



Client Newsletter

The Dangers of Concentrated Positions

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Introduction

In general, a concentrated position is a security holding that is disproportionately large relative to a fully diversified market benchmark. Concentrated positions work to distort overall portfolio performance by skewing returns either negatively or positively. For our clients seeking consistency of returns to achieve critical long-term goals, concentrated positions work to create additional downside risk exposure and the potential for large losses that undermine the intended long-term goals of the overall investment plan.

Many of the concentrated positions we discover in the investment accounts of new clients are unintentional and fairly easy to correct through our portfolio planning process. Others are more difficult to correct due to large unrealized capital gains and the natural reluctance to accelerate the payment of capital gains taxes. In our experience, most investors should be encouraged to eliminate this additional investment risk by systematically correcting the imbalances.

There is wide agreement with our position among registered investment advisers. Recently, we received the following article from RiverFront Investment Group, a prominent Richmond-based investment manager we routinely include in our client portfolio strategies. We think this article clearly explains why it makes sense to use the recent recovery in asset prices to address a concentrated positions problem. RiverFront has graciously agreed for us to share it with our clients. As always, please feel free to pass this *Client Newsletter* along to your friends and family members who may be exposed to concentrated position risk.

Concentrated Positions, Revisited

Two-Year Bull Market Presents Opportunity to Address a Major Portfolio Risk

In our opinion, concentrated positions present one of the biggest obstacles to investors being able to achieve their long-term goals. We believe the outsized risks that these positions bring to investment portfolios are almost never worth the tax savings an investor hopes to recognize by holding them. With the long-term capital gains tax rate near historically low levels, and the market (as measured by the S&P 500) having rallied nearly 100% since the March 2009 market lows, we believe the window of opportunity to adjust these positions is closing.

What is a concentrated position?

The term "concentrated position" could mean different things to different people. We define concentration as any single position that is three or more times larger than an average position in a portfolio. (Our definition does not apply to mutual funds, exchange-traded funds [ETFs] or other diversified investment vehicles.) Concentrated positions can end up in a portfolio for many different reasons: they can come from a successful investment; they can be inherited from a parent or grandparent; or, more commonly, they can represent a percentage of ownership in a current or former employer.

The problem with concentrated positions

Concentrated positions generally have two things in common. First, most concentrated positions were accumulated at relatively low prices. Second, because of the low cost basis, many investors tend to treat these holdings more passively than anything else in their portfolios. Anecdotally, financial advisors often tell us that their clients have directed them to ignore a low-cost-basis concentrated position or to manage a portfolio around a concentrated position. While we can sympathize with an investor's desire to minimize their tax bill, we also worry that this justification could potentially lead to investment behavior that is irrational and potentially dangerous.

Why Concentrated Positions Can Be Dangerous

1. **Concentrated positions can make portfolios more susceptible to "lightning strikes":**
A concentrated position can be like a tall tree in a lightning storm. The more a single position stands out from the rest of the portfolio, the greater the portfolio's chance of being struck, in our view. While this risk may be obvious, what might surprise investors is the frequency at which portfolio lightning strikes occur. The risk that a single position could underperform the market by a significant margin --say 15% annually --is not minor. For example, over the last 13 years, 39% of the S&P 1500 (the 1500 largest domestic companies) underperformed the aggregate index by more than 15% (see the Table on the following page). **Said another way, nearly two years out of five (39% of the time) it has been better to take the certain 15% capital gains hit than to risk a greater than 15% punishment by the stock market.** It is for this reason that concentrated positions are not only non-permissible in the institutional (pension fund, endowment, etc.) world, they are generally viewed as a breach of fiduciary duty when present in a portfolio.

Time Period	Percentage of S&P 1500 Companies Underperforming by 1500 bps* or more
2010	18%
2009	31%
2008	30%
2007	58%
2006	34%
2005	42%
2004	33%
2003	34%
2002	31%
2001	32%
2000	45%
1999	45%
1998	71%
Average:	39%

*Data Courtesy FactSet Research Systems * Basis points = 1/100th of 1%*

2. **Concentrated positions in the stock of one's employer can be especially dangerous.**

We invest for many reasons, but one of the primary objectives is as protection against an uncertain future. A properly structured investment portfolio can act as an income supplement during periods of wage softness or unemployment. For this reason, we think a concentrated position in the stock of an employer is especially dangerous. There is typically a strong correlation between the performance of a company's stock and the compensation and job security of that company's employees. During those periods when job security is low and compensation most under pressure, an investor with a portfolio dominated by the stock of their employer will likely find their financial hardships exacerbated. Recently, the prior and current employees of Bear Stearns, Lehman Brothers, Washington Mutual and General Motors have had to learn this lesson the hard way.

3. **Concentrated positions can force sub-optimal strategies:**

Simply put, an investment plan with significant limitations and restrictions will generally produce sub-optimal risk-adjusted performance. Investors who ask their financial advisors to manage around or ignore a concentrated position are making a choice to hold a potentially inferior portfolio and accept inferior risk-adjusted returns, in our view. This is the case when a concentrated position is performing well and not detracting from the portfolio, and becomes increasingly apparent in an environment in which the performance of that holding sputters. The more a concentrated position underperforms, the more difficult it becomes to execute a well-devised investment plan. Concentrated positions present the greatest risk to those investors who regularly rely on withdrawals from their portfolio to supplement their income. An investor who takes systematic withdrawals will be forced to

increasingly eat into the healthy portions of their portfolio to compensate for the decline in their concentrated position.

4. **There is a threat that the current tax environment could become significantly less favorable.** We believe the current capital gains tax rate of 15% is a gift with an expiration date. Since 1916, when the capital gains tax was first introduced, it has changed 21 times and has only been 15% or below 19 of those 95 years. The rising societal costs of an aging America, the ongoing conflicts in the Middle East, and an economy coming out of Recession create a situation for Federal and state governments in which revenue (tax proceeds) is not growing fast enough to offset rising costs. Ultimately, either costs must fall or revenue must rise for governments to stay solvent. We believe the latter is more likely. Historically, when the government has needed to tighten its belt, the burden has been disproportionately distributed between those who have money and those who don't. Thus, the taxes saved by not recognizing a capital gain today may be more than offset by significantly higher tax rates tomorrow. The current 15% long-term capital gains rates are set to "sunset" in 2012, potentially reverting back to 20% rates or higher.

Bottom Line: We believe that the most important advice we can offer investors is to avoid holding concentrated positions in their portfolios. The most sophisticated financial planning tools and products and the most capable portfolio management teams can't completely insulate an investor from the risk of these positions. It is startling and sad how quickly the fortunes of major "blue-chip" companies can change in today's dynamic investment environment. There is typically no warning alarm, and very little time for an investor to recognize a problem before the market has fully incorporated it into a troubled company's share price. A 20% position in a stock that underperforms the market by 20% in a single year puts the entire portfolio at a 400-basis-point deficit that would be difficult to overcome, no matter one's investment prowess.

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