Get that Elephant out of the Room – Diversify!

What should an investor do when there is one very large elephant squatting in his or her portfolio? The answer is similar to the advice on how to eat an elephant….take it one bite at a time.

A concentrated stock position in an investment portfolio can be the result of any number of situations: employment by a company which has provided generous stock options; inherited wealth; or a successful investment which has multiplied through stock splits, among other sources. And like a rogue elephant, a concentrated stock position can be blamed for bullheadedness and irrational behavior by the portfolio owner.

The reasons investors typically give for reluctance to address concentrated positions typically fall into one of two categories: tax liability and emotional attachment.

Selling a large position in one stock *outside of a non-taxable retirement account* will have tax implications. But there are three considerations for an investor when this resistance point looms:

- Is it likely that the concentrated stock position might drop lower than the tax that might be incurred if it were sold;
- Where is the capital gains tax rate likely to be if the investor delays selling the stock (it's currently at 15 percent, an historic low); and
- Could the resources tied up in the concentrated position be invested more profitably?

Retaining the concentrated position merely delays the inevitable: It's not a question of eliminating the capital gains liability, it's a question of when does the investor want to pay the tax? Given the current political and economic conditions, it's likely that the United States government will, under the next administration, adjust tax rates to meet financial obligations. The present is as good a time as this country has known since 1933 to face the capital gains tax and address that elephant.

The retention of a concentrated position also can carry more risk than just a capital loss: it also carries the risk of lost opportunity. In today's terms, those employees of Enron and WorldCom who had large holdings of company stock lost more than just the stock value – they lost the opportunity to diversify their holdings and reinforce their financial foundation. Bill and Melinda Gates understand that risk: they have directed their foundation's investment committee to diversify their foundation's holdings across a broad range of investment vehicles, with an ultimate goal of having holdings in all major sectors of the global economy. The Gates want to ensure, as best anyone can, that their Foundation will be around for a very long time to continue its benevolent work. That couldn't be accomplished with concentrated positions of Microsoft or Berkshire Hathaway stocks.

Over-attachment to a stock is another behavior that needs intervention. As Joan Crawford said, “Love is a fire. But whether it is going to warm your heart or burn down your house, you never can tell.” The same is true of the love of a single stock holding. Some view the paring of a stock position as an act of disloyalty, particularly in the case of an employee who has prospered by virtue of service to a company. Team members can sell a stock without jeopardizing the well-being of the team. And no matter how many shares an employee does or doesn’t hold, the bottom line is that their financial well-being will remain tied to their company because of the many other standards for a company’s health: like bonus plans, salaries, pensions, 401K matches, and deferred compensation plans.

What constitutes a concentrated position of stock in a portfolio? The definition varies, with ranges of 15-25 percent identified as the point at which red flags arise. Even a holding that approaches the double-digit mark can trigger an emotional response which in turn generates irrationality when volatility occurs.

It’s always better to be proactive than reactive. Be that investor who addresses the elephant while it’s simply sitting in the room rather than moving or even rampaging. There are several strategies for diversifying a concentrated position. Establish a diversification strategy inclusive of all tax considerations. Take the time necessary to address all issues the stock sale could generate. You’ll sleep much better when the elephant is out of your room.

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