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Managing Concentration Risk

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Managing Concentration Risk

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Concentration risk often is defined as an exposure to a single security, or multiple holdings with correlated tendencies, of greater than 10 percent of the total portfolio value. Although the sources of concentration risk often are pleasing—significant equity awards to a corporate executive, explosive growth in a single stock, acquisition of a business holding paid via a non-taxable equity transaction, long-term accumulation via a family legacy holding—investors need to be cognizant of the unintended consequences of these positions. The most obvious consequence is significant financial loss and wealth destruction along the lines of investors who held large positions in Enron, Sears, Lehman, and other notable companies that suffered significant declines. Although market beta is a necessary factor for an equity market participant, idiosyncratic risk—the additional risk of holding a specific security with unique attributes and risk factors—can be reduced via effective portfolio diversification.

Additionally, although overall market volatility, measured as standard deviation of the S&P 500, historically has averaged around 16 percent, the volatility of a single stock in an index could be significantly greater (see figure 1). Many investors are unaware of this significant risk, and just as importantly, often are not paid for the assumption of it in their returns.

This additional volatility can have adverse consequences for investors both financially and emotionally. Increased volatility can reduce the probability of successful outcomes, in particular during retirement distribution, because any drawdowns require the investor to liquidate more assets to meet cash-flow needs, leaving fewer dollars available for exposure when markets turn higher. This volatility also can lead to negative behavioral decisions, because investors' emotional responses often lead to lower investment returns.

OBSTACLES INVESTORS FACE

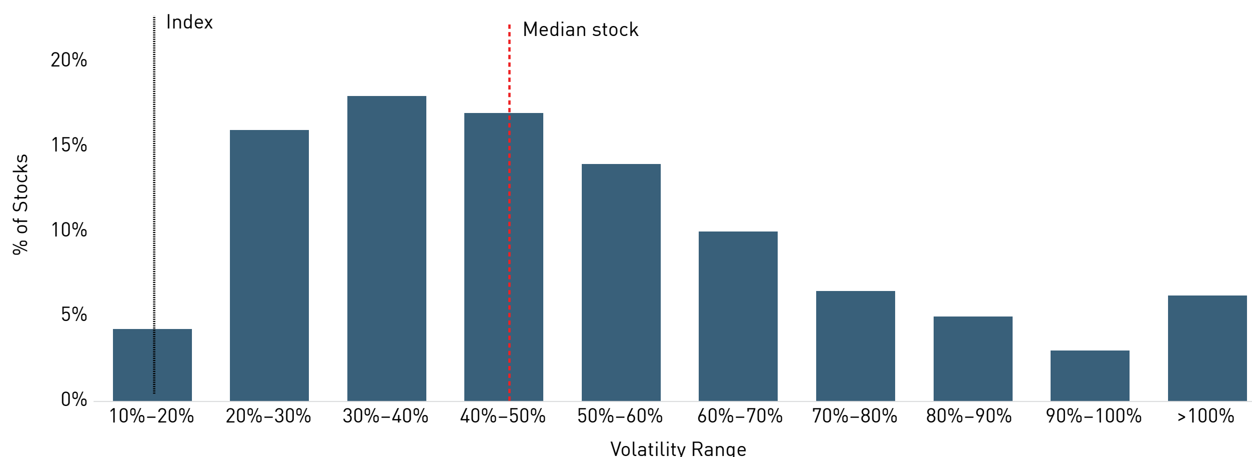
Investors often maintain an existing predisposition toward these concentrated positions, preferring to maintain current exposures instead of taking proactive steps to manage them in a prudent fashion. These views can be based partly on financial logic; investors may prefer to avoid the immediate tax recognition due to the sale of a highly appreciated position. But the behavioral biases described in table 1 frequently are also a contributing factor.

OVERCOMING OBJECTIONS BY ASKING THE RIGHT QUESTIONS

Advisors can help to create a viable path forward by providing broader education,

Figure 1

CONCENTRATION RISK: INDIVIDUAL STOCK VS. INDEX ILLUSTRATION



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Source: PIMCO. Data does not represent any specific index or stock and is provided for illustrative purposes only to illustrate how the volatility of a stock held by an index may vary from the index.

