BNY MELLON
WEALTH MANAGEMENT

Why You Should Consider *Diversifying* Concentrated Stock Positions

Investment portfolios with concentrated positions can pose significant risks to long-term investment goals. Here's how you can diversify a concentrated portfolio.

While a concentrated position in one or a few stocks may have created wealth for an investor, it may also represent a hidden risk to a portfolio. There are many ways investors accumulate an outsized amount of a single stock. Whether stock was received through an initial public offering, part of compensation through work, or an inheritance, too much wealth in one or a handful of stocks can prove costly if the stocks lose value over time.

Past Performance is Not a Guarantee of Future Success

There is no guarantee that yesterday's outperformers will continue to do well in the future and in some cases, they could experience a significant decline. Consider a company like Intel, once a market leader of chip development, that has been outpaced by competitors in the race to dominate semiconductor chips in the artificial intelligence (AI) space. From the end of 2002 through 2023, the stock has delivered a total return of roughly 450% versus Qualcomm's nearly 1100% and Nvidia's 55,000% return. Or, General Electric, once a blue-chip icon, a century-old, diversified conglomerate that suffered several catastrophic losses after the Great Financial Crisis (GFC) revealed its transition to a pool of diversified businesses (e.g., GE Capital). The GFC caught the company overextended, and restructuring and new leadership failed to impress shareholders. The stock has never recovered to reach its prior peak. In fact, it is a pattern we have seen repeated throughout history – stocks that were the biggest winners often collapse as a result of macro forces that change the competitive landscape, or by company-specific issues such as bad management or fraud.

Emotions Can Drive Poor Investment Decisions

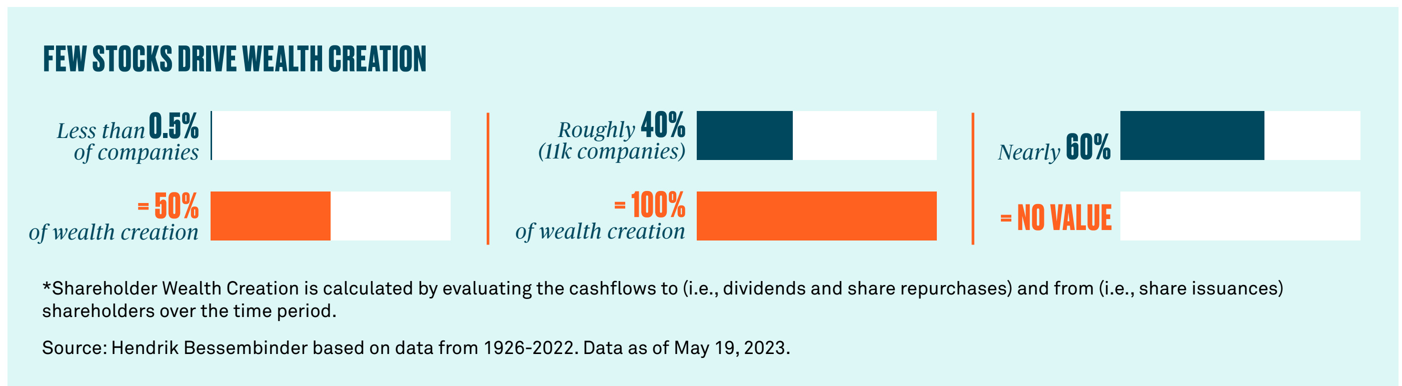
Still, there are a myriad of emotions that cause investors to hold onto stocks that have helped to build their wealth over time. Some investors are reluctant to diversify away from these stocks and seek out information that confirms their positive view of a stock. They fail to recognize that companies rarely dominate or provide excess returns over extended periods of time or do not want to miss further appreciation.

In order to mitigate risk associated with a single stock, you can create a plan to manage and reduce concentration risk. Let's take a closer look at the risks of a concentrated portfolio.

Risks of Concentrated Stock Positions

Contrary to what investors assume, most individual stocks will underperform the broader market.

