



# Sigma Summaries

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## Concentrated Positions (Top 10 Excuses Why I Can't Sell My Stock)

For many investors, it is not uncommon that a particular stock grows to such size that it dwarfs the value of other investments held within a portfolio. For some, this may be deliberate. For others, it may be by chance. Regardless of the rationale, there are potentially significant financial and estate planning issues that may arise given the existence of a concentrated position within one's portfolio.

There are no clear-cut rules on what defines a concentrated position. For example, if a single investment represented 50 percent of one's net worth, most individuals would consider this a concentrated position. A question that might be raised, however, is what about 40 percent, 20 percent, 10 percent or less? The answer depends on the quality of the investment. The circumstances are clearly different for a concentrated holding represented by an attractive parcel of property, or an investment grade bond, versus an investment in a speculative stock.

So, while it may be difficult to quantify a value that constitutes a concentrated position, particular attention should be placed on any investment where a change in its market value would have a discernable impact on the value of the

overall portfolio. Within the context of an equity portfolio, this percentage may be as low as 5 or 10 percent. Particular attention should be paid to such positions if the investor is depending on such an asset at least maintaining or even rising in value to meet his or her current or future financial needs.

Despite the risks inherent in owning an investment whose value is of such size that its future performance can have an unusually large impact on the overall portfolio, Sigma has found a considerable amount of inertia that keeps many investors from diversifying these investments. Following is a top 10 list of excuses for maintaining such positions, along with creative strategies to deal with the issues embodied in these reasons.

### **Excuse #10: I didn't know!**

Often, an investment may quietly appreciate in value without a lot of fanfare or attention. Perhaps an investor owns 100 shares of stock valued at \$50 per share. If the shares split 2 for 1 five times over an extended period of time, 100 shares turns into 3,200 shares with no added investment. If the value of the stock is worth \$50 per share following the multiple splits, the initial \$5,000 investment is now worth \$160,000. This is a classic example of how a

relatively small investment can become a concentrated position over time.

Another example involves company stock. For many long-term employees of publicly traded companies, it is not uncommon to own company stock within retirement plans. In addition, these employees may have been granted restricted stock and stock options. As stock options are often worthless at the time of the grant and the stock cannot be sold without the passage of time, the initial value of these awards is quite small but can increase substantially over time given a steady increase in the value of the underlying stock. Examined independently, the value that an employee may have in company stock may appear insignificant but in aggregate, may represent a substantial portion of one's net worth.

### **Response:**

We believe investors should take an annual inventory of their assets. They should know what "bets" they are making in their portfolio by virtue of not only what they own, but also how much they own of each investment. This provides the opportunity to either reaffirm the appropriateness of these "bets" or make necessary changes.

**Excuse #9: If it ain't broke, why fix it?**

For other investors, there is full understanding of what they own and the fact that a particular investment represents a large weight within their portfolios is of no concern. Rather than locking in gains, the investor is content with the investment returns, however large or small, and does not feel compelled to make a change unless there is convincing evidence to do so.

**Response:**

It is sometimes difficult to argue with such logic. However, a stock need not be "broken" to lock in gains and diversify one's holdings. Moreover, at the first sign that a stock may truly be "broken", the value of the shares has probably already corrected by a sizable amount. Given the near impossible task of predicting when these occurrences are likely to happen, a structured program to whittle down over-weighted positions may be in order even when there is no evidence that something may be amiss.

**Excuse #8: I'm on a roll!**

In rare circumstances, an individual may make a modest investment that exceeds all expectations and quickly represents a sizable portion of one's portfolio. Emotion overtakes objectivity and the underlying assumption is that this positive momentum is likely to continue.

**Response:**

All too often, investors fall in love with their investments and are lulled into a false sense of security with stocks that are rising in price. While the stock is heading in an upward direction, there is often a tendency to resist selling the stock under the

belief that the stock will continue to appreciate in value indefinitely.

Unfortunately, nothing goes up forever. The act of locking in some of the gain while the stock is appreciating protects the portfolio in the event that the stock reverses. There is an often-quoted phrase in the investment arena that "bulls and bears make money, pigs get slaughtered." The key is to remain objective in one's decision making and not allow greed to replace sound investment advice and strategy.

**Excuse #7: I can't afford to pay the taxes.**

Many investors are reluctant to sell a highly concentrated investment given their desire to avoid the tax due on the sale. Typically, the cost basis of these investments is quite low so a substantial portion of the investment may be subject to tax.

**Response:**

There are a number of strategies that may be employed to reduce this tax. For example, if losses exist elsewhere in the portfolio, they may be harvested to offset the gain. In addition, if the individual is accustomed to making charitable gifts, the gift of appreciated securities may be preferred versus gifts of cash. In the case of an investor who inherited a portfolio with a concentrated position, these assets may be eligible for a step up in the cost basis upon the death of the original owner and the concentrated position can be diversified without tax consequences.

In circumstances where taxes must be paid, consideration should be given to the alternative investment.

If a concentrated investment is growing at 7 percent per year and an alternative investment has the potential of growing at 10 percent per year, it does not take many years for the alternative investment to more than make up the tax liability on the sale of the original investment. Even if the alternative investment does not show a higher return than the original investment, there is often value in diversifying the portfolio to achieve another end, which may be to reduce the overall risk profile of the portfolio. The payment of taxes should be built into the cost of doing business.

One final thought regarding taxes is that investors may find it useful to view the payment of taxes as a confirmation that they own a successful investment rather than a penalty to be avoided at all costs. If one thinks back to the inflated values of equities in March of 2000 and compares those values to today's, how many investors would gladly jump at the chance to go back in time and sell a few of their select investments at the peak?