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Table 1

BEHAVIORAL BIAS

Bias	Definition	Potential effect on investor
Overconfidence	The tendency to overestimate or exaggerate one's ability to successfully perform a given task.	Because executives generally have access to greater inside knowledge of an individual firm, they tend to overrate their abilities and overvalue company holdings.
Status quo	Increased choices and information generally lead to greater indecision.	The scientific principle of inertia; investors often avoid making changes, instead selecting the option that keeps conditions the same.
Home country	The tendency to favor companies in one's own country over those from other regions and countries.	With wealth heavily concentrated in a single stock, investors may not realize their allocations could be negatively impacting portfolio diversification.
Recency	A belief that recent past returns will be replicated in the future.	Investors choose to maintain their concentrated holdings expecting similar results.
Endowment	Tendency to give holdings that are owned a disproportionate value because they already are owned versus purchasing outright.	Investors may hold onto inappropriate assets that they otherwise would not buy (or own) if they didn't already hold them.

For illustrative purposes only.
Source: PIMCO

Table 2

MATRIX OF POTENTIAL SOLUTIONS: MATCHING STRATEGIES TO CLIENT OBJECTIVES

Liquidity	Tax minimization	Hedging	Diversification	Wealth transfer
• Restricted stock sale • Writing OTC covered call • Securities-based loan	• Variable prepaid forward • 83(b) plan • NUA • Direct indexing	• Purchase OTC put option • Zero-premium collar • Participating collar	• Variable prepaid forward • Exchange fund • Purpose loan • Custom diversification collar	• Gifting to family • Donor-advised funds • Charitable remainder trust • Family foundation

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Source: PIMCO

and by personalizing the experience through a discussion that helps investors better understand their own financial and emotional preferences. The following discovery questions may uncover helpful insights:

- What is your primary objective for these assets (tax minimization, appreciation, risk reduction)?
- What is the primary purpose of these assets in your financial plan (retirement, business, charitable)?
- What is your expectation for the future performance of your concentrated holding?
- What is your view on the direction of tax rates?
- Can you describe your exit strategy for these positions?
- If you didn't work at your current company, how much of the stock would you own in your portfolio (for executives)?
- What would be more disturbing: selling a security that continues to rise or holding one that continues to fall?
- If we were designing an objective portfolio and you were presented with cash equal to the value of your current position, how much would you allocate to this position?

POTENTIAL CONCENTRATION RISK SOLUTIONS

Helping clients develop an effective strategy to deal with a concentrated position in a portfolio often depends on a number of inputs, including overall portfolio holdings, required capital needs, tax circumstances, and risk tolerance. An effective approach might start with an understanding of a client's primary objectives and the solution matrix best positioned to solve for them (see table 2). Primary objectives may include the following:

- Liquidity
- Tax minimization
- Hedging
- Diversification
- Wealth transfer

STOCK SALE/LOAN FOR LIQUIDITY

An outright sale of the underlying security might be the simplest solution for consideration and could be a baseline to use in comparison with other strategies. An outright sale is a perfect hedge against future downside risk. The sale creates immediate liquidity that can be used for diversified reinvestment, e.g., into complementary assets with low correlation to the client's core holding, or for personal expenditures. Of course, a sale would produce immediate tax recognition, but low-basis positions held in excess of 12 months would receive preferential tax treatment at long-term capital gains rates, which are attractive relative to ordinary income tax rates. The 2024 maximum capital gains rate is 20 percent for married joint filers with income in excess of $583,750 and single filers at $518,900 (see table 3). Of course, the additional 3.8-percent net investment income tax applies to married joint filers with income above $250,000 and single filers at $200,000, producing a combined maximum tax rate of 23.8 percent.