In fact, less than half of 1% of all U.S. stocks since 1926 have delivered 50% of gross wealth creation. This represents just 110 companies out of a total universe of 28,000 companies. Shareholder Wealth Creation* measures the dollar amount by which investors in aggregate were rewarded for participating in company stock appreciation. And, approximately 40%, or over 11,500 companies, create the remaining 50%. That means that nearly 60% of companies available to investors do not generate any value and in many cases lose wealth over time. Given the difficulty to identify the real winners and losers within the investment universe of stocks, it remains crucial to employ a diversified portfolio of holdings to capitalize on the full value being created in markets.



*Shareholder Wealth Creation is calculated by evaluating the cashflows to (i.e., dividends and share repurchases) and from (i.e., share issuances) shareholders over the time period.

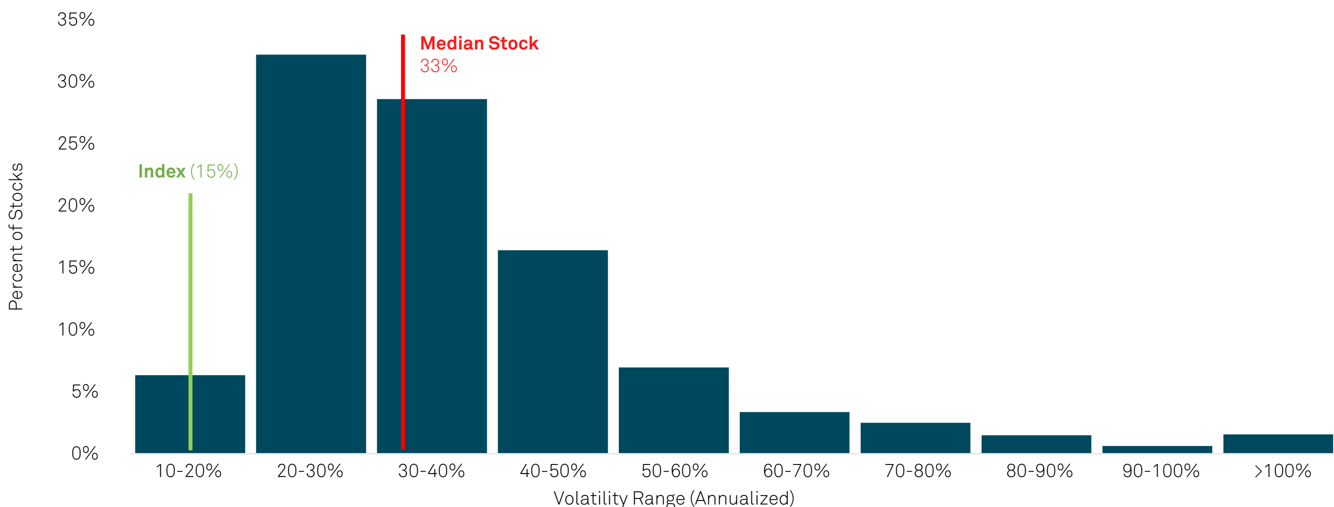
Source: Hendrik Bessembinder based on data from 1926-2022. Data as of May 19, 2023.

In addition, individual stocks can vary in how much their value fluctuates up and down. While some stocks are more volatile than others, on average, the median stock is more than twice as volatile as the index itself. For example, the Russell 3000 has historically fluctuated 15% from the mean in any given year, while the median single stock's volatility is 33%. This suggests investors in a single stock should be prepared to weather a much bumpier ride.

