Too much concentration?

Despite the proven risk-reducing benefits of diversification, many portfolios are underdiversified. A concentrated stock position is natural for the founder of a company, or for executives who are expected to own stock to keep their interests aligned with shareholders'. Inheritance and exercise of stock options also can lead to concentration in too few stocks.

A portfolio dominated by a single asset is risky. But one may recognize the risk of a concentrated position and still be unwilling to take action. The tax costs of diversification are real, and they can be a deterrent to sound investment management. An owner may need to keep shares to retain voting control, or because of "company politics." Finally, there is often an emotional attachment to stock that has played an important role in establishing financial success.

Look for the warning signs

When is a position concentrated? No single definition is appropriate, but, generally, if much more than 10% of your net worth is tied to a single company, caution is needed. You may need to become concerned about a concentrated stock position when:

• The stock has outperformed the market significantly. Few stocks can go up indefinitely.

• The stock has started to lag the market. Could this signal the start of an extended period of underperformance?

• You plan to retire within ten years. Large positions need to be unwound in an orderly fashion over time for optimum results

Consider these strategies

When you've concluded that it's time to do something about a concentrated stock position, consider these alternatives.

Use derivatives to control risk. A number of techniques are available to guard against substantial loss in value of a concentrated stock position. You'll need professional guidance in this area.

Begin selling gradually over time. The current low tax rates on long-term capital gains may represent a historic opportunity to convert some of your shares to cash with a minimum tax drag. Sales can be handled in an orderly fashion—for example, a sale of a certain number of shares each month or each quarter. If the shares were purchased over a long period of time, sell those with the highest cost basis first. If taxable losses have been incurred in other parts of the portfolio, they may be used to reduce further the tax costs of diversifying the concentrated position.

Exit on a tax-favored basis with a charitable remainder trust. You can meet multiple planning objectives with a charitable trust. Major philanthropic goals can be met, even as an income is reserved for yourself or other beneficiaries. Income tax deductions are available upon funding the trust, and all capital gains taxes are avoided. Potential death taxes (estate or inheritance taxes) are reduced as well.

Questions

Do you have a concentrated stock position? Is the position large enough to justify the costs of hedging? Could you diversify simply by investing new money in other securities? If any of these questions come to mind, consider speaking with an investment professional about your current holdings.

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