Tax Aware

Are Completion Portfolios Effective for Managing Concentrated Stock Risk?

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This study investigates the most effective ways to manage the risk of concentrated stock positions. While the completion portfolio approach to hedging the risk of concentrated stock appears conceptually sound, the empirical evidence shows that it offers limited practical risk-reduction benefits. The risk of concentrated holdings is dominated by the stock-specific component, which cannot be hedged with unrelated stocks. We find that simple sector-exclusion completion portfolios are generally ineffective as concentrated stock hedges. Optimized completion portfolios can hedge common-factor risk to a degree, especially when shorting is used. However, their overall impact on forecast risk is small, and on realized risk, negligible. Selling the concentrated position quickly and tax efficiently is the most effective risk-mitigation strategy. Tax-aware strategies, particularly tax-aware long-short strategies, can be highly valuable in this respect. The study concludes that investors and their advisors should temper their expectations about the risk-hedging ability of completion portfolios and prioritize the tax-aware aspect of the strategies to facilitate the tax-efficient liquidation of concentrated holdings.

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