EXHIBIT 1

Single Stocks More Volatile than Overall Market

Russell 3000 - Individual Stock Volatility



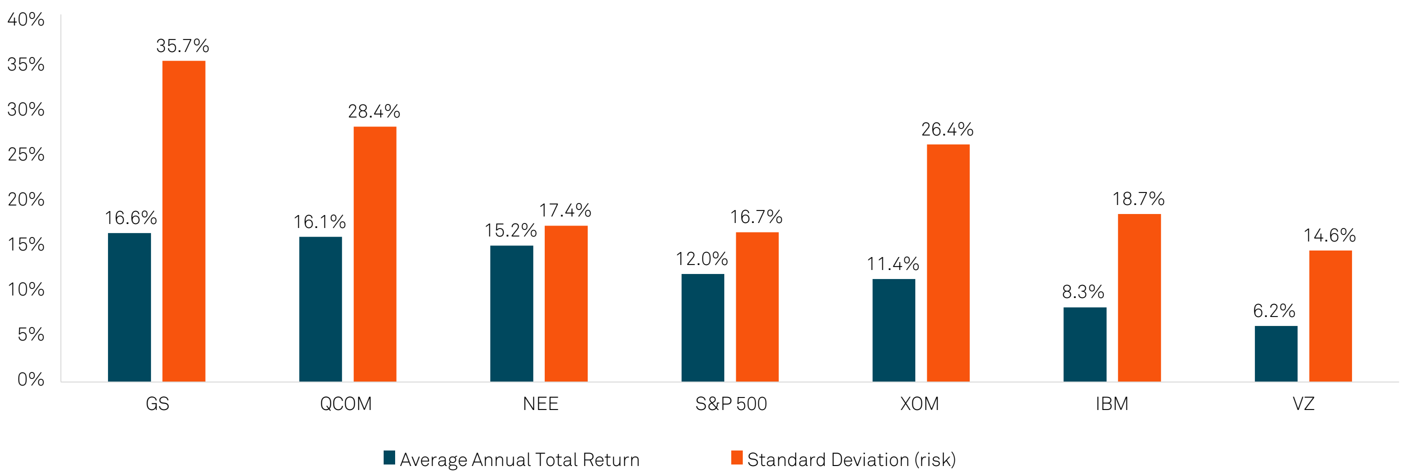
Source: Morningstar Direct. Data as of January 2003 – December 2023.

Concentration in a single stock can also create more uncertainty about reaching long-term goals because higher stock volatility negatively impacts long-term cumulative returns. If we look at a few examples of bellwether stocks that delivered strong annual returns from 2003 through 2023, we can see large dispersions in their cumulative returns driven by this volatility. For example, Goldman Sachs (GS) and Qualcomm (QCOM) had similar average annual returns, as illustrated in the top chart of Exhibit 2, but since GS had much higher volatility, it resulted in a much lower cumulative return (bottom chart). An investment of $1 million in GS at the beginning of 2003 would have increased to over $7 million by the end of 2023, versus almost $11 million for QCOM. Further, while NextEra Energy (NEE) had a lower annual average return than GS over this same period, its total cumulative return of over $14 million was almost double Goldman's due to its much lower volatility. The key message here is that a concentrated portfolio is likely to have high volatility, and high volatility reduces long-term cumulative returns.

