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- **Concentrated positions make a portfolio susceptible to more risks, in our view.**
- **We believe diversification can help protect wealth.**
- **In our opinion, emotional attachment to a stock leads to irrational investment behavior.**

## Control What You Can

### OVERSIZED POSITIONS MIGHT BE AS RISKY TO AN INVESTMENT PORTFOLIO AS COVID-19

The COVID-19 pandemic continues to disrupt financial markets around the world as investors try to quantify the economic impacts from this virus. However, modeling the potential impact is extremely difficult since there are few comparable pandemic examples and none with the kind of aggressive monetary and fiscal response that has been applied to COVID-19. We have offered our current thinking in our recent weeklies. This week, while many investors will continue to be laser-focused on virus statistics and epidemiology, we believe now is a good time to focus on risk management measures that don't require modeling or forecasting.

**In our opinion, it's a great time to focus on concentrated positions.** These positions are disproportionately large and are typically long-time holdings that are loaded with various emotional attachments and tax implications. Specifically, we believe there are three reasons why now is a good time to focus on concentration issues:

1. Bear markets remind us of the dangers posed by concentrated positions. Unfortunately, many investors might already be experiencing the risks of these large positions, as traditionally stable blue-chip favorites such as Boeing (BA) and Exxon Mobil (XOM) have wreaked havoc on retirement portfolios.
2. The recent drawdown has reduced the capital gain "tax bill." Investors are typically hesitant to reduce a concentrated position due to the tax consequences. This volatile environment reminds us that taxes should be a secondary consideration.
3. The risk management steps for addressing concentration issues are more straightforward than protecting a portfolio from the COVID-19 pandemic. We believe investors should start with the lower hanging fruit for making investment portfolios more resilient in this time of volatility.

We strongly believe in the importance of a financial plan that is tailored to meet investment goals. Because this planning is so valuable, it's important that the implementation isn't overshadowed by the potentially negative effects of concentrated positions. In our opinion, concentrated positions present one of the biggest obstacles to achieving investors' long-term goals. Meanwhile, we believe diversification is an effective method for achieving goals and protecting wealth.

**How we define a concentrated position?** The term "concentrated position" could mean different things to different people. Some consider a highly concentrated position as being 10% or more of an overall account. We define concentration as any single position that is three times larger than the average position in a portfolio (our definition does not apply to mutual funds, exchange-traded funds [ETFs] or other diversified investment vehicles). Concentrated positions can end up in a portfolio for many different reasons: they can come from a successful investment; they can be inherited from a parent or

grandparent; or they can represent a percentage of ownership in a current or former employer.

These positions generally have three things in common:

1. *Accumulated at low prices over a long time period:* As a concentrated position generates superior returns, it becomes a larger part of a portfolio. Then, given the low cost-basis, many investors choose to ignore the risks related to the concentrated position because they dislike the idea of paying taxes on their gains.
2. *Preferential Treatment:* Because concentrated positions can result from a successful investment, many investors treat these holdings differently than everything else in their portfolio. If you've been to a casino, consider the gambler that doubles their money and is now playing with his or her "winnings." Unfortunately, they don't always consider their next losing bet as an actual loss. Instead, they fall prey to a mental accounting trap of thinking they've just "won less" and fail to recognize the destruction of wealth.
3. *Loaded with emotional attachments:* Concentrated positions might have been inherited from a loved one or accumulated through a storied career at a public company. Because of loyalty to a former employer or trusted family member, investors can be reluctant to sell. However, it's our belief that diversifying a concentrated stock position might be a better way to maintain their legacy.

**Concentrated positions can make portfolios more susceptible to "lightning strikes":** A concentrated position can be like a tall tree in a lightning storm. We believe that the more a single position stands out from the rest of the portfolio, the greater the portfolio's chance of being struck. It is for this reason that institutional investors, such as pension funds and endowments, might put limits on the maximum size of an individual position in their portfolio. While we can sympathize with an investor's sentimental attachments or their desire to minimize a tax bill, we also worry that these justifications could potentially lead to investment behavior that is overly risky.

**Concentrated positions in the stock of one's employer can be dangerous, in our view.** We invest for many reasons, but one of the primary objectives is to protect against an uncertain future. The COVID-19 outbreak is a reminder of how quickly "lightning can strike from a clear blue sky." Luckily, a properly structured investment portfolio can act as an income supplement during periods of lower wages or unemployment. For this reason, we think a concentrated position in the stock of an employer is especially dangerous. Typically, the performance of a company's stock price is strongly correlated to the job security of that company's employees. During periods when job security is low and compensation most under pressure, an investor with a portfolio dominated by the stock of their employer will likely find their financial hardships exacerbated. We generally recommend reducing employer stock once it vests.

**Government policies and tax code are temporary.** There is a threat that the current tax environment could become significantly less favorable. With the recent fiscal stimulus package to combat COVID-19, the federal budget deficit has continued to expand. Eventually, the government will need to find creative ways to generate additional tax revenue down the road. In other words, the current maximum capital gains tax rate of 20% might be a gift with an expiration date. Thus, the taxes saved by deferring a capital gain today could be more than offset by significantly higher tax rates tomorrow.

## Ways to Mitigate the Risks of Concentrated Positions

**Diversification can help protect wealth:** In our view, investors who ask their financial advisors to manage around a concentrated position are making a choice to hold a potentially inferior portfolio. Should a concentrated position underperform, it becomes more difficult to execute a well-devised investment plan, especially for those investors who regularly rely on withdrawals from their portfolio to supplement their income. In the case of a declining concentrated position, an investor who takes systematic withdrawals will be increasingly forced to liquidate the

healthier portions of their account to compensate for the decline of their concentrated position. Diversification can help mitigate the drawdown risk of an individual company.

**Charitable Opportunities:** Investors with philanthropic intentions can transfer a concentrated position, especially one with a low cost-basis, directly to a charitable organization, or into what's called a Charitable Remainder Trust. This process preserves the market value of the stock and avoids the payment of large capital gain taxes, allowing a larger contribution to the charitable beneficiary. Furthermore, the trust can be structured to provide an income stream to the donor as well as an immediate tax deduction. It's important to note that the donor cannot reverse the transfer once complete.

**Working with a trusted advisor can help:** As we've seen over the last few years, the fortunes of major "blue-chip" companies can change rapidly in today's dynamic investment environment. According to a 2017 publication by Credit Suisse, the average company listed on the S&P 500 is less than 20-years old, which represents a significant decline from the 60-year old average in the 1950s. While the cause of shortening corporate life-spans can be disputed (technology disruption, acquisition, etc.), the conclusion that companies die more quickly today is what is important. To investors, we think this means two things. First, it is not prudent to buy a stock and forget about it. In a world where companies do not endure like they used to, the necessity of risk management has become increasingly important. Second, since it is difficult to predict which companies will endure and which won't, investors should diversify more today than they may have in the past.

For these reasons, we encourage investors to speak with a financial professional. A trusted advisor can offer an unbiased opinion of the concentrated position, as well as more detailed options for mitigating the risks, especially for those stocks with a low cost-basis. Whether it is some portfolio protection from COVID-19, or the concentrated position risks outlined above, we believe diversification and a well-executed financial plan are the best tools for maintaining (and growing) wealth.

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*You cannot invest directly in an index.*

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