, and taxes aren't an issue. You could sell your stock and replace it with anything you choose. You could buy another stock, or you could diversify. Ask yourself this question: If I had $5 million in cash, would I put it all into the same, single stock? It's important to realize that without the constraints of taxes, or family loyalty, or insider status, keeping your single stock is just like deciding to take all your money and invest it in that same stock. It may be a great company. It may even be a great stock. But concentrating in a single stock creates unnecessary risk. Worse, the market doesn't reward you for taking that risk.

The Extra Risks of a Concentrated Portfolio

Let's review why diversification is a good idea. To do this, we'll take a brief detour into the world of Modern Portfolio Theory (MPT). MPT had its beginnings (insofar as it's possible to identify the beginnings of such things) with the publication by Harry Markowitz of a paper called, simply, "Portfolio Selection," in the *Journal of Finance* in 1952. Prof. Markowitz's key insight was that it's the risk and return of an investor's overall portfolio, rather than of the individual holdings in the portfolio, that matter.

Markowitz realized that the returns on any given stock are subject to multiple influences. Some of these are factors that affect the returns of many, or even all, stocks. These are "common factor," or "systematic" risks. Systematic risks might include the general health of the economy, commodity prices, interest rates, or the political environment. In addition, each stock is subject to its own stock-specific, or idiosyncratic, risk. A new product introduction, a

[1] I couldn't find an authoritative source for this quote, although it appears in collections of on-line one-liners like www.quoteland.com, and it seems universally attributed to Baruch. A related remark also usually ascribed to Baruch is "Don't try to buy at the bottom and sell at the top. It can't be done except by liars."

scandal, or an executive change might cause a substantial move in an individual stock. In a diversified portfolio, those stock-specific effects average out. The more diversified the portfolio, the less the stock-specific effects matter. But diversification doesn't eliminate the common factor risks, like the general health of the economy. A diversified portfolio still feels their effects. Since you can't get rid of the common factor risks when you invest in stocks, the market must give you a reason to take them — otherwise, nobody would invest in stocks at all. The market does this by paying you, pricing stocks to give a likelihood of enough return to make the risk worthwhile. But since you can invest in stocks and still eliminate stock-specific risk, the market doesn't pay you to bear it. It's just extra risk, without extra reward.

A concentrated portfolio lacks diversification, so it has a great deal of uncompensated risk. Your one stock might continue to do very well. But it also might turn the other way. If your one stock has already made you rich, diversify. You'll have a much better chance of remaining that way.

Is There Any Reason to Keep a Concentrated Position?

Investors must constantly make judgments and tradeoffs. We've talked about the risks of holding a concentrated position. Isn't there some potential benefit to holding on? Let's look at some possibilities.

Tax reduction. In some circumstances, an investor may be able to arrange matters so that it becomes possible to avoid tax, or pay it at a lower rate, by holding to some future date. This is a much greater benefit than mere tax deferral. Consider a simple case, in which an investor can reduce the tax on a capital gain from 35% to 15% simply by waiting until after the end of a one-year holding period. If that threshold is close, then the benefit of waiting — a substantial reduction in tax — may well be worth the incremental risk of holding the position for a short while longer.

Insider trading rules. Successful entrepreneurs often hold stock in companies in whose management they still actively participate. If they qualify as corporate insiders, then they must comply with significant legal constraints on their trading. These rules may affect the timing of their trades (especially around the time of earnings announcements), as well as imposing reporting requirements.

Senior managers of publicly traded companies may also face informal constraints on their trading. Outside investors and public shareholders may watch carefully for any sign that management's confidence in a firm is eroding, and may take stock sales by management as such a sign. Nevertheless, investors ought to recognize that if the managers of their firm are completely undiversified, it may distort their decision-making in ways that are not healthy for the company or its shareholders. These investors should understand that managers holding a substantial stake in their company can make more clear-minded decisions if they also have a well-diversified nest egg.

Conclusion: Analyzing the Tradeoffs

If you have a high-value, low-basis position, you must make a classic tradeoff. Basically, you must balance the benefits of diversification against the opportunity to defer taxes, and keep the amount thus deferred in the market, hopefully earning further returns. As in most matters concerning portfolio construction, it comes down to the balancing of risk and opportunity. I have created a model that uses the framework of MPT to analyze this tradeoff. The actual results depend on a variety of factors. The most important one is the stock-specific risk of the concentrated holding. The relationship of the stock to the market in general and the investor's time horizon also matter. In the vast majority of cases, though, an investor can improve the balance of risk and return by selling at least part of the concentrated position, and investing the proceeds in a diversified portfolio.

If taxes are not a consideration for you, but you hold a concentrated position because of loyalty or a continuing involvement with a company, then it's worth understanding the effect of the concentration. In many cases, the analysis can support at least a partial move toward a diversified portfolio.

Many investors have large positions in single stocks. These concentrations are the result of an investment or business activity that created substantial value. For many, the natural inclination is to hold on to the position that brought them wealth. Taxes, loyalty, and continued involvement may reinforce this inclination. But in the vast majority of cases, portfolio concentration just means unnecessary risk, without any compensating benefit. Most holders of concentrated positions should actively consider moving to a diversified portfolio.

\- Jonathan Tiemann
Menlo Park
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The model mentioned in this note is designed to be a flexible tool for evaluating a number of possible portfolio policies for investors holding concentrated positions. Readers interested in evaluating concentrated holdings and exploring their policy choices are invited to contact me at the address below. Readers interested in the mathematical details of the model are also invited to contact me at the address below.

Tiemann Investment Advisors, LLC is an SEC-registered investment advisor based in Menlo Park, California. More information is available on request to: information@tiemann.net or

750 Menlo Avenue, Suite 300
Menlo Park, California 94025
650 566-0200

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TIA takes full advantage of the power of structured portfolio management. The firm has developed technology-based methods for managing most routine investment functions, thus releasing a greater amount of expert time for tackling the unique investment challenges of each client's circumstances. The firm's starting point with each client is to understand the individual complexities of their investment situation, from the most sophisticated investment vehicles to the most fundamental emotional constraints. This evaluation leads to a custom portfolio design, which leads seamlessly to implementation through a structured portfolio management approach. By managing most clients' portfolios directly, TIA often simplifies account structures and removes layers of fees. TIA charges a set management fee (less than the expense ratio of many mutual funds) and receives no "under the table" fees or commissions. TIA also works to reduce the costs of trading your account, and regards brokers as counterparties whose interests differ from those of investors. TIA operates to the highest standards of professional and ethical conduct, including complete confidentiality and forthright reporting. We take seriously our role as a fiduciary in the advisory relationship, and do not represent any corporation's securities, hold an inventory of securities, hire securities analysts or tout any investment. TIA currently has over $50 million under management, and our clients include professionals in finance, entertainment and technology. TIA's founder and president, Jonathan Tiemann, holds a Ph.D in finance from Yale University and has more than two decades of experience in academia, institutional investment management, and high net worth investment management. Dr. Tiemann founded TIA on the belief that you *can* get the right portfolio at the right price.