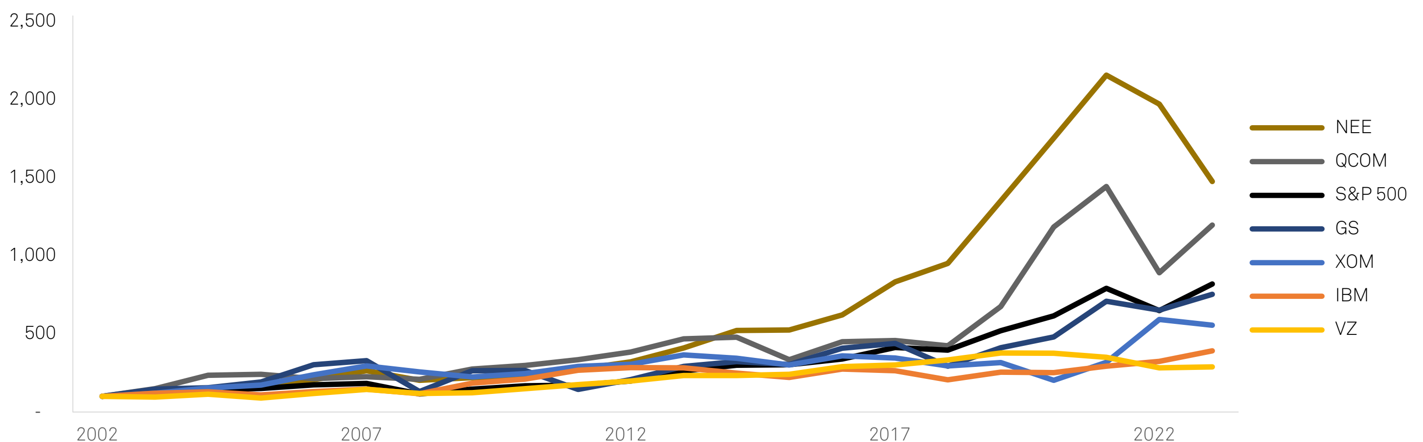
EXHIBIT 2

Single Stocks Have Higher Volatility, Which Can Reduce Cumulative Returns

Return & Risk of Select Stocks vs. S&P 500
2003 - 2023



Total Return of Select Stocks vs. S&P 500
2003 - 2023



Source: Morningstar Direct. Data as of January 2003 – December 2023.

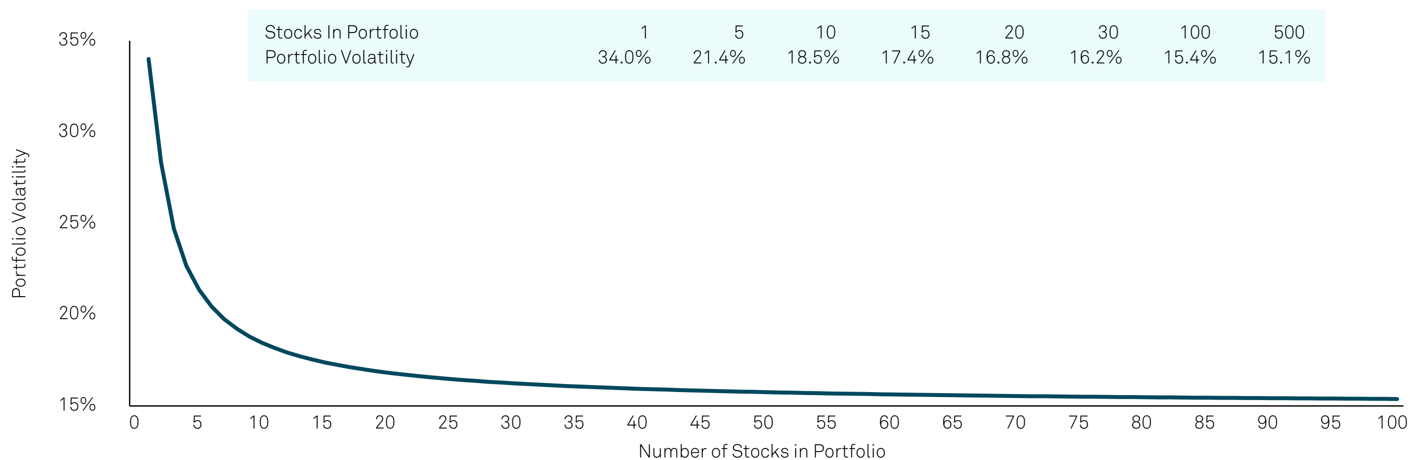
The Value of Diversification

As illustrated in the chart below, a concentrated portfolio will have a higher level of volatility, which can detract from long-term returns. Diversification, or investing across a broad array of stocks, allows a portfolio to achieve a higher potential return for any given level of expected risk at no additional cost. Importantly, the benefits of diversification are greatest for the most concentrated portfolios (i.e., one security) with the benefits increasing at a decreasing rate thereafter. Assuming 15% market volatility and 34% stock-specific volatility, we can observe that the volatility of a single-stock portfolio can be significantly reduced by adding just four more stocks while a portfolio of 100 stocks is in line with that of the broader market (e.g., S&P 500).

