

Understanding the risk associated with concentrated stock

The unfathomable collapse of the iconic Bear Stearns, the country's 5th largest investment bank, dramatically shows the danger of having all of your eggs in one basket. On Monday, March 17, 2008 thousands of employees saw nearly their entire net worth disappear over the weekend because it consisted of one class of asset—their company's stock. The collapse of Bear Stearns was horrendously quick and very painful for employees, who owned approximately one-third of the firm. Having a highly concentrated equity position in one's company stock is not that unusual. The question is: are there ways to protect yourself from the dangers of lack of diversification? Fortunately, the answer is yes. Unfortunately, the solutions seem and sometimes are very complicated and sophisticated.

Public company executives are at greatest risk.

Executives of public companies represent the largest segment of shareholders with concentrated stock. By our definition, any one position that represents more than 20% of a portfolio is considered a **concentrated** position. The ultimate dilemma for the executive is contemplating "should I sell and lose up to 25% of my value in taxes, or hold the stock and continue bearing the single stock risk?" The executive who holds a large percentage of stock in the company where they work exposes them to not only the concentration of their stock, but also the uncertainty of future employment, if the company goes through a significant downturn. We will examine this risk/reward imbalance of holding a single stock.

Reasons why executives own concentrated stock.

- Research has found that the number-one reason executives hold concentrated stock is through the issuance of stock grants or options as part of their compensation; i.e., equity compensation. As corporations have become more profitable, their desire to reward top performers in the company increases. The tax treatment for grants and options vary based on several factors including certain restrictions placed on the grant or option.
- Research also indicates there are powerful psychological reasons why executives hold on to concentrated stock.

Loyalty - As an employee of the company, selling company stock may be perceived as a lack of confidence in the future of the company.

Future Appreciation - The executive feels the stock has done well in the past, and as an upper-management employee they have a good idea of when to sell.

Tax Avoidance - By not selling, the executive feels they save \$1,000's in taxes to the IRS. Therefore, by holding a concentrated stock they avoid parting with money that otherwise would have gone to the IRS.

The Risk/Reward Myth

One of the greatest ways to build substantial wealth is by buying/holding a single stock. \$1 million invested in Target (TGT) in 1988 would today be worth around \$16 million. The same invested in Medtronic (MDT) would be worth \$35 million, while investing \$1 million into Best Buy (BBY) would currently be worth over \$120 million. However, virtually no stock is immune to downturns. The last significant bear market was March of 2000 through September 2002.

Former Stanford Business Professor Jim Collins looked at every stock listed on the New York Stock Exchange to find companies that were “sustainably great”. They defined “sustainably great” as companies that outperformed their peer group for at least fifteen years. Out of all the stocks on the New York Stock Exchange, he found eleven.¹

Below is Fortune Magazine’s “Top 10 Most Admired Companies” for the year 2000 with their 2 ½ year stock performance following the article.

<u>Company</u>	<u>Total Return 3-31-00/9-30-02</u>
Lucent	-98%
Cisco	-86%
Intel	-79%
Home Depot	-59%
Microsoft	-59%
Dell	-56%
General Electric	-50%
Wal-Mart	-12%
Southwest Airlines	-6%
Berkshire Hathaway	29%

