

Managing Concentrated Holdings

Whether you own shares of General Electric that your great grandfather began buying in the 1920's or you have been socking away shares in your employers' company for years, you understand very well that having wealth concentrated in one or two stocks carries with it enormous risk. Many studies as well as good old anecdotal evidence show that the odds for success improve significantly over time with diversification.

At some point, every investor whose wealth is concentrated in one or two stocks is forced to confront the agonizing decision of whether to sell that special holding or sit tight. Both alternatives present a dizzying array of potential consequences that can only be seen with certainty in retrospect. Aside from tax considerations, probably the most significant obstacle preventing investors from selling and diversifying the proceeds is psychological. It is very difficult to sell a stock that has created so much wealth. Many families have come to depend on the largess of certain legacy holdings to pay for college, weddings and even retirement. The emotional baggage associated with dumping a family jewel could last for generations.

In a study of individual S&P 500 stocks by the research firm Neuberger Berman, it was found that over a period of more than five years, 58% of individual stocks underperformed the overall index by at least 30%. Further studies show that over periods of at least ten years, diversified portfolios outperform individual stocks on average 84% of the time. With these probabilities at work, those that are still wealthy after owning one stock for many years are actually quite lucky. One need only imagine what employees of Enron or World Com wish they had done with their nest eggs.

Remedies for an overly concentrated portfolio range from relatively simple to very sophisticated strategies, depending on individual circumstances. Such strategies may include the use of call or put options for hedges or collars, exchange funds and several estate planning tools such as charitable remainder trusts or the formation of a Family Limited Partnership. The appropriate strategy will vary with tax and estate planning considerations and financial goals. A well-conceived and effective plan should unfold over a three to five year period to take full advantage of market cycles and tax periods.

If one or two stocks represent a large percentage of your retirement assets or your net worth and you haven't suffered as a result, consider yourself lucky.

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