EXHIBIT 3

Diversification Provides Downside Protection

Portfolio Diversification by # of Stocks Held



Assumes market volatility of 15% and stock specific volatility of 34%.
Source: NDVR, Inc.

A diversified portfolio will never generate returns in line with the best performing single stock, but more importantly, it will dampen volatility and effectively eliminate the odds that its value will go to zero. For an investor with significant wealth, compounding, even at lower rates of return, will result in meaningful wealth accretion. Significant loss, on the other hand, is often hard to recoup as illustrated in the table below.

EXHIBIT 4

Recovering Full Value

If a Stock Falls This Much	It Must Rebound This Much to Fully Recover	Years to Recover (At 10% Per Year)
10%	11%	1.1
20%	25%	2.4
25%	33%	3.1
50%	100%	7.4
75%	300%	14.7

Diversification Protects from Leadership Change Within Sectors

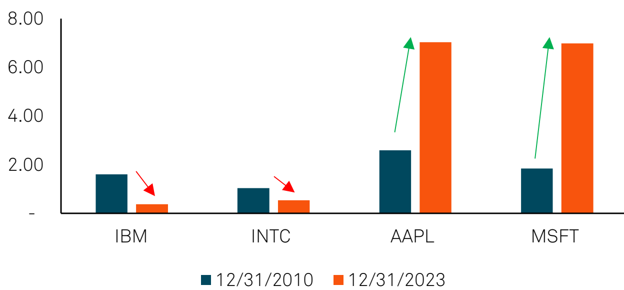
Thinking that one stock will be a perpetual outperformer is more likely to lead to underperformance than create wealth over the long run. Leadership changes within sectors occurs because companies compete to take market share, innovation disrupts incumbents, consumer preferences change, poor capital allocation is made or when executives commit fraud. Even if lucky enough to own a successful company within a sector, it is difficult to foresee when the change in leadership will occur.

Some examples of leadership change within sectors since 2010 can be found in the charts below.

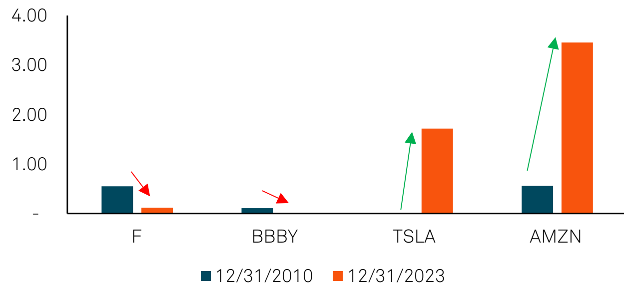
EXHIBIT 5

Sector Leadership

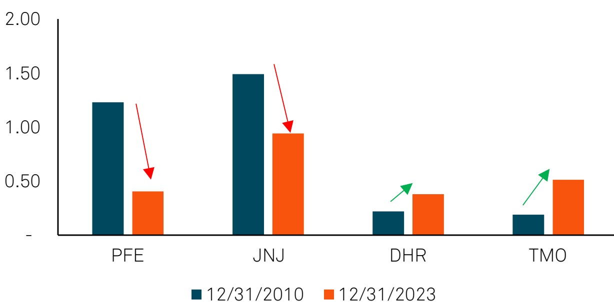
Select Information Technology Stocks
% of S&P 500



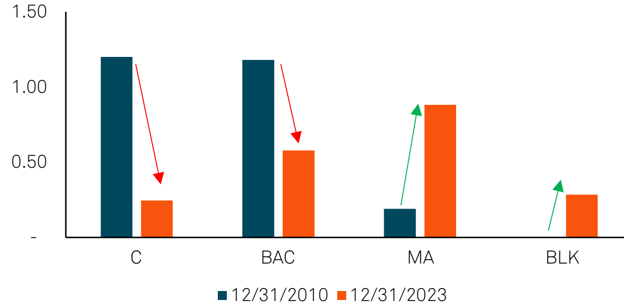
Select Consumer Discretionary Stocks weight
% of S&P 500



Select Healthcare Stocks weight
% of S&P 500



Select Financials Stocks weight
% of S&P 500



Source: Bloomberg. Data as of December 31, 2023.

