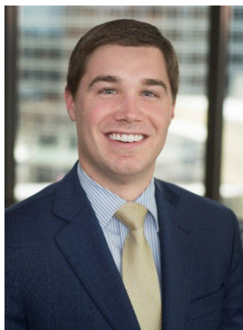
Legacy Trust

Investment Perspectives

Concentrated Stock Positions

May 2021



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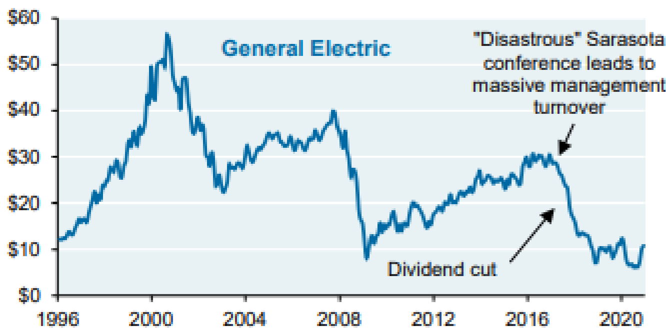
Key Takeaways

- Concentrated stock positions present challenging decisions to taxable investors.
- Having a plan is essential to manage risk and mitigate tax consequences
- The appropriate solution will depend on the individual situation and it may help to discuss with your advisor

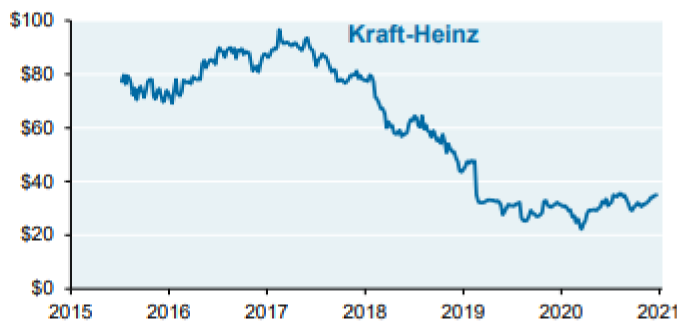
With the stock market reaching new high levels after years of growth, many investors are facing challenging decisions around concentrated stock positions that have built up in their portfolios. There are several options that investors can consider to buffer the impact of a single stock position while still being sensitive to tax considerations.

Over the last several years, really dating back to the Great Financial Crisis, the US stock market has done tremendously well. We have seen nine double-digit return years and only one negative year since 2008. This includes 2020, which saw the S&P 500 return +18.25% despite the COVID-19 pandemic that flipped our lives upside down and was a major disruption in what had previously been a very strong economy. All of this being said, many individuals have benefitted from strong market performance. Some have seen positions in certain companies soar relative to the price at which they bought in, creating a concentration issue within their portfolio.

Concentrated stock positions present some very challenging decisions to an investor. The decision is centered around the prospects for continued price appreciation, key risks to the company, investor tax consequences, and many other considerations. History has presented us numerous cases of when a company that seemed to be untouchable has fallen from grace. A couple of recent examples are General Electric and Kraft-Heinz. General Electric, which believe it or not was the most valuable company in the world in the year 2000, now carries a market value of $123 billion, far beneath the likes of Amazon and Apple. Another near-term example is Kraft-Heinz, which in 2017 topped out at nearly $100 per share and is now trading below $45. Investors in those companies who held large concentrations have suffered the consequences in recent years.



Source: Bloomberg, Factset, WSJ. December 2020.



Source: Bloomberg, Factset, WSJ. December 2020.

Source: JPMorgan

Let's build out an example to illustrate this and highlight a few ways to begin reducing the risk related to having a substantial stake in a single company.

Stock: Tesla (TSLA)
Initial purchase: $50,000
Current market value: $603,175 (+1,106.35%)
Purchase date: 4/30/2016
Embedded capital gain: $553,175

While this has certainly been a phenomenal investment over the years and could continue to go up in value, for many people this type of rapid growth has skewed their portfolio to be very reliant on this single company. Based on the initial purchase, a 15% fall in the stock would be a $7,500 loss. Certainly meaningful but assuming the position was a part of a diversified portfolio, likely not a major concern. However, if we assume a 15% loss on the current market value, that would imply a loss of $90,476. If this type of loss did occur the investment would still be at a significant gain but from an emotional standpoint, it would be very difficult to sell the position.

The below considerations are some ideas to think about if you want to try and buffer the impact of the single stock position, hopefully prior to any large negative price movements.

1. Develop a diversification strategy with other assets
   - This is something that can be done if the investor has a portfolio beyond just the concentrated position; for instance, dollars in an IRA, Roth IRA or investment account. If this is the case, the investor could strategically allocate investments within those buckets to help diversify around the concentrated position. One item to keep in mind is within the retirement accounts (401k, IRA, Roth IRA, etc.) you do not realize gains/losses on trade activity. This would allow the investor to diversify around the large, single position with little to no cost.
2. Set-up a reduction plan or staged selling
   - If the investor does not have outside assets to help diversify the position the next thought might be to set-up a reduction plan. For this strategy, you would look at your tax situation (assuming the asset sits in a taxable account). Identify the tax expense you are comfortable paying in a given year and then begin to reduce the position accordingly. Doing this will allow you to take structured, proactive steps to reduce the concentration while not realizing the full brunt of the tax liability overnight.

Source: FactSet Research Systems

3. Utilize an option strategy to mitigate market volatility

    - One common strategy to protect a concentrated stock position is an equity collar. This strategy consists of purchasing a long-dated put option, as well as, selling a long-dated call option. The put option provides the investor with downside protection and the call option provides the investor with premium income to offset the put cost. This type of strategy is an effective way to neutralize the impact of the market but will limit upside potential in the stock.

4. Diversify with an exchange fund

    - An exchange fund allows the investor to exchange a concentrated position for a share of a more diversified portfolio. This is a good option to achieve diversification without incurring tax liability. However, this type of strategy has certain requirements and will be selective as to which stock can be used. If this is something you want to explore it is best to talk with a financial advisor to figure out what next steps should be taken.

5. Give the position away

    - The final option worth highlighting is to use the concentrated position to either fund charitable gifts (outright or to Charitable Remainder Trust) or even gifts to family members.

        - Charitable – using concentrated stock to fulfill charitable intentions can be a great way to reduce the position. You are able to avoid the tax consequence from a sale, obtain a tax benefit from the gift and reduce the position. The other benefit is that by using a concentrated stock to fulfill charitable gifting, you are able to keep any cash liquidity for living expenses or other investments.

        - Family – by gifting concentrated stock to family you are able to provide family members with an investment that may not be as heavy of a position in their portfolio. Certain family members may also find themselves in a lower tax bracket so a gain on the sale would be less costly. The one caveat to this strategy is that under current law at death each individual receives a step-up in cost basis. This implies that any taxable position with a significant gain would be reset to a tax cost that matches the market value at date of death. Therefore, any heirs that inherit the large position will essentially inherit the position tax-free.

Those are a few thoughts on what to do with a concentrated stock position. Each situation is unique, and it is best to consult with a financial advisor about your specific considerations, but hopefully this provides a foundation for where to start. If any questions arise or you would like an opinion as to what makes sense for your situation, please do not hesitate to contact a Legacy Trust advisor.

Source: FactSet Research Systems