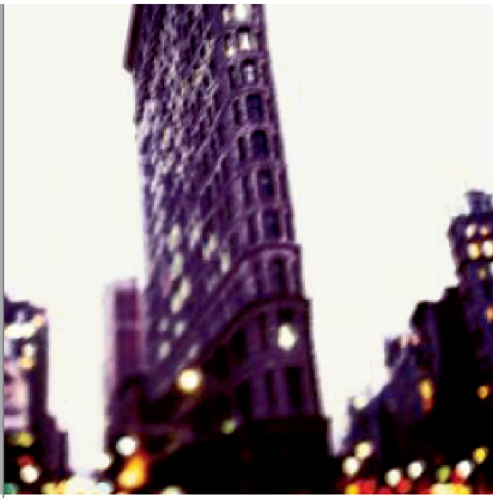
» STRATEGIC THINKING

Managing Equity-Concentration Risk

Today's Reduced Tax Rates and Lower Realized Gains May Make Now a Good Time to Diversify



Edward Munshower
Managing Director,
Director of Asset Management
Tailored Portfolio Group

There is a long-standing and widely held belief among investors that stocks purchased or acquired at a low cost basis should almost never be sold, on the grounds that selling may expose the investor to a tax liability that outweighs the benefits of diversification—but this isn't necessarily so. Over time, diversified exposure to the equity market can offer a better risk/return profile than concentrated positions in individual stocks. And with today's 15% federal long-term capital-gains tax rate—which may not be in place much longer—this may be an especially good time to consider diversifying out of long-term, concentrated equity holdings.

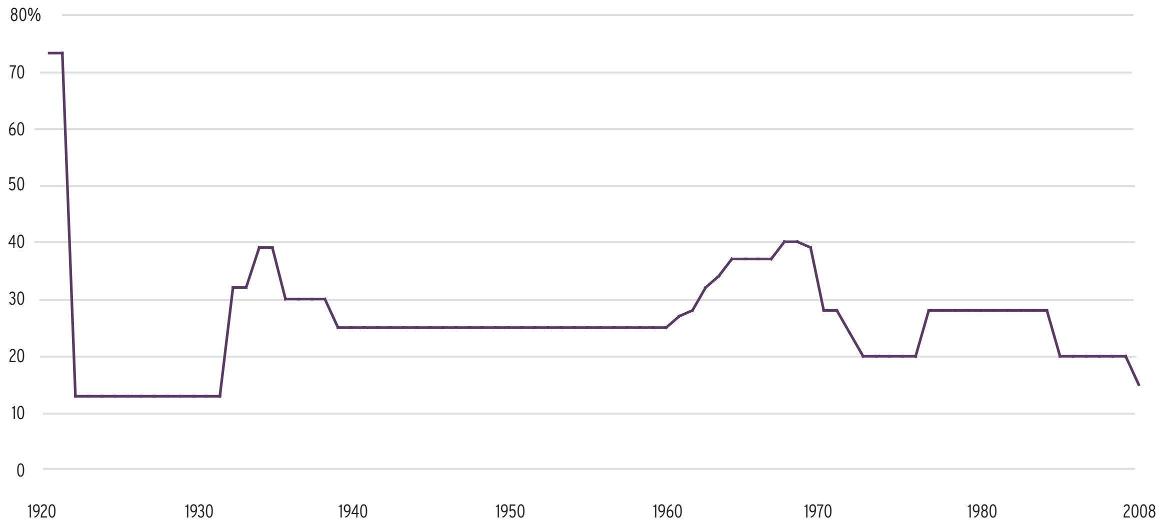
KEY TAKEAWAYS:

- » The current multigenerational low federal tax rate of 15% is scheduled to expire on Dec. 31, 2010, or sooner.
- » Holding a concentrated position introduces significant risks into a portfolio and leaves the investor vulnerable to significant loss of capital.
- » In any given year during the last 25 years, from 18% to 58% of individual stocks have underperformed Standard & Poor's 500 Index by 15% or more.
- » Maintaining a diversified portfolio allows greater potential for active management and tax efficiency.
- » Given the market sell-off in the past 12 months, it may be wise for investors who have large equity concentrations to take advantage of today's low tax costs and lower realized gains to achieve diversification.

