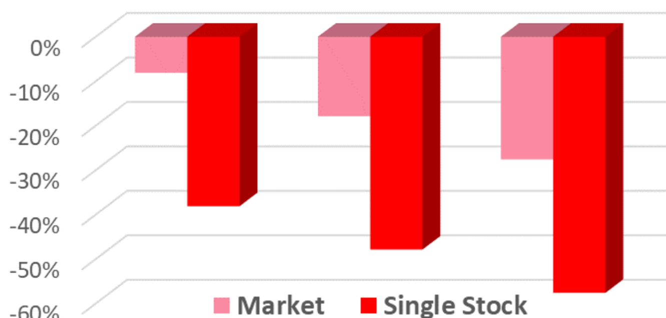
How to manage the added risk of concentrated stock positions

Synopsis

Overview

An investor who accumulates a concentrated stock position in their investment portfolio typically reacts in one of two ways: "It's not a problem" or "Sure it's riskier, but there's nothing I can do about it." An astute advisor knows neither of these statements rings true.

Concentrated positions and portfolios suffer from both systematic market risk as well as idiosyncratic risk. The latter, unique to individual companies, adds numerous potential events to the risk equation such as earnings releases, executive mis-conduct, legal matters, government investigations, new regulations, etc. Due to the non-diversification inherent in concentration, normal portfolio risk reduction methods won't work.



However, proper hedging techniques can solve for idiosyncratic risk, without divesting the concentrated position and potentially suffering disastrous capital gains taxes. In addition, this hedging expertise can further reduce the systematic market risk of the entire portfolio—more so than classic diversification—while offering additional income generating opportunities.

What investors want

There are several reasons why an investor winds up with a concentrated stock position. There are the lucky employees when startups go public, and executive compensation or bonus programs that grant stock or stock options; the inheritance from the rich aunt; long-term dividend reinvestment programs; and, our personal favorite, the great advisor stock pick that just keeps growing and growing in value.

There are valid reasons not to reduce a concentrated stock position even after an investor acknowledges the added risk. Clearly, investors want to avoid capital gains tax on low cost basis positions. Or an executive's stock options might be restricted by corporate rule or by concern for the investing public's reaction to insider sales.

But we also need to fully understand what an investor's goals are specific to any concentrated position; and what impact, if any, this has on the respective investment goals established for the overall portfolio. Generally, an investor wants to participate on some level of growth in the stock. However, we find that even more importantly they would like to retain value. (Many aren't even aware that protection against dramatic selloffs is available to them.)

For some, their concentrated position might pay a dividend that represents a significant portion of their annual income. They may also be interested in augmenting their income through new strategies that capitalize on existing holdings. In the end, the predominant theme we hear is preservation. This means preserving levels of income, preserving levels of wealth, and preserving opportunities to provide generational wealth transfers to family and/or charities.

The tools of hedging

While hedging is a term you have heard, here we specifically mean the use of derivatives (i.e. options) to define or offset losses in an underlying stock. We call this "creating a downside floor." This may include a "full hedge" which sets a definitive price point below which no losses are incurred; or a "partial hedge" where we again set a floor, but with only a portion of losses avoided.

The protection, once established, creates a line in the sand, so to speak. Losses in the underlying stock position begin to be

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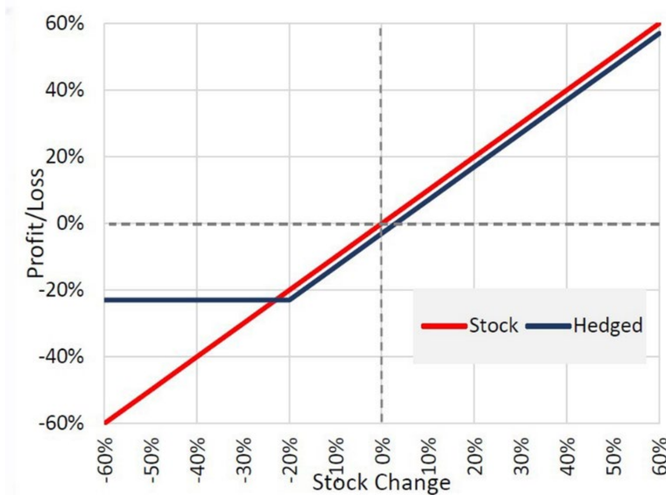
The disciplined option

offset as the hedging instrument starts to gain in value dollar for dollar.

Hedging involves paying a premium much like with car insurance. We refer to this premium as the “cost of hedging” (between 2-4% on an annual basis). While avoiding downside risk is the primary tactic, generating income—or simply reducing the cost of the hedge—can be achieved either through the direct sale of overhead volatility (e.g. covered calls) or through an overlay of a broad index. In the latter, we generate income by selling broad market volatility, but solely in high probability scenarios.



Positions utilize laddered expirations (e.g. varied tranches with varied expiration dates). This allows traders to opportunistically roll or close protection at various points on the calendar, and it spreads single strike and expiration risk over a series of positions.

The hedger’s opportunity

One of the unique aspects of implementing a hedging program is that by avoiding the loss, it provides an opportunity. The first part is rather obvious in that investors who miss out on a majority of a down move preserve their purchasing power relative to portfolios that are unhedged.

Consider a $2,000,000 concentrated stock position where a downside floor is set 15% below the stock’s current market price. Then the company reports bad news or misses earnings, etc. leading to a 30% decline over several months. The investor would suffer the first 15% decline, but the hedges would rise in value dollar for dollar as the stock price moved from -15% to -30%. The avoided losses amount to 15% or $300,000 in hedging profits available for investing in other assets such as a more diversified portfolio; without selling shares or giving up the existing dividend. Then any market recovery significantly adds to the overall return of the portfolio, in essence outperforming the market.

Possibly the most interesting aspect of reinvesting hedging profits is that they tend to be put to work while prices are depressed, thus buying more shares than would have been possible given bull market conditions.

Wait, there’s more

Frankly, the strategies to reduce the added risk of a concentrated stock position while managing capital gains taxes and maximizing income are straightforward. However, the execution of the related options programs is not.

Take, for example, covered call writing. Using this simple income generating tool—when the stock must not be called away—requires more careful consideration of factors such as timely rolling, volatility skew, dividend capture arbs, and corresponding long calls. We cover all this and more in the white paper version of this topic on our website.

The conundrum that exists with concentrated stock positions is real. Thankfully, there are positive alternatives. Hedging programs to build in floors may offer real opportunities for advisors to provide value to clients holding concentrated portfolios. That value extends beyond protecting losses to providing opportunities to leverage holdings to generate additional returns and/or income for the investor.

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