Advisors might consider the following approaches to help clients effectively manage this process:

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- Setting specific price targets that would trigger a sale to limit risk.
- Systematic selling at different intervals to reduce timing risk and to spread the tax liability.
- Simultaneous sales of loss holdings in the portfolio to offset recognized capital gains in concentrated positions.

Table 3

TAXABLE INCOME: MARRIED, FILING JOINTLY VS. SINGLE, 2024

	Taxable income	
Tax rate	Married, filing jointly	Single
0%	$0–$94,050	$0–$47,025
15%	$94,050–$583,750	$47,025–$518,900
20%	$583,750+	$518,900+

Source: Internal Revenue Service

Alternatively, clients might consider avoiding an outright sale and borrowing against their securities as a method to create liquidity and maintain upside exposure while deferring tax recognition. Generally, securities-based loans provide access to approximately 75 percent of the underlying value with variable interest rates based on an underlying index such as the secured overnight financing rate. Although loan proceeds can be used to affect personal expenditures, e.g., college tuition, auto purchases, real estate acquisitions, etc., they cannot be used to purchase additional securities.

USING ZERO-PREMIUM COLLARS FOR HEDGING

Listed options can be used to achieve certain objectives. Selling covered call options against a concentrated, highly appreciated position can be useful in generating additional income but fails to provide downside protection. Purchasing put options against a long position can hedge against downside risk but can become expensive over an extended time horizon.

Zero-premium collars can be used to reduce downside exposure while deferring capital gains recognition at no or limited cost.

Zero-premium collars can be used to reduce downside exposure while deferring capital gains recognition at no or limited cost. Collars are created by selling call options with a strike price above the current market price, then simultaneously using the premiums received to purchase put options with a strike price below the current market price. Assuming the premiums received are equal to the premiums paid, the net cost to the investor is zero. These derivative contracts can be created allowing the investor to specify option maturities and option strike prices with intended upside/downside price exposure. The investor retains all ownership benefits, including dividend income and voting rights, and defers potential capital gains exposure until expiration, if exercised.

The following transactions are structured as European options, which, unlike listed options, cannot be exercised before maturity. There are three potential outcomes at maturity:

The stock remains at a price between the upper and lower collars. The investor retains ownership and is now free to hold, sell, or engage in another transaction. The call premium received is taxed as a short-term capital gain and the put premium paid is treated as a long-term capital loss.

The stock finishes at a price higher than the call strike price. The underlying stock position is called away at this price. The investor recognizes a capital gain equal to the call strike price plus the call premium received minus the original cost basis. The put premium paid is treated as a long-term capital loss.

The stock finishes at a price below the put strike price. The underlying stock

Table 4

ZERO-PREMIUM COLLAR

Share delivery				
Closing price	Client value	Total value	Value protected	Profit participation
$25	$45	$4,500,000	$2,000,000	$0
$40	$45	$4,500,000	$500,000	$0
$45	$45	$4,500,000	$0	$0
$50	$50	$5,000,000	$0	$0
$55	$55	$5,500,000	$0	$500,000
$60	$60	$6,000,000	$0	$1,000,000
$75	$60	$6,000,000	$0	$1,000,000

Assumptions: Number of shares: 100,000 / Current price: $50 / Total value: $5,000,000 / Put (floor) price: 90% ($45) / Call (ceiling) price: 120% ($60) / Net premium: 0% ($0) / Term: 12 months / * Net premium may vary based on the terms of the structure.*

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is put to the counterparty at this price. The investor recognizes a capital gain equal to the put strike price minus the original cost basis and put premium paid. The call premium received is treated as a short-term capital gain.

Although these transactions offer many benefits, the greatest potential risk is the lost profit potential if and when the underlying stock reaches a price far in excess of the call strike price, producing a cost of lost opportunity.