*Source: Fact Set, Fortune, Standard and Poor’s

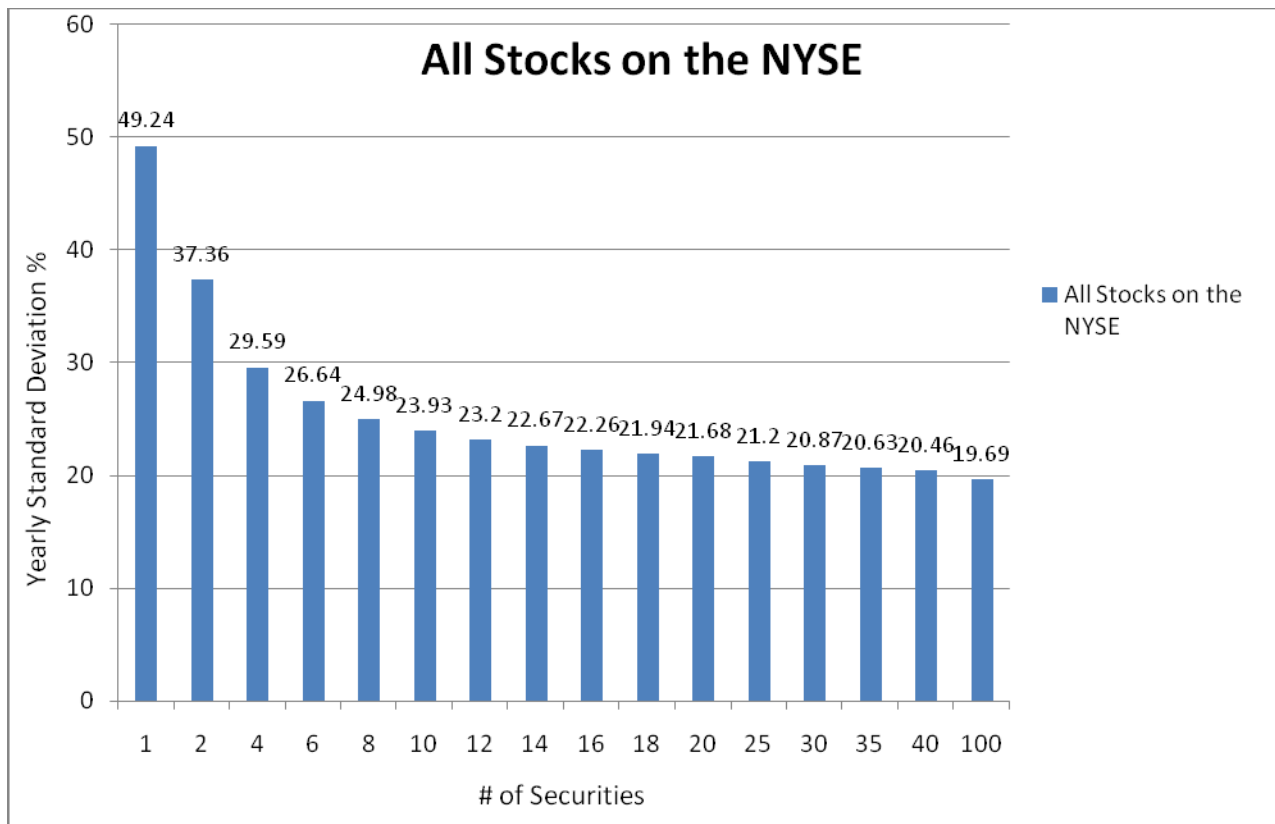
Only Berkshire Hathaway had a positive return during this period, and seven of the ten lost more than half their value. Dramatic losses like those are not isolated only to market conditions but occur for a whole host of other reasons, such as over-expansion, poor management, new competition, or simply diversifying at the wrong time.

¹ Jim Collins, Good-To-Great, HarperCollins (1st ed. 2001)

Systematic Risk vs. Unique Risk

Is it possible to eliminate over 50% of the risk in a portfolio while not giving up any of the returns? Understanding compensated risk (market risk) and uncompensated risk (diversifiable risk) allows us to accomplish the aforementioned.

When an investor invests in stocks versus bonds, the expected return is greater because of the equity risk premium that compensates the investor for bearing the risk of the stock market. However, diversifiable risk can result in large gains or large losses. The difference between market risk and diversifiable risk is that the investor is compensated for bearing the market risk, while the additional return for bearing diversifiable risk is zero. Therefore, investors are not compensated with higher-expected returns by holding a concentrated position, because this risk can be diversified.



Source: [Wikipedia](#)

As shown on the above graph, adding 1 stock reduces the standard deviation (σ) from 49.24 to 37.36 (24%). Having 8 stocks from 1 stock reduces the σ from 49.24 to 24.98 (49%) and by having 100 stocks the portfolio's σ is reduced to 19.69 - a drop of over 60%.

Therefore, when the securities are pooled together, the returns to the portfolio vary less than the returns to the individual securities, because the below-average returns on *some* securities are offset by the above-average returns on others. Moreover, research has shown that the average stock tends to lag the market, and the more volatile the stock the lower the expected growth. The reason for this is that the index contains a handful of really great performers that skew the returns; therefore the average stock returns less than the market. From 1984-2003, only 6% of the stocks in the S&P 500 beat the index by more than 5% a year, but 27% underperformed by 5% or more per year. Historically, the upside of a single stock pales in comparison to the downside risk.

Tax Avoidance

Minimizing taxes is a worthy objective, but should never be allowed to override a prudent risk management strategy. The maximum federal tax on long-term capital gains is currently at 15%. With a single stock worth \$10 million with a low cost basis, paying \$1,500,000 to Uncle Sam appears to be daunting on an absolute basis, but is still only 15%. Remember that the 15% federal capital gain is set to expire on January 1, 2011, and is scheduled to go up to 20%, a number that ultimately could go higher.

In summary, by holding a large position in a concentrated stock, the investor is subjecting themselves to substantial risk (uncompensated) without additional return potential. Many executives could have 50% or more of their net worth tied up in company stock.

The dramatic example of Bear Stearns should serve as a constant reminder of the importance for corporate executives to protect and insure one of their most valuable assets. We protect our lives, homes, cars, boats, etc.; shouldn't company stock be looked at in the same way?

Dan Langworthy is the founder and president of Executive Capital, LLC, an investment firm working exclusively with Executives of public companies. Securities offered through LPL Financial, Member FINRA/SIPC