

Too Much of a Good Thing

A look at the risks of owning large quantities of a single stock and the strategies to help reduce these risks

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In my wealth management practice I frequently encounter high net worth clients with large quantities of a single stock. These concentrated stock positions can be both a blessing and a curse for the investor.

Individuals accumulate large quantities of stock in a variety of ways. Many times they are employed by a company which grants stock options or restricted stock, which results in ownership of large quantities of that employer's stock. At times stock reinvestment programs, along with company stock ownership requirements, are also reasons for single stock concentrations. Finally, gifts and inheritances can also result in one stock dominating an investor's portfolio.

The upside of a large quantity of stock is the value it adds to the investor's net worth. The downside of a large concentration of stock is the potential threats associated with a single stock position. A single stock is inherently risky. Stock in a single company can suffer a decline in value due to specific events that may not impact the overall market, making a single stock more risky than the stock market as a whole. This is the basis for the concept of diversification – not putting all of your eggs in one basket. Business risks such as the speculative nature of an individual business, the management of a business, or the philosophy of the business can create risk specific to a company. Business risk can also be thought of as the uncertainty of income. In addition, a specific company can incur a variety of financial hazards, default threats, or regulatory issues that might harm the particular firm even if the overall market is rising. Many of these risks can be lessened by diversifying one's portfolio

Many people fail to realize the risks involved with one stock dominating their portfolio. They may have worked for a company for many years and cannot conceive of potential dangers in owning large amounts of their employer's stock. Alternatively, a certain stock may have been owned by the family for many years and have sentimental value. Even today, as stocks like Enron and Kmart have been punished by the market, people seem to believe that would never happen to "their" stock. No more than five to ten percent of an individual's net worth should consist of a single stock holding.

Statistically, because a single stock may be more volatile than a diversified portfolio of stocks, the compounding benefits of the stock will be limited even if the expected returns are equal. When comparing a single stock with a diversified portfolio of stocks, even if each possesses identical expected returns, the expected volatility, or standard deviation, in the returns of the single stock will be much greater. The result of a statistical distribution of returns will result in the diversified portfolio of stocks having a greater ending modal value, or most frequently occurring value, than the single stock.

Although selling the single stock and buying a diversified group of stocks may seem like a simple answer to this issue, there are many interrelated factors in determining the best course of action.

Aside from the emotional aspects of selling the single stock, there will likely be other financial issues that must be considered. The tax impact of the sale is most frequently the biggest investor concern. Ordinary income taxes, capital gains taxes or alternate minimum taxes due on the sale of the stock can complicate the decision. The key tax variable, the cost basis of the stock, is an important factor, as it will determine the gain on the stock sale. Specific investor circumstances such as tolerance for risk, interim cash requirements, and income needs can also impact the decision to diversify a single stock holding.

Fortunately, there are specific portfolio management strategies that can protect the investor's value of a concentrated stock position. One of the alternatives available to investors to protect the value of their stocks is through the use of options. Although many people associated the use of traded options as a high risk activity, used properly, options can reduce the risk associated with concentrated stock holding.

Options come in two basic varieties. A put option gives the owner the right to sell a stock at a certain price. A call option gives the owner the right to buy a stock at a certain price. Each option corresponds to an underlying security – an individual stock in this example.

Each option has a strike price (or exercise price) – the price at which the option can be exercised. For example, a put option with the strike price of \$45 means that if the stock price declines to \$40, the put option can be exercised at a financial gain because the option value is the difference between the \$45 dollar option strike price and the \$40 market price of the underlying stock.

As you can imagine, using a put option with the right to sell a stock at a certain price can be a big advantage when you own a large number of shares of a particular stock. You can buy put options to provide a “floor” price which allows an investor to limit any losses that may be incurred in the event there is a sudden decline in the stock price. View the strategy as buying portfolio insurance. Buying the put options is similar to buying insurance against the decline in the stock price. You pay for the right to sell the stock if the stock price declines to a point lower than the put option strike price. The strategy is commonly known as “buying a protective put.”

To expand the example above, if you own 20,000 shares of XYZ stock worth \$50 per share you have \$1,000,000 of value in that particular stock. You may be concerned that a sudden drop in the stock price, say from \$50 per share to \$40 per share, would cause your portfolio to decline by \$200,000, or 20%!

Buying put options with a strike price of \$45 limits your loss to \$100,000, since the options would gain value as the stock price declines below the strike price of \$45! It is

important to note that the cost of the put options would need to be considered as part of the strategy.

If the cost of buying the put options creates too much of a financial concern, a slightly more complex strategy can be used. To reduce, or even eliminate the cost of reducing the risk, the investor can combine the protective put with the sale of a call option.

As was mentioned earlier in this article, buying a call option gives the purchaser the right to buy the underlying stock at the exercise or strike price. An individual who owns a particular stock may choose to sell a call option. Selling a call option obligates the seller of the call option to deliver a particular stock to the call option buyer at a specific (strike) price. In this case, the owner of a stock receives a fee in return for guaranteeing that the stock will be delivered if the price reaches a certain level.

As an example, let's assume that someone owns a stock currently selling for \$50 per share. If they sell a call option at \$55 per share and the stock advances to \$60 per share, they would be obligated to deliver that stock to the buyer of the call option for the \$55 strike price, even though the stock is worth \$60 per share in the open market. The seller of the call would have received a fee for selling the call, but would give up any upside price potential of the stock over the strike price of the option.

Although this can be a very risky strategy if the underlying stock is not owned, when someone owns the underlying stock additional income can be earned by selling the right for someone to buy the stock at a certain price. Obviously, any stock price appreciation over the option strike price is lost as a result of the transaction.

Combining the sale of the call option with the purchase of a protective put option offsets the purchase cost of the put option with the additional income from selling the call option. In effect, the transaction limits the downside with the price "floor" created by the protective put, but also caps the upside price with the call strike price. A "collar" is created between the put price on the downside and the call price on the upside.

The collar strategy is a common way for investors with a large individual stock holding to limit their downside risk while recouping the cost of buying the protection (put option) by giving up some of the upside potential.

An example may better serve to explain the collar strategy. In the previous example an investor owns 20,000 shares of XYZ stock worth \$50 per share. To protect against a sudden drop in the stock price, let's assume the put option is purchased with a strike price of \$45. Let's further assume that the cost of that put option is \$1.50. To offset the cost of the put option, a call option is sold for \$1.50 at a strike price of \$55 per share. Now the investor has placed a "collar" around the underlying stock price – limiting the decline to \$45 per share but giving up any upside appreciation over \$55 per share. The cost of the put is offset by the income earned on the sale of the call option.

There are several other strategies that can be used to reduce the risk of a concentrated stock position such as prepaid variable forward contracts, exchange funds, or charitable remainder trusts, all of which are beyond the scope of this article.