Table 4 presents an example of an investor that is long 100,000 shares of a security trading at $50/share for a total position value of $5 million. The client wishes to hedge downside risk and avoid the capital gains liability from an immediate sale. The investor chooses to create a collar by selling call options with a strike price of $60/share (20 percent above current market) and by selling put options with a strike price of $45/share (10 percent below the current market). The premium received from the calls offsets the premium paid for the puts, resulting in a zero-cost transaction. If the stock remains between the $45 and $60 limits, the investor will retain the position without any capital gain impact. If the stock rises to a price above $60/share, the investor will have the position called away at $60, forgoing any additional profit beyond this price. If the stock were to fall to a price below $45/share, the investor would put the shares, resulting in a sale at $45 and eliminating any downside exposure below this price.

Although these transactions offer many benefits, the greatest potential risk is the lost profit potential if and when the underlying stock reaches a price far in excess of the call strike price, producing a cost of lost opportunity. Investors need to accept this potential outcome before execution, recall the original intent of the strategy, i.e., hedging against loss, and recognize that the increase in price is a more desirable outcome than a decline that would reduce the value of unhedged holdings.

EXCHANGE FUNDS FOR DIVERSIFICATION

Exchange funds are used to diversify a large, highly appreciated equity position while deferring capital gains recognition. Investors contribute securities from different sectors into a common pool. Participants "exchange" ownership of a single security (and the associated attributes) for a proportional share of this diversified pool and avoid the tax recognition that typically would accompany an outright sale. This specialized tax treatment is achieved primarily via Internal Revenue Code 352C, which requires a minimum exposure of 20 percent to non-liquid holdings (generally attained through real estate positions) to avoid constructive sale. These private placements are exempt from registration and avoid the public disclosure, and participation is not a public sale and does not require a Form 144 filing from affiliates, e.g., executive offices, directors, and 10-percent owners.

Here are some characteristics of these vehicles:

- Participation is subject to acceptance by the fund sponsor. Many funds look to produce overall portfolio diversification and may therefore limit or reject the contribution of securities that would produce an overweight in a sector or single security.
- The contribution of restricted securities held by executives is permissible but may be limited or discounted by the sponsor when accepted.
- The minimum contribution for these funds generally is $1 million and the upfront placement fee is approximately 1 percent of the contributed amount. Although the fund charges administrative fees, there are no ongoing management fees because these vehicles are professionally selected but not actively managed.
- Liquidity is limited for the first seven years. Although earlier withdrawal may be allowed, it could produce adverse tax consequences including constructive receipt based on the date and price at the time of contribution.
- Some funds do permit minimal distributions to shareholders, generally from the dividends received from securities held inside the fund.
- Withdrawal requests from the fund can identify specific securities for distribution, but it's ultimately the choice of the fund sponsor to determine the exact make-up of the distribution. Fund sponsors often will use these withdrawal requests to rebalance the portfolio by distributing securities or sectors that have grown to overweight positions.
- The resulting cost basis of the received distribution is allocated on a pro-rata basis. The original cost basis of the contributed security is divided among each of the received securities based on the security's proportional weight in the total distribution amount.

Figure 2 may help to illustrate. An investor contributes $1 million of ABC stock with an original cost basis of $100,000 to an exchange fund. The investor's return is no longer determined by the performance of the contributed stock but by the performance of the entire fund. The investor holds this share of the fund for the required seven-year term, and the fund doubles in value, increasing the investor's position to $2 million. The investor requests a withdrawal of the investment, receiving five different securities each worth $400,000. The original cost basis of $100,000 is divided equally among the five securities, so each would obtain a cost basis of $20,000/security.

