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## NeuViews ▶ Wealth Management

### Remedies for Concentrated Portfolios

#### If One Stock Has Grown to Dominate Your Portfolio, Skillful Money Management Can Help You Regain Balance

*When Mae West said, “too much of a good thing can be wonderful,” she wasn’t talking about investment portfolios. Too much of one stock in your portfolio may be hazardous to your financial health. Fortunately, there are ways to reduce your exposure to a single stock without necessarily reducing your overall upside potential.*

In the wake of the Enron scandal, it is hard to imagine anyone questioning the wisdom of maintaining a diversified portfolio. Enron employees who held the bulk of their retirement savings in company stock saw their nest eggs vaporize in a matter of months. This was a company that, before the scandal erupted, was widely praised as one of America’s best.

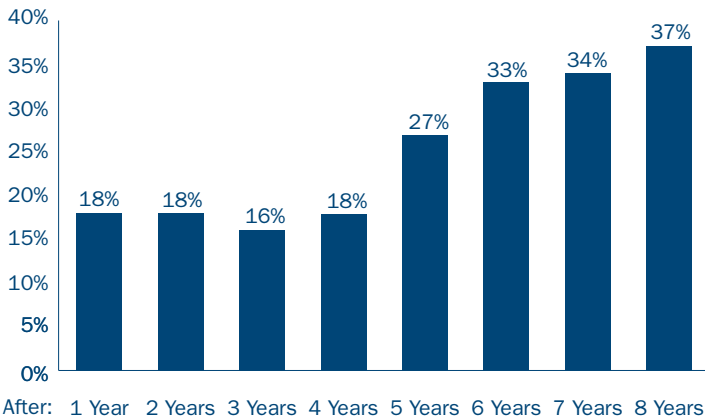
Yet thanks to the rise of stock-based compensation plans, many executives and professionals still hold oversized positions in shares of their employers. These investors may be seriously exposed, yet unable or unwilling to sell shares in order to diversify. And the longer they hold the concentrated position, the greater their risk grows. Whether the stock has performed well or poorly, a concentrated portfolio is inherently more risky than a diversified portfolio (*see Figures 1 and 2*).

“An investor may love a company,” says Gary Kaminsky, a Neuberger Berman Money Manager. “But if he doesn’t diversify, his wealth becomes subject to above average risk. Studies have shown that holding a high portion of one’s net worth in a single concentrated position substantially increases risk. Conversely, implementing a

### Time Increases the Chance of One Stock Underperforming

FIGURE 1

Percent of Stocks in the S&P 500 Cumulatively Underperforming the Index by More Than 20%



Companies included in S&P 500 as of 12/31/02. Company returns include prices only, and periods are from 12/31/94 to 12/31/01.

Source: Baseline, Neuberger Berman.

plan to diversify a concentrated stock position over time substantially cuts risk. Even for the most confident investor, diversification is a must.”

How much of one stock in a portfolio is too much? The answer depends completely on the individual. An investor who is young and seeks growth of capital may be able to handle more concentration than an investor who requires steady income. Similarly, shares of a family or closely-held private business present more complex issues than shares in a large publicly traded company.

Remedies for an overly concentrated portfolio range from relatively simple to highly sophisticated strategies, depending on your situation. The strategies will vary depending on your ability to sell the concentrated stock, your financial needs and tolerance for risk, and tax and estate planning considerations.

Every individual with a concentrated stock holding should establish a three- to five-year plan to minimize the risk, says Kaminsky. The plan may include any of the strategies outlined below, “but barring a dramatic change in the markets or company, the investor should stick with the plan.”

### Using Taxes to Your Advantage

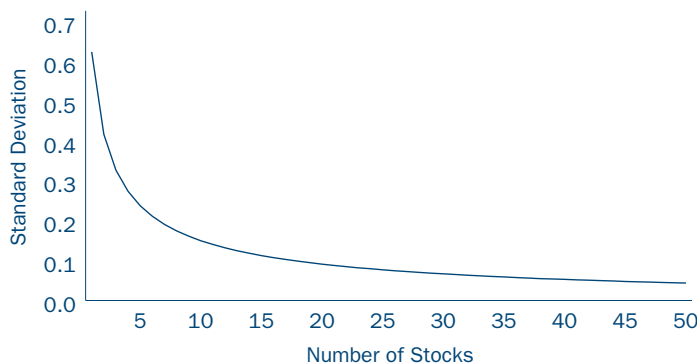
If you are free to sell your concentrated stock, the biggest challenge may be to sell a portion of it without incurring a huge tax bill. Often, the stock was acquired at a low cost, and has racked up substantial capital gains. These gains can represent a potentially enormous tax liability.

