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Concentrated Stocks

CHALLENGE

Concentrated stock with a low cost basis is common among ultra-high-net-worth investors, including entrepreneurs and families with multigenerational wealth. However, for those investors seeking to diversify,[1] the tax cost can be large.

SOLUTION

Many strategies for dealing with the risks associated with a concentrated stock portfolio are available to investors. These include simply holding on to the stock, donating some/all to charity, contributing to an exchange fund, using options (e.g., buying put protection), benefitting from various programs,[2] and selling with or without tax-loss harvesting. Here, we compare two approaches:

Sales without tax management (which investors can do by themselves)	Sales combined with tax-loss harvesting

Aperio can be helpful with evaluating a tax-loss harvesting program, where loss harvesting can help offset some of the gains realized from reducing the concentrated stock position. Furthermore, Aperio believes that a gradual, multiyear liquidation plan may be more tax efficient than liquidating the entire position at once,[3] because loss-harvesting beyond the first year may help offset some of the gains realized from sales beyond the first year.

There may be many complexities in dealing with each client's specific concentrated stock circumstances, such as having more than one concentrated position or additional cash, the ability to donate to charity or to use a tax budget, as well as risk and other tax considerations. We encourage investors to reach out to Aperio to discuss each unique situation.

CASE STUDY

Gradual Liquidation over Five Years

An advisor wanted us to consider a hypothetical scenario where a hypothetical client with a $10 million concentrated stock position with zero cost basis is facing a $3.71 million tax cost (federal and state of California combined long-term rate of 37.1% as of December 2020) to liquidate the position. In this scenario, Aperio analyzed a five-year gradual liquidation plan where 50% would be liquidated immediately, while the other 50% would be liquidated pro rata over the next four years. Liquidated stock would be invested in an Aperio equity SMA (separately managed account) with tax-loss harvesting, and taxes would be paid from the account. The advisor wanted us to assume a 7% annual return for both the Aperio portfolio and the stock position. Aperio projected in this hypothetical scenario that tax-loss harvesting may reduce the overall tax by $783K, a 21% reduction.

Example Scenario of Gradual Liquidation Year	1	2	3	4	5	5-Yr Total
Liquidation – Begin of Year ($)	5,000,000	1,341,875	1,440,503	1,546,380	1,660,039	
Stock Remaining ($)	5,000,000	4,025,625	2,881,006	1,546,380	–	
Aperio Portfolio ($)	5,000,000	5,036,822	6,454,882	8,044,888	9,849,074	
Aperio Losses Harvested ($)	(538,942)	(331,037)	(340,192)	(417,014)	(482,327)	(2,109,511)
Gain from Sale of Stock ($)	5,000,000	1,341,875	1,440,503	1,546,380	1,660,039	
Net Gain ($)	4,461,058	1,010,838	1,100,311	1,129,366	1,177,712	
Taxes Paid ($)	1,655,053	375,021	408,215	418,995	436,931	
Taxes Saved ($)	199,947	122,815	126,211	154,712	178,943	782,629
End of Year Portfolio Value ($)	9,062,447	9,335,888	9,591,268	9,849,074	10,101,578	

This analysis is provided as an example only and should not be considered representative of an actual portfolio.[4]

BENEFITS

- Tax-loss harvesting may reduce the overall net tax cost of diversifying from a concentrated stock.
- A diversified equity portfolio may dramatically reduce the overall risk versus a concentrated position.
- A gradual liquidation with an annual schedule may offer a good balance between getting some diversification and acknowledging an investor's reluctance to sell.
- Aperio has the ability to customize the gradual liquidation parameters, including the liquidation percentage over time, to meet individual investor profiles.
- This strategy can be used as a partial solution in combination with other approaches.

COSTS/ LIMITATIONS

- The "sell with tax management" and "sell without tax management" alternatives represent only a narrow segment of the opportunity set.
- This solution is a portfolio with 100% equities—a more diversified asset allocation would require additional tax costs.
- Taxes are still paid on the liquidation—this is not a tax-free approach.
- If the account is liquidated in the future, any deferred taxes would then be owed.
- The gradual liquidation over five years can be difficult to stay committed to, as investors may forget why they selected this strategy.
- The concentrated stock may realize better returns than a diversified portfolio.

[1] For more information on the risk of single-stock portfolios, please see the following papers: (1) "Do Stocks Outperform Treasury Bills?"; and (2) "The Agony and the Ecstasy: The Risks and Rewards of a Concentrated Stock Position."

[2] For example, qualified small business stock (QSBS), life insurance retirement plans, and private placement life insurance.

[3] Within an Aperio separately managed account (SMA) and depending on the strategy and the specific stock(s), it may be possible to integrate some of the existing shares into the portfolio.

[4] Every situation presents a unique set of circumstances and opportunities, and investors' results may differ substantially from the illustration presented. Market conditions, timing of liquidation, and other events may cause this hypothetical example to be different than presented herein. Investment in equity securities presents investment risk, and there is the possibility of loss as well as gain. Assumptions include a 7% annual return for both the SMA and the stock and payment of taxes out of the SMA. Assumptions do not include transaction costs nor management fees.