Data Source: Tailored Portfolio Group

JUNE 2009

FIGURE 1: Historical Capital-Gains Rate (for high-income individuals)



Data Source: Citizens for Tax Justice

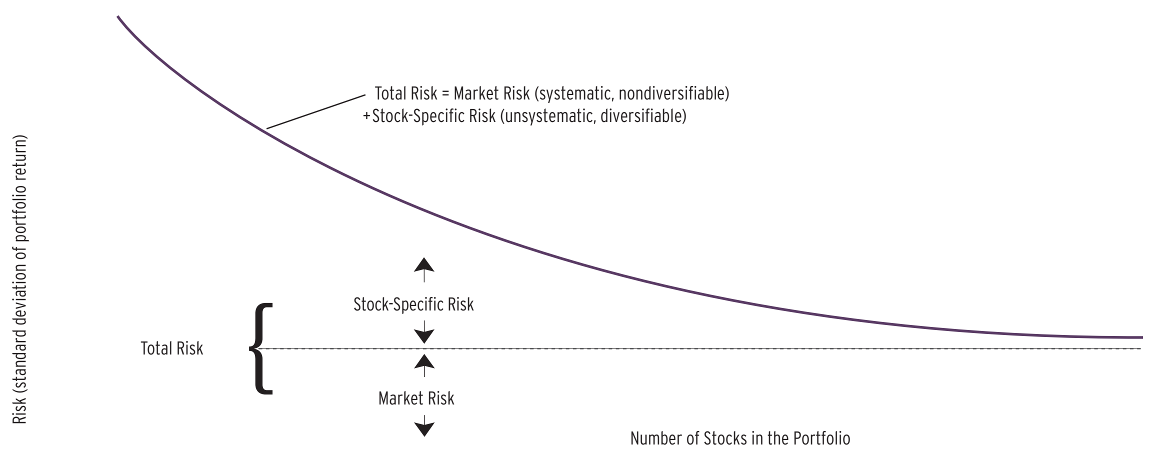
THE 15% WINDOW OF OPPORTUNITY

Right now, there is a window of opportunity for taking advantage of relatively low capital-gains rates because, though near their historical lows, they are subject to change. The current federal tax rate on long-term capital gains is 15%, a rate that hasn't been seen in nearly 70 years (see Figure 1). Unless Congress makes the tax cuts permanent, this 15% rate is scheduled to expire on Dec. 31, 2010. But it may not even last that long. We believe that considering the markets sell-off in the past 12 months and the current historically low capital-gains rates, it may be wise for many investors who have large equity concentrations to take advantage of today's low costs and lower realized gains to achieve diversification now.

REDUCING RISK THROUGH DIVERSIFICATION

Regardless of the tax rate, portfolio diversification makes more sense than portfolio concentration.

FIGURE 2: Two Types of Risk



Data Source: Tailored Portfolio Group

There is always some risk inherent in investing. Investors don't have to look too far for examples of high-profile "blow-ups"—events that clearly underscore the value of spreading that risk among multiple securities. Among Internet, telecommunications or even blue-chip stocks that saw severe value erosion between 2000 and 2003, the risk of suffering great losses was high for investors holding large, concentrated positions in almost any security. Indeed, even if the stock markets had merely cooled instead of going into a steep decline, statistical evidence is ample that investors who overly concentrated their holdings were more likely to have been hurt by market- or stock-specific events than investors who were diversified. Moreover, the long-term benefits of diversification will likely outweigh any one-time capital-gains tax cost.

To measure the value of equity diversification, it helps to have a good understanding of the risks associated with equity investing. A given stock's total risk can be divided into two components: market risk and stock-specific risk. Market risk stems from events that can have an impact on all stocks, such as the events of Sept. 11, 2001, which pulled down virtually the entire market. Stock-specific risk is unique to a particular stock, such as the failure of a pharmaceutical firm to get FDA approval for one of its new drugs. Overly concentrated holdings are much more likely to be at the mercy of the risks inherent in those specific stocks.