Diversification Protects from Leadership Change Across Sectors

Diversification also reduces the risk of being overconcentrated in an outperforming sector. Leadership changes across sectors are usually a result of a regime change — powerful, underlying structural forces — that affect markets and investment returns. No company or sector operates in a vacuum. Instead, the investment landscape is dynamic, changing along with a wide range of factors. Technology disrupts incumbents and creates new opportunities and markets. Policy and legislation can shift the competitive balance across and within industries. Trends in globalization impact currency rates and inflation while central banks adjust interest rates to maintain healthy economic growth. Changes in these factors create new regimes, and history shows that sector relative performance often changes with regime changes. As such, persistent outperformance of a sector is rare.

EXHIBIT 6

Regime Change

Period (years ending Dec 31)	1990–1995	1995–2000	2000–2005	2005–2010	2010–2015	2015–2020	2020–2023
Regime	Fed cuts rates from ~8% to ~6%	Fed keeps rates steady	Volatile Fed Funds rate	Global Financial Crisis	Quantitative Easing	Quantitative Easing	Quantitative Tightening
	Jobless Recovery	Productivity / Tech Boom	Tech Bubble Pops / Housing Boom	Housing Bubble Pops	Slow U.S. Growth / ObamaCare	COVID	COVID Recovery
		Low Commodity Prices / NAFTA	High Commodity Prices / EM Growth	Globalization	Globalization	Deglobalization	Deglobalization
Sector Cumulative Total Returns							
S&P 500	115.3%	132.0%	2.7%	12.0%	80.8%	103.0%	33.1%
Energy	72.1%	117.9%	72.9%	49.1%	(0.3%)	(23.4%)	152.9%
Utilities	75.9%	116.0%	(10.7%)	21.1%	68.8%	72.3%	11.0%
Consumer Discretionary	114.3%	113.4%	14.1%	23.5%	127.2%	124.2%	11.6%
Consumer Staples	119.8%	92.1%	12.0%	44.8%	96.9%	54.8%	18.5%
Financials	202.1%	192.1%	20.2%	(43.0%)	64.4%	69.5%	35.5%
Healthcare	112.4%	206.5%	(11.0%)	9.5%	151.9%	73.4%	26.2%
Industrials	128.6%	126.7%	10.8%	16.9%	72.7%	79.2%	35.2%
Real Estate				12.8%	84.7%	41.4%	21.3%
Materials	99.3%	24.4%	59.8%	43.4%	27.6%	85.4%	25.7%
Information Technology	128.3%	248.0%	(29.2%)	27.8%	92.2%	240.8%	52.5%
Telecommunications	105.2%	58.6%	(30.0%)	37.9%	49.2%	74.9%	13.9%
Shaded = Top 3 sector							

Source: Bloomberg. Data as of December 31, 2023.

In the following examples, we can see how structural forces helped propel tech stocks during the dot-com bubble, the consequences of which led to a new regime that created an even larger bubble in homebuilder stocks. In both cases, the long-term benefits of diversifying out of regime winners would have exceeded the tax liability from selling at their peak levels, when taxable gains would have been highest.

Tech Boom/Dot-com Bubble (1995 – 2000)
In the mid-90s, the internet offered so many productivity possibilities that the potential benefit was hard to quantify but easy to imagine. Against a backdrop of low unemployment and low commodity prices, reduced international tariffs (e.g., NAFTA) and an accommodative Federal Reserve post-Asian Financial Crisis, investor enthusiasm led to a rise in both margin debt and stock valuations as investors chased what was thought to be the disruptive force of technology.

From December 31, 1994, through February 29, 2000, the S&P 500 was up almost 200%, but tech stocks did much better. The tech-heavy NASDAQ Index was up over 500% over that same period.

