A road map for selling concentrated stock positions

If a client's position in a single stock has become untenable, here are five strategies for reducing concentration risk.

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But the advances also further highlight the issues of having concentrated positions within a portfolio — which is an especially big problem for some tech workers who get an outsize proportion of their compensation via company stock.

MOST COMPANIES UNDERACHIEVE

As a practical matter, almost everyone appreciates the risk associated with having all your wealth tied up in one spot. But how often do individual companies underachieve? As it turns out, a lot.

Indeed, broad indexes have a long history of piggybacking the outsize performance of only a handful of companies. Consider that only 4% of the market was responsible for stocks besting Treasury bill returns over the 90 years beginning in 1926.

Naturally, it would have been next to impossible to know which companies would be among the 4% from year to year. And it would have been equally challenging to figure out when those same companies would begin to outperform and for how long.

GETTING IN TOO DEEP

So how can you help a client from getting in too deep? If their compensation comes, in large part, from restricted stock units, the solution is somewhat easy: Stop. In theory, the same goes for former DIY investors, although breaking their bad habits can require advisors to have a few carefully worded conversations.

Either way, if a client's concentrated position has become untenable — and in some circumstances that could be when one stock makes up as little as 10% of the portfolio — here are five easy strategies to set for reducing concentration risk.

Sell shares based on a financial goal. This is a great way to focus clients on their long-term priorities and demonstrate how lowering concentrated stock positions can

help achieve them. Rather than just hope that a stock does not unexpectedly fall in value, clients can sell enough shares to meet goals they have set for themselves, whether it's paying for their children's college expenses or funding an early retirement.

Set a share price. A client can forge a contract with themselves. Like a covered call, they can sell a set number of shares if the stock reaches a specific upper limit price and sell a different number of shares — potentially all of them — if the position reaches a stated lower limit. Aside from providing a client with income, it can help them resist the temptation to try to time the market — which few investors can do consistently, including professionals.

Set a liquidation amount. Specify a dollar amount of the concentrated stock position for the client to unload each year, regardless of its share price. If the price rises, the client doesn't have to sell as many shares to achieve the liquidation amount. If the price falls, though, they will have to get rid of more to do so.

Set a concentration percentage. The idea is for the client to gradually move toward a lower single-stock concentration within their total portfolio, over several years, at a pace that depends on the client's needs and life circumstances, as well as on the performance of the stock in relation to the rest of the portfolio. Even if the client never reaches the ideal lower long-term concentration percentage, the exercise can help their overall financial plan.

Set a donation target. This strategy can minimize capital gains on concentrated positions of highly appreciated stock. Clients may establish donor-advised funds or simply contribute to their preferred charities. Advisors should coordinate with other service providers, including CPAs and tax attorneys, on any relevant trust and estate considerations, as well as to determine which types of organizations qualify for such donations from a tax perspective.

To be sure, any time an investor sees one of their assets surge in value, it falls squarely within the "good problem to have" category. Still, what to do with a highly appreciated stock — not to mention when and how to do it — can be a complex maze to navigate. However, by employing the above strategies based on each client's unique needs and, in most cases, in conjunction with one another, advisors can help them traverse it properly.

NOTE FROM PETER KOTE:

Notice that the advantages of a charitable remainder trust (CRT) are not discussed. Most writers and advisors are not familiar with charitable vehicles or know how to "run the numbers" to see if the technique makes sense to you. You need special software that costs about $3k; if interested in this method of selling concentrated stock position

or turn a stock into income ask a major charity or Financial & Estate literacy to “run the numbers” for you.

A client holds an overweight position. The client knows that the “average” investor should diversify. But the client wants to hold onto his or her position because of some hard-to-explain feeling. We believe that feeling, that unexplained emotional attachment, is what psychologists (like Nobel Prize winner Daniel Kahneman) would call a cognitive bias. The cognitive bias is the belief that amounts to “it’s special.”

Except, of course, the stock is not special. At least not most of the time.

How is that possible? Hasn’t the stock market generated an average long run compound return of about 10%?

Yes. But that emphatically does not mean that the *average stock* has generated that return.

Based on the evidence from many advisors who have clients who won’t diversify a massively overweight position, many shareholders either don’t know, don’t understand, or just don’t care.

In the great majority of cases, the concentrated position is not special, at least not looking forward. It is, quite simply, extremely risky to keep a large fraction of your portfolio in one stock. Of course, if you knew ahead of time that you’d picked a “winner”, this would be a good strategy, but most people don’t pick the winners.

Even, or perhaps especially, if you own a large position in a company that has done very well, diversification is, from a risk management perspective, a “no brainer.”

One excellent solution to the problem of capital gains tax is the use a CRT. When appropriate, a CRT can sell the stock, defer your capital gain tax, provide you and your spouse an income stream (to children as well), an income tax deduction and an opportunity to reinvest in a diversified portfolio in a tax-free zone. In addition, through the magic of the charitable software it will give you a number (value) to donate to the CRT to zero out any tax that you may have to pay.