

# Concentrated wealth, concentrated risk:

## A decision guide for when one asset dominates

As their wealth grows, many families gradually become overly concentrated in a particular asset due to a large employer stock position, business ownership, highly appreciated real estate, inheritance or simply the tremendous growth of a single stock holding.



While significant growth in a concentrated asset can seem like validation for smart decision-making, it can also expose you to significant risk. A single adverse event, such as a market decline, regulatory change, company-specific setback or a new competitor threatening market share, can wipe out years of gains and jeopardize your financial security.

Perhaps the most infamous example of the dangers of concentrated wealth occurred in 2001 following Enron's bankruptcy. Enron employees with highly concentrated stock positions lost both their jobs and their life savings in one fell swoop.

Let's consider the risks of concentrated wealth and explore tax-efficient diversification strategies to help you balance your portfolio.

## The risks of concentration

Being overly concentrated in a single position, sector or asset class can lead to the following risks:

- **Market risk:** Being overly concentrated in a certain sector of the market can result in increased volatility. For example, if you hold a concentrated stock position, your portfolio may be subject to increased stock market volatility, compared to a portfolio that is diversified across equities, bonds and cash.
- **Bankruptcy risk:** This refers to the risk that a company may not be around in the future, due to bankruptcy. This risk is amplified if you both work for and hold a concentrated position in the same company, as both your salary and your portfolio's performance are tied to the success of the company.

- **Tax exposure:** A concentrated position can also put you at risk for significant tax exposure, should you decide to sell appreciated shares. Your appreciation will likely be subject to capital gains tax, and certain forms of equity compensation are taxed as ordinary income, which can have the potential to bump you up into a higher tax bracket.
- **Unsystematic risk:** Unsystematic risk is a risk that is specific to a particular company or industry, rather than the overall market. Examples of this risk include poor management decisions at a company that result in weak performance or bankruptcy. Or, this risk could result from a sector bubble that bursts, similar to what we've experienced in the past with technology and real estate.
- **Direct indexing:** **Direct indexing** is an investment strategy that seeks to mirror the performance of a designated stock index, such as the S&P 500. Unlike traditional index funds or ETFs, direct indexing involves owning the individual stocks of a benchmark, which provides an opportunity to engage in tax-loss harvesting. A direct indexing strategy can allow you to gradually reduce the risks of a concentrated stock position while building broad market exposure, though it may involve higher costs, increased portfolio complexity and potential tracking differences relative to the target index.

This combination of market performance and **tax-loss harvesting** provides an opportunity to gradually sell shares of concentrated stock and invest the proceeds in an indexed portfolio. The losses generated can generally be used to offset a portion of the capital gains from your stock sale and as you gradually sell more of your concentrated position, your portfolio becomes more diversified. However, the availability and effectiveness of tax-loss harvesting depend on market conditions, individual tax circumstances and applicable tax rules such as wash sale limitations, and tax strategies may not be beneficial in all market environments.

Another benefit of direct indexing is that you control what stocks you invest in, which allows you to avoid inadvertently purchasing additional shares of your concentrated position.

## Diversification strategies

If you maintain a concentrated holding, it's important to take steps to diversify your portfolio in a tax-efficient manner. The following strategies may help, but each involves its own risks, costs and limitations that should be carefully evaluated:

- **Gradual sale:** The simplest way to diversify a concentrated holding is to sell it off over time, spreading out your tax liabilities across several years. However, the downside of this approach is that you will continue holding concentrated assets while you gradually sell. Certain circumstances may require a faster method of diversification.
- **Equity exchange fund:** An equity exchange fund is a pooled investment vehicle intended to help investors diversify their concentrated holdings. Established by a bank, investment company or other type of financial institution, these funds allow investors to exchange their stock holdings for units of the entire fund's portfolio. Participating in an equity exchange fund enables you to have access to the potential returns of other investors' stock, and the portfolio becomes more diversified as more investors participate, though these vehicles typically involve limited liquidity, long holding periods, fees and reduced control over investment selection. Diversification is not guaranteed and depends on the composition of the fund.
- **Charitable donations:** If your goals include **supporting charitable causes**, it may make sense to make an in-kind donation of appreciated shares, rather than donating cash. This allows you to maximize the amount the charitable organization receives, while helping you to avoid capital gains taxes on the sale. You may then claim the full market value of the shares as a charitable deduction on your itemized tax return.

For those looking to take this strategy a step further, a **charitable remainder trust (CRT)** can offer additional flexibility. Contributing a concentrated asset to a CRT allows the asset to be sold within the trust without triggering immediate capital gains taxes, which may allow for a full reinvestment of the proceeds into a more diversified portfolio. In return, you can receive an income stream from the trust and a charitable income tax deduction in the year of the contribution. This approach can help you reduce concentration risk, create ongoing income and support charitable goals as part of a broader wealth strategy, though CRTs are irrevocable, involve administrative costs and may limit access to or control over the contributed assets.

These vehicles are only available to accredited investors, and they often come with minimum holding periods and investment requirements. Your wealth advisor can help you determine if an equity exchange fund makes sense for you.

## Next steps

Maintaining a concentrated holding can expose you to unwanted risk and threaten your long-term financial security. But **unwinding that position** may create significant tax exposure. Your advisor can help you navigate these trade-offs and identify strategies that are appropriate to your situation. With the right approach, you can manage concentration risk while staying aligned with your broader financial goals.



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