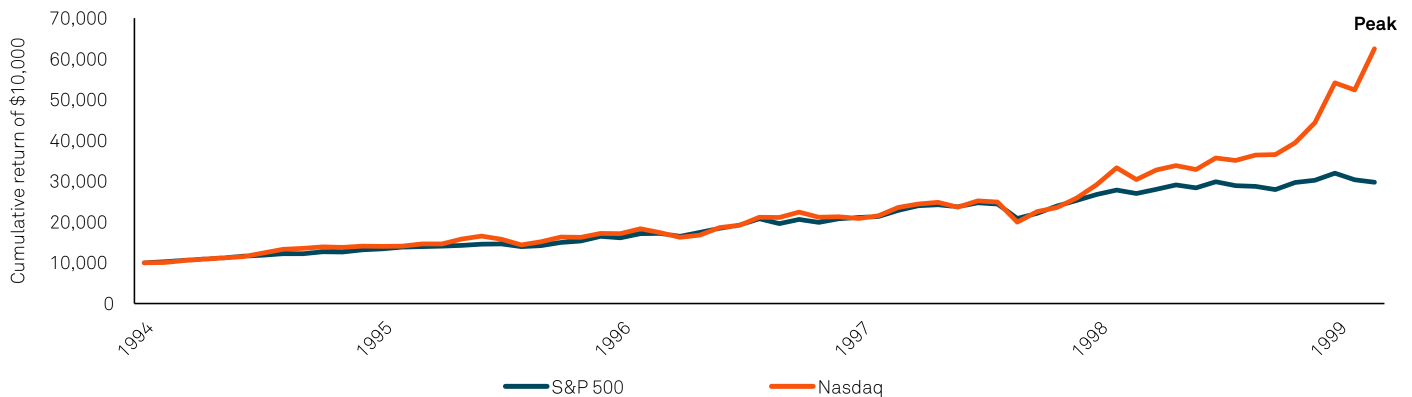
By this time, many of the IPOs from the 1990s were not delivering on the growth and profits investors expected. Eventually, the market realized valuations for technology companies were far too high and began heavily selling these stocks. From February 19, 2000 to the end of 2002, the S&P 500 dropped roughly 35%, while the NASDAQ was down 72%. And many of the tech IPOs from the prior decade had gone bankrupt.

Even though selling the NASDAQ at its peak would have led to a massive tax bill, the benefits of diversification would have outweighed these costs. An investor who sold the NASDAQ at the peak, paid a 20% capital gains tax and reinvested into the S&P 500 would have been better off for the next 18 years versus holding onto the NASDAQ.

