TAX AWARE

# A 3-for-1 Solution for Concentrated Stock

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Becoming rich from holding a single stock is rare.[1] Staying rich that way is even rarer.[2]

A big reason for this is that individual stocks tend to be very volatile, and volatility can erode compounded returns.[3] For example, a stock that goes up 10% one year and down 10% the next loses a bit of money round-trip (-1%); but a stock that goes up 50% one year and down 50% the next loses much more (-25%). This so-called "volatility drag'[4] goes a long way toward explaining why even good companies can end up as a detriment to long-term wealth.

In theory, diversification is the simplest way to reduce the volatility drag because diversified portfolios have meaningfully less volatility than a single stock. However, in practice, diversification of concentrated stock is quite hard to achieve.

We probably all know investors with a large fraction of their wealth concentrated in a single stock. Their objections to diversifying some of that concentration risk may range from the behavioral ("why would I sell the company that made me rich") to the statutory ("I'm an insider of the company and am restricted in what I can do"). Another common objection is taxes: Selling highly appreciated stock entails a significant tax burden. And more important, after the stock is diversified, how should the proceeds be invested such that the resulting portfolio is not only diversified but also profitable?

Long/short tax-aware factor strategies may be of particular interest here.[5] As we've shown elsewhere, long/short strategies designed to generate pre-tax returns can also realize meaningful net capital losses if executed with an eye toward tax efficiency. This helpful "byproduct" of the investment process can provide the means to offset gains resulting from a transition from a concentrated stock to a diversified portfolio.

From an investment perspective, we think of this as a 3-for-1:

1. The ability to de-risk concentrated stock into a diversified portfolio,
2. the addition of active pre-tax returns (i.e., returns in excess of a passive index), and
3. potential ongoing tax benefits after the transition is complete

…all facilitated by a highly tax-efficient transition.

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[1] Stein et al (2000), Miller (2002), Boyle et al. (2004), and Bessembinder (2018).

[2] For example, Bessembinder (2018) shows that, during the 1926–2016 period, for all the 25,967 common stocks in the Center for Research in Securities Prices (CRSP) database, by far the most frequent one-decade buy-and-hold return is -100%. (Granted, Bessembinder rounds to the nearest 5% — but even a -97.5% cumulative return probably feels just as catastrophic as the full -100%.)

[3] This can be a big problem for buy-and-hold investors (such as holders of concentrated stock), less-so for strategies with regular rebalancing.

[4] Sometimes called "variance drain" or even "volatility tax."

[5] Another we've written about is the use of Variable Prepaid Forwards, where we also find a potential role for long/short factor strategies.

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