An adept investment manager can identify unrealized losses in an investor’s portfolio and

### A Benefit of Diversification

FIGURE 2

Volatility Tends to Drop as Stocks Are Added to a Portfolio



The chart plots annualized excess standard deviation against the number of stocks in a hypothetical portfolio, for sample periods 1986 to 1997. Excess standard deviation of a portfolio is the difference between the portfolio’s standard deviation and the standard deviation of an equally weighted index.

Source: Campbell, John; Lettau, Martin; Malkiel, Burton; Xu, Yexiao, “Have Individual Stocks Become More Volatile? An Empirical Exploration of Idiosyncratic Risk,” *The Journal of Finance*, February 2001, pp. 1-44.

use them to offset the tax liabilities embedded in appreciated holdings. These unrealized losses may be in the concentrated stock itself, or in other securities. (Of course, if your concentration of stock is held in a tax-advantaged account such as a retirement plan, you may be able to reallocate holdings without tax consequences.)

The most important first step is to analyze *all* the investments in the portfolio, identifying investments by their “tax lot”: when they were acquired and for what cost. This kind of analysis is labor intensive, but it enables you to start rebalancing your portfolio in the most efficient, least costly way.

For example, let’s say you have a portfolio in which 60% is invested in Company A stock, originally acquired at a few dollars a share and now selling for nearly \$100 per share. Elsewhere in the portfolio, you also have Company B shares acquired at varying prices of \$20, \$50, and \$80 a share. Company B is currently trading at \$52 per share. By selling the Company B shares that were purchased at \$80, you can take a \$28 per share tax loss, and reduce the capital gains tax of selling your appreciated Company A stock.

Segmenting a portfolio by tax lots — as opposed to viewing the portfolio as blocks of stocks — can be a time consuming process. It is, however, one of the most efficient means to offset gains inherent in a low cost-basis position. It enables you to sell the low cost-basis stock while paring away your losses, with the potential for little or no tax consequences. As an ongoing strategy, selling off some of the high-cost tax lots in a portfolio can effectively establish a stepped-up cost basis in the low-cost concentrated position.

Yet not every investment manager is willing to do this. “It’s a paper hurdle,” says Richard Nackenson, a Neuberger Berman Money Manager. “But one of the first things we do with new clients is to prompt them to bring all of their tax lot information up to date. It is a lot of work. Without that information, however, the portfolio manager simply cannot do an effective job.” Nackenson recalls one recent situation in which a money manager was able to sell off and diversify a large concentrated position with very little tax impact, because his client’s previous manager had traded aggressively and paid little attention to the tax effect of his actions.

Paying attention to taxes can affect timing of sales too. For instance, you may sell a portion of the concentrated holding early in a given tax year, using the proceeds to diversify during the rest of the year. In an average year, any portfolio is bound to incur some losses, and the tax-sensitive manager will apply these to gains made on the concentrated stock sales early in the year.

This strategy can actually provide a money manager with greater flexibility to pursue opportunities for the client. For instance, let’s say the money manager wants to invest in a drug company that has a new drug in clinical trials — with the potential for a blockbuster new product or a washout, depending on the trial results. This manager typically might allocate 1% to the stock, planning to build gradually to a 2% position. But for an investor who had booked a large gain from a concentrated stock, the manager could take a riskier 2% position at the outset. This strategy might provide greater potential for gain should the drug succeed and

the stock rise, with a capital gains “cushion” to absorb a short-term loss if the promising drug is not approved.

In some cases, Nackenson adds, investors may have tax loss carryforwards from prior years. These can also be applied to offset gains on low cost-basis stocks. “Some investors are embarrassed by them. But there’s nothing to be embarrassed about. It’s worth addressing, because this knowledge can help save clients money in the future.”

### Other Options, Including Options<sup>1</sup>

Despite all the good reasons for diversifying a highly concentrated portfolio, sometimes you may not be able to sell the stock in question. For instance, you may have received restricted stock, which cannot be sold until certain conditions are met. Or you may own illiquid shares in a family or closely held company. Or you may simply be unwilling to part with the upside potential.

In this case, a completion portfolio may be in order. As its name suggests, such a portfolio seeks to complete the diversification that does not exist in your concentrated portfolio. For instance, if your concentrated stock is in a software company, the rest of your portfolio should probably not invest heavily in software shares, and you might want to avoid technology shares in general.