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Figure 2

DIVERSIFICATION: EXCHANGE FUND

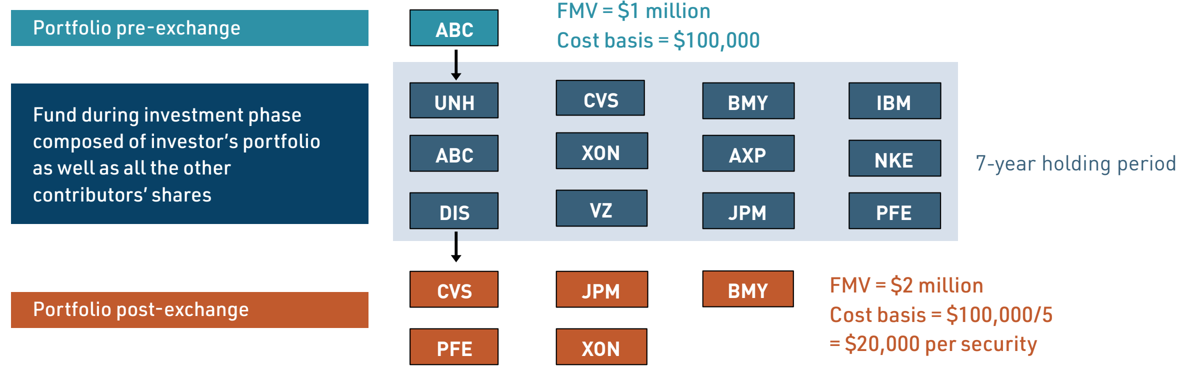

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Table 5

DEDUCTION LIMITS FOR CHARITABLE GIFTS

	Public charity		Private foundation	
Property	Deduction	AGI limit	Deduction	AGI limit
Cash	FMV	60%	FMV	30%
Ordinary income property	Cost basis	50%	Cost basis	30%
Long-term capital gain property	FMV	30%	Cost basis/FMV**	20%
Personal property—same use	FMV	30%	Cost basis	20%
Personal property—not same use	Cost basis	50%	Cost basis	20%

**Can elect cost basis deduction with 50-percent AGI limit.*

***Cost basis if non-operating, FMV if operating.*

Charitable contributions that are not deductible due to AGI limitations can be carried forward for up to five years.

Source: Internal Revenue Service

USING CONCENTRATED POSITIONS TO FULFILL CHARITABLE INTENT

Wealthy investors continue to share their success philanthropically, with charitable donations continuing to reach all-time annual highs in the United States. Using low-basis, highly concentrated assets to fund charitable giving can provide numerous advantages including a reduction in concentration risk, a potential income tax deduction, avoidance of capital gains tax, and a reduction in a taxable estate.

Charitable giving remains one of the few available itemized deductions under Schedule A, along with state and local taxes, mortgage interest, and medical expenses above 7.5 percent of adjusted gross income (AGI). Giving long-term, appreciated property to a public charity, including most 501(c)(3) organizations, provides a deduction of the full fair market value (FMV), subject to a maximum deduction of 30 percent of AGI in a given tax year (see table 5). Any contribution in excess of this limit would be carried forward for a period of up to five additional years. For example, a contribution of $250,000 of long-term property to a public charity made by an investor with AGI of $700,000 would produce a current deduction of $210,000 (30 percent of $700,000) with the remaining $40,000 carried forward.

In addition to a potential income tax deduction, using appreciated property to fund charitable giving allows the investor to avoid the capital gains tax liability that would accompany an outright sale (see table 6). Consider an investor with a long position of $100,000 in appreciated stock with a cost basis of $20,000. A sale would produce capital gains exposure of $80,000 and a tax liability of $19,040, leaving approximately $80,960 available for donation and a tax benefit of $29,955. Giving the $100,000 property directly to charity avoids the associated capital gains liability, affording a full $100,000 charitable donation and a tax benefit of $37,000. The net benefits are an incremental gift to charity of more than $19,000 and an additional tax deduction to the donor of more than $7,000.

Donors can make direct gifts to charity or instead leverage the benefits of donor-advised funds (DAFs), which provide the opportunity to complete a

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Table 6

WEALTH TRANSFER: GIVING APPRECIATED PROPERTY TO REDUCE CAPITAL GAINS LIABILITY

Sell asset, contribute cash		Contribute appreciated asset	
Capital asset FMV	$100,000	Capital asset FMV	$100,000
Cost basis	$20,000	Cost basis	$20,000
Realized capital gain	$80,000	Realized capital gain	$0
Capital gain tax @23.8%	$19,040	Capital gain tax @23.8	$0
Charitable contribution	$80,960	Charitable contribution	$100,000
Value of deduction @ 37.0%	$29,955	Value of deduction @ 37.0%	$37,000
Net benefit to charity: $19,040			
Net benefit to donor: $7,045			