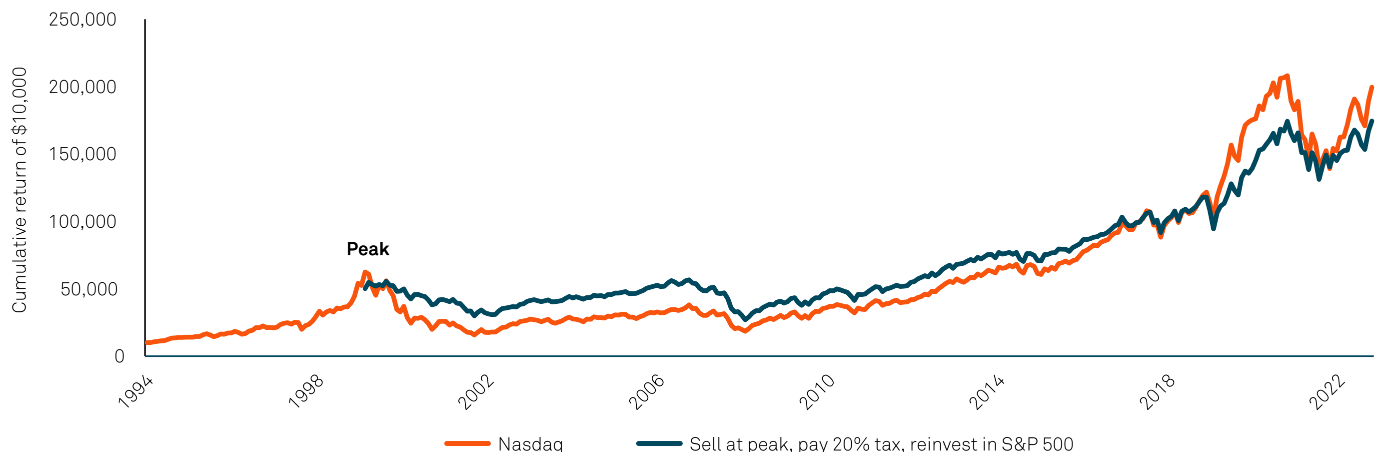
EXHIBIT 7

Case Study: Tech Boom

Concentrated Position



Benefits of Diversification



Source: Bloomberg. Data as of December 31, 2023.

Housing Boom (2000 – 2005)

After the dot-com bubble burst, the U.S. Federal Reserve (the Fed) reduced the fed funds rate from 6.5% in December 2000 to 1% in July 2003 to jumpstart the economy. Meanwhile, the 10-year U.S. government Treasury yield fell below 4% and lending standards loosened. Investor demand for yield paved the way for the subprime mortgage collateralized debt obligations (CDOs). This new regime of easy money led to the next euphoric investment trend: housing.

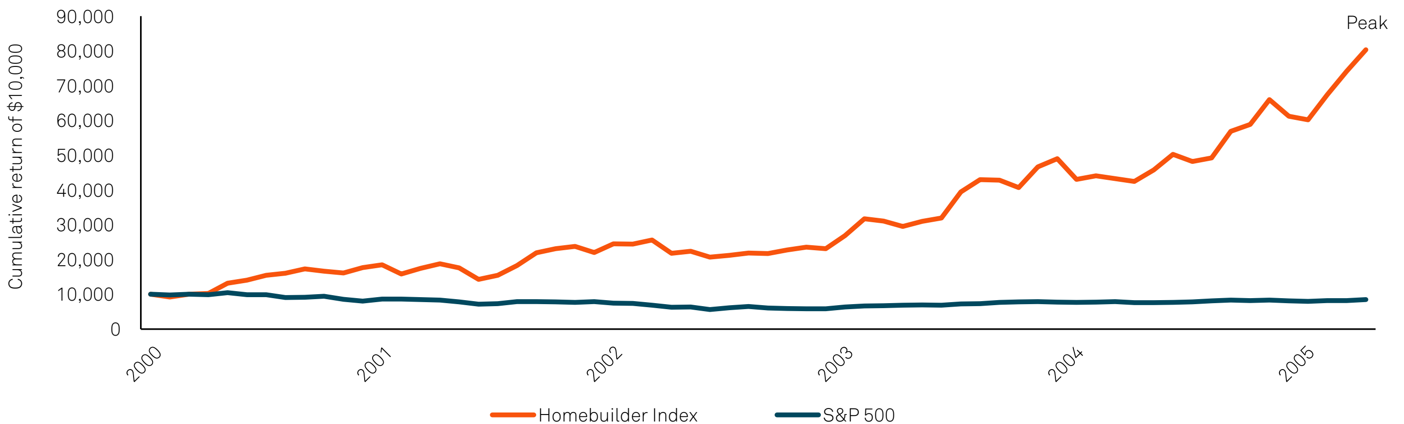
From the end of April 2000 to the end of July 2005, the S&P Homebuilder Index increased 700% while the S&P 500 was down 12%.

The Fed raised interest rates from 1% in mid-2004 to over 4% by the end of 2005, as increased globalization drove commodity prices and inflation higher. Consumers were getting squeezed by higher costs, which made it more difficult to pay their (rising) variable interest rate mortgages. The housing bubble popped. While the idea of realizing capital gains on an investment that had risen 700% seems painful, the benefits of investing after-tax proceeds into the broader market would have been significant and persisted for almost two decades. Further, it took until July 2020 for the Homebuilder Index to finally surpass its July 2005 peak.