If you have a very large concentrated position, you may want to consider sophisticated financial strategies that allow you to hedge the risks, using options or

other derivative securities. Flexible money managers can work with your legal and tax advisers — and perhaps your employer as well — to devise a strategy to limit your risk while also meeting all the necessary regulatory or corporate limitations on stock sales.

More sophisticated strategies include but are not limited to the following:

- **Zero-premium collars** (sometimes known as zero-cost collars or costless collars) use options to protect stockowners from price volatility. In this strategy, you sell a call option on the concentrated security, thus limiting its upside, but receiving cash. You use the cash to buy a put option, setting a floor under the potential loss if the security’s value falls. This locks in a range of stock prices between the floor and cap levels. With a floor price secured, you can take a loan against the primary holding, to invest in a diversified and liquid portfolio.

(It is worth noting that the “zero-cost” name is a misnomer. Executing the option strategies generates trading costs, and the loan bears an interest charge. Zero-premium collars may be useful tools in certain situations, but they are not free.)

- **Prepaid variable forwards** can help liquify a position without actually selling, as far as taxes are concerned. These forward contracts enable you to receive payment upfront against delivery of shares at a later date. The contract therefore protects you from a drop in the security’s value, while allowing participation in its upside, up to the agreed-upon

<sup>1</sup>Investing in options may involve significant risks. Option transactions are not suitable for all investors and the risks of options should be weighed against the potential rewards. A copy of the *Characteristics and Risks of Standardized Options* may be obtained by calling your Neuberger Berman, LLC representative at 1.800.223.6448 or accessing the website for the Chicago Board Options Exchange at [www.cboe.com](http://www.cboe.com).

Although zero premium collars and prepaid variable forwards may protect against certain risks, both strategies may limit gains above a certain ceiling.

price. You can use the proceeds to invest in a diversified portfolio.

- **Exchange funds** have been in use for a number of years, but have been challenged by the Internal Revenue Service, so you should consult carefully with your tax specialists before considering them. Exchange funds allow investors to pool their low-cost-basis stocks in a fund with other investors' stocks. Each investor owns a share of the fund. After a set period of time — generally seven years — you can redeem your interest in the fund. You will receive a non-taxable distribution of a diversified pool of stock from the fund's portfolio. The value of this distribution is equal to the net asset value of your pro-rata interest in the fund at the time of the distribution.

### Integrating Estate Planning

No financial planning should take place in a vacuum: When considering remedies for a concentrated portfolio, you should always take into account your wishes for your family and your legacy. Do you wish to leave a substantial bequest to charity? Do you want to keep a business in the family? Estate planning and/or business succession planning is often a critical piece of the concentrated portfolio solution.

- **Charitable remainder trusts** may be appropriate if you have highly appreciated, low-basis stock and you wish to leave an amount to charity. You can fund a charitable remainder trust with your appreciated stock. The trust sells the stock and reinvests the proceeds in a diversified portfolio. You will receive regular distributions from the trust during your lifetime or for a term of years, avoiding immediate payment of capital gains taxes on the sale of the stocks, thanks to the charitable status of the trust.

You receive a current income tax deduction based on the projected gift to charity at the end of your life expectancy or the term of years.

- **Family limited partnerships (FLPs) or Limited liability corporations (LLCs)** can be useful tools for family business owners. The idea is to cut estate or gift taxes while protecting the family legacy for future generations. In a typical example, the business owner forms a partnership and contributes business assets to the newly formed entity. Once the partnership is established, the business owner can begin giving or selling limited partnership interests or membership interests to family members. Because they are only limited partners, and the IRS considers their limited interest in a closely held business to be illiquid, the partnership interests or membership interests may be significantly discounted. An FLP or LLC can be a cost-effective way to transfer the business, reducing estate or gift taxes. For larger businesses, Employee Stock Ownership Plans may also be an effective way to accomplish the same goals.

### Your Personal Situation Is the Key

Concentrated portfolios come in as many shapes and sizes as there are people, and the potential methods of diversifying are even more numerous. The key to finding the best remedy for your situation is to work with professional advisors who can help you navigate the tricky shoals of wealth management. Tax and estate laws are constantly changing; you will need up-to-date advice and the wisdom of experience. Creating the best remedies for a concentrated portfolio requires investment expertise, tax and estate planning skills, and a dedication to *personalized* solutions. ■

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The S&P 500 consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value. The "500" is one of the most widely used benchmarks of U.S. equity performance.

Standard deviation measures how widely a set of values varies from the mean. Standard deviation is a good historical measure of the variability of return earned by an investment portfolio. In performance measurement, it is generally assumed that a larger degree of dispersion implies that greater risk was taken to achieve the return.

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