FMV = fair market value
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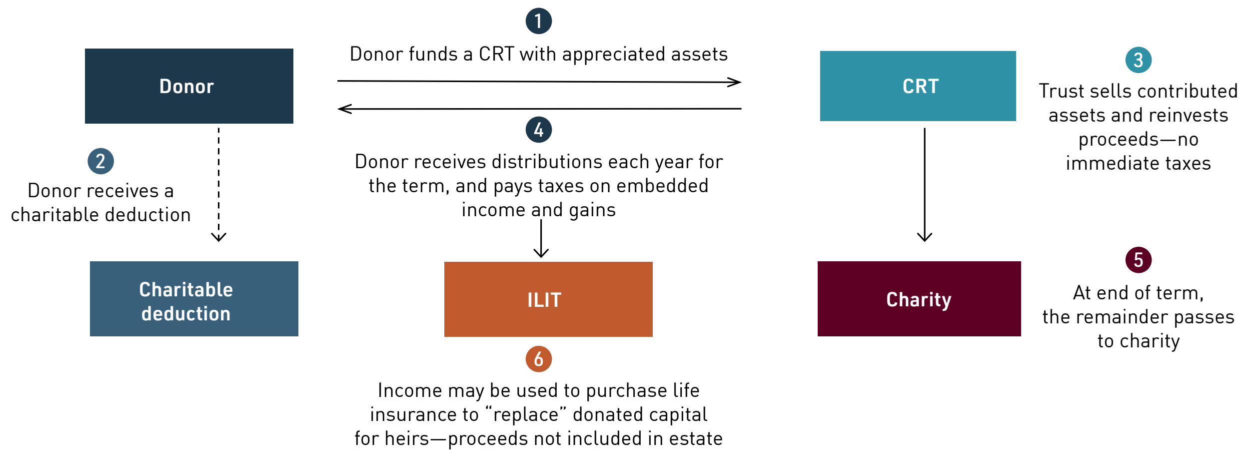
Source: PIMCO

Figure 3

WEALTH TRANSFER: CHARITABLE GIVING



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contribution (and associated tax deduction) in the current taxable year that allow grants to charity at later dates. DAFs also provide the opportunity to bunch a donor's giving activities into a single calendar year in order to exceed the standard deduction (currently $29,200 in 2024 for joint filers) and produce the maximum tax benefit. Most DAFs offer relatively low minimum contribution requirements, varied investment options, and flexible grant-making to provide a significant convenience in executing a charitable program.

A charitable remainder trust (CRT) may be a viable tool for investors with concentrated stock positions, because CRTs allow for the sale of a concentrated position to improve diversification and avoid immediate tax consequences. Here's how CRTs work (see figure 3):

- The donor establishes a CRT for a specified term (either a number of years or life of income beneficiary).
- The donor funds the trust with the appreciated property and receives a current income tax deduction, generally discounted from the full value of the property.
- The trustee sells the appreciated property and reinvests in a diversified portfolio, deferring the capital gains recognition.
- The donor receives annual distributions from the trust, either a fixed dollar amount through a charitable remainder annuity trust or a fixed percentage of trust assets through a charitable remainder unitrust. The donor is responsible for the taxes on these distributions.

The remainder passes to the charity at the end of the term.

The benefits of a CRT include the following:

- Fulfillment of charitable intent
- Diversification of a concentrated position
- An immediate income tax deduction
- Beneficial capital gains treatment
- An income stream to the donor for a specified term
- Removal of the asset from the donor's taxable estate

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MANAGING CONCENTRATION RISK

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CONCLUSION

Investors with concentrated positions may be accepting additional risks that they are unaware of or not being compensated to assume. These investors face a number of financial and emotional obstacles that need to be addressed in the development of an effective strategy with their financial advisors. The identification of an individual's primary objectives, including liquidity, tax minimization, diversification, hedging, or wealth transfer, can help in targeting potential solutions.

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