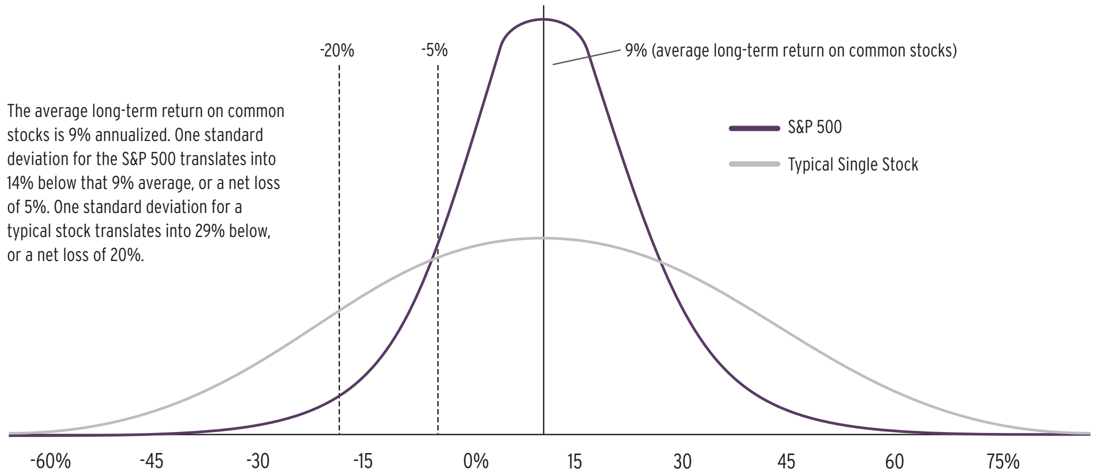
Diversification is the best way to reduce stock-specific risk. Figure 2 (on previous page) indicates that as more stocks are added to a portfolio, the total risk of the portfolio falls until it approaches the baseline-market risk. The "typical single stock" corresponds to the stock in the S&P 500 that exhibits the median volatility in Northfield's model. Our analysis leads us to believe that, typically, 25 to 30 stocks are needed to achieve a portfolio that is diversified enough to minimize stock-specific risk. This risk reduction results from the fact that individual stock returns are not perfectly correlated (i.e., don't move together).

TWICE THE RISK

Risk is often expressed using a statistical term known as standard deviation. Standard deviation measures the extent to which returns can deviate—both up and down—from the expected average. As Figure 3 shows, the total risk of a typical single stock in the S&P 500 is approximately 29%, whereas the total risk of a diversified portfolio (in this example, the S&P 500) is about 14%. What this means is that a single stock in the S&P 500 can be expected to return somewhere between 29% per year above or below its expected annual return approximately two-thirds of the time, while the entire S&P 500 would be expected to return somewhere between 14% above or below its expected return two-thirds of the time. As more securities with returns that are not perfectly correlated to each other are added to a portfolio, the overall risk of that portfolio can be reduced. The implication is that a diversified portfolio would be expected to preserve capital more effectively over a longer time frame. In other words, it would be less likely to experience a "blow-up."

An investor who voluntarily holds onto a concentrated position generally does so because he or she believes that this particular stock will significantly outperform the market over the long term. Unfortunately, an analysis of returns for S&P 500 stocks over the last 20 years indicates that, on average, only one in ten of these stocks has been able to consistently outperform the index over any given three-year period. Under these circumstances, it would be unrealistic to believe that the investor holding a single stock can indefinitely continue to generate a long-term return greater than that of the market.

FIGURE 3: Distribution of Returns



Data Source: Tailored Portfolio Group, Northfield 2008

Vertical axis measures frequency; horizontal axis measures return.