**Excuse #6: I have faith in the company.**

Often, a concentrated position may reflect company stock or simply, a company that has served the investor well over the years, garnering a high level of respect and loyalty. In these circumstances, there is a tendency to believe that by selling a portion of one's holdings, this represents a bet against the company.

**Response:**

It is important to remember that selling stock to diversify one's risk is not an indictment of management or indicative of a lack in confidence

in the company's outlook. In fact, if there was a true concern regarding a company's outlook, one should sell the entire investment. By selling only a portion of the stock, there is every motivation to want the remaining shares to perform well.

**Excuse #5: It's been in the family for years.**

In some circumstances, a large investment becomes part of the family. Typically, the investment is acquired by the matriarch or patriarch of the family and has been handed down throughout generations. When stocks are passed down from one generation to the next, family lore and tradition may induce holding the stock, sometimes at any cost.

**Response:**

A more constructive strategy is to evaluate the fundamental attractiveness of the stock. Assuming the stock is fundamentally sound, determine how many shares should be held for the benefit of each beneficiary. Moreover, if there is a desire to hold additional shares for emotional reasons, segregate that stock from the lot. With the remaining shares, establish an appropriate exit strategy based on the underlying fundamentals and valuation.

**Excuse #4: It's the only stock I really know.**

Investing in stocks can be a mystery for many, particularly in stocks that are not well understood. For this reason, individuals often like to invest in stocks that they know. In fact, this advice was reinforced in a book written by legendary investor Peter Lynch. If this stock is a concentrated position, it has

probably been held in a portfolio for many years and it may be well understood following years of reading the annual report, listening to management, etc.

**Response:**

In principal, I like this idea. If you have a consistently positive experience buying a product or using a service, chances are other consumers feel likewise and the company providing these goods or services may represent attractive investments. Moreover, if the individual was employed at the company, there may be a high level of comfort with management as well as an insider's view of the fundamentals of the company.

Clearly, it is often difficult to replicate the "feel good" aspect of owning such stocks. Yet history is full of examples of fallen angels, stocks that once provided this sense of comfort and security yet have disappointed investors. Examples include AT&T, Toys R US and Kodak, to name a few.

Hence, investors would be well advised to complement their "knowledge of" and "comfort with" experiences with a healthy dose of fundamental analysis. If a stock becomes overvalued or if fundamentals begin to deteriorate, the stock may be hard pressed to keep up with the broad market indices. Keep in mind that we are not mandating a complete elimination of the position but rather, consideration that it may be prudent to reduce one's exposure.

**Excuse #3: I will sell it after it peaks.**

We regularly hear investors suggest

that they will sell a stock when it begins to fall in price.

**Response:**

Not only is it nearly impossible to time the market with such precision, share price movements can be dramatic upon new information and an opportunity may be lost without proper preparation.

In addition, assuming that only a partial position is to be sold versus the entire investment, selling into strength may be more desirable than selling into weakness. Through proper planning, price targets can be established such that the decision on when to pull the trigger becomes less of an emotional event.

**Excuse #2: I will sell it after it reaches \$x.**

An investor may have a price target in mind in which to sell a highly concentrated stock. However, after a stock reaches the pre-determined price point, there may be a feeling of confidence that the stock is poised to repeat this success. As a result, the investor raises the price target but promises to lock in gains after reaching the higher price. This pattern may be repeated again and again without any reduction in the shares.

**Response:**

Every stock has a price. Particularly with concentrated positions, it is important to understand the value of the underlying company and establish sell targets. If a target price is reached, the stock should be sold. To minimize the emotional side of selling, investors may be well advised to establish limit orders with their advisors such that the stock is automatically sold when a price

target is reached. Of course, these limit orders should be regularly reviewed and adjusted as new information becomes available. The key, however, is to follow through with the plan.

**Excuse #1: I have such a gain; it would take a lot for me to lose my original investment.**

Consider a scenario where an individual invests a modest amount of money and over time, reaps rewards that are substantially greater than the original investment. There may be a lack of initiative to reduce the investment given the feeling that there is very little chance that the original investment is at risk.

**Response:**

This would be akin to the gambler who enters the casino with \$100 and parlays his chips into \$1,000 following several well-timed bets. As the gambler considers his next game of chance, he does not feel that he has \$1,000 at risk. Rather, he places his original investment of \$100 into his pocket and is now playing with the house's money. Moreover, given that he can't lose his original investment, his style of

gambling may become more aggressive.

While this behavior may be suitable for a recreational gambler, it is not the behavior well suited for an equity investor. At the beginning of each day, an investor should start with a clean slate. The value of each investment should be tallied, a review of the individual's investment goals should be noted, and decisions should be made based on achieving those objectives.

Similarly, assume an investor (Billy) owns \$1 million worth of stock in XYZ Company and this investment represents 50 percent of his net worth of \$2 million. While Billy did not set out to own \$1 million of XYZ, he may be comfortable holding onto the shares given his modest original investment.

Now let's assume that Billy has a twin brother named Joel. Joel is identical to Billy in every way except for the fact that Joel's \$2 million portfolio is 100 percent invested in cash. It would be unusual to think that Billy would recommend that Joel invest half of his portfolio in

XYZ. But by holding onto the \$1 million investment in XYZ himself, Billy is essentially making this "purchase" decision each and every day.

**Summary**

There are a variety of reasons why some investors may be reluctant to sell concentrated positions. Whatever the reasons, it is important to take an assessment of one's financial goals and determine the suitability of each investment within the portfolio. A decision to reduce or sell a concentrated position does not necessarily imply a loss of confidence in the underlying company. Rather, it is simply a process to rebalance a portfolio to meet the unique needs of the investor. A well thought out investment strategy should be sensitive to the quantitative and qualitative obstacles presented above, yet responsive to the investor's unique investment objectives.

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