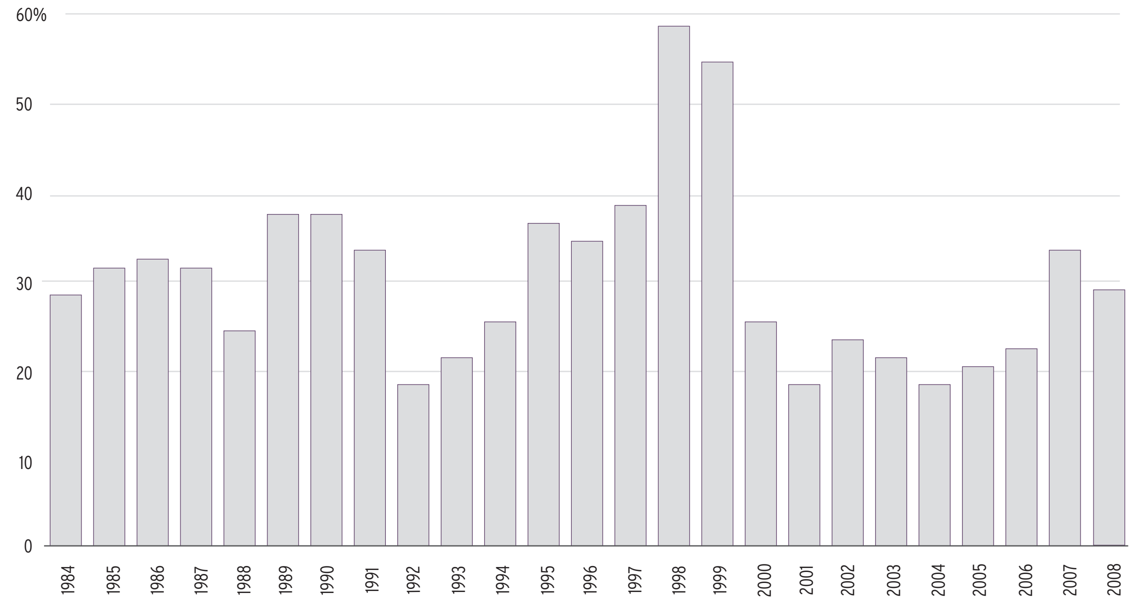
OVERCOMING THE TAX HURDLE

What does all this have to do with capital gains? As an investor today, you have a choice between holding on to a concentrated position or diversifying your portfolio and paying 15% tax on any capital gains. An analysis of returns for S&P 500 stocks across 25 years indicates that, on average, about one out of three stocks in the S&P 500 underperformed the overall market by 15% or more in any given year. See Figure 4 (on the next page). When looked at this way, today's 15% rate (plus a possible state tax) is an important factor in determining whether and when to diversify.

ADDING VALUE TO A PORTFOLIO

Aside from reducing risk, a larger and more diversified portfolio provides greater opportunity to add value through both active stock selection and active tax management. Active stock selection can

FIGURE 4: Percentage of Stocks in the S&P 500 That Underperformed the S&P by 15% or More During a Given Year



Data Source: Tailored Portfolio Group Quantitative Analytics

be used to take advantage of available information and to differentiate between those securities that are expected to add or detract value. In those cases where market-price movements have been negative, or where active stock selection has not resulted in gains, losses generated can be used to offset other gains within the portfolio, thus leading to greater tax efficiency and more attractively valued securities in the portfolio. Losses not used in one calendar year can be carried forward and used to offset realized gains in subsequent years. Furthermore, if an investor were to have any gains or losses in assets managed outside the actively managed portfolio, those gains or losses could also be used to offset any gains or losses realized in the investor's actively managed portfolio. When designed appropriately, the joining together of active stock selection and active tax management in a diversified portfolio should result in greater after-tax returns in the portfolio going forward.

It is always difficult for investors to change their behavior, even when the advantages are obvious. However, given the possible limited window of opportunity available, it may make sense to reduce concentrated positions now, pay the taxes today and reinvest the balance in a well-diversified portfolio. Investors are being offered a multigenerational opportunity to take advantage of relatively low capital-gains rates that are not guaranteed to continue. These low rates enable investors to achieve diversification at a much lower cost. Holding a concentrated position introduces significant risks into a portfolio and can leave the investor vulnerable to a significant loss of capital, while maintaining a diversified portfolio allows greater potential for active management and tax efficiency. ■

PBG 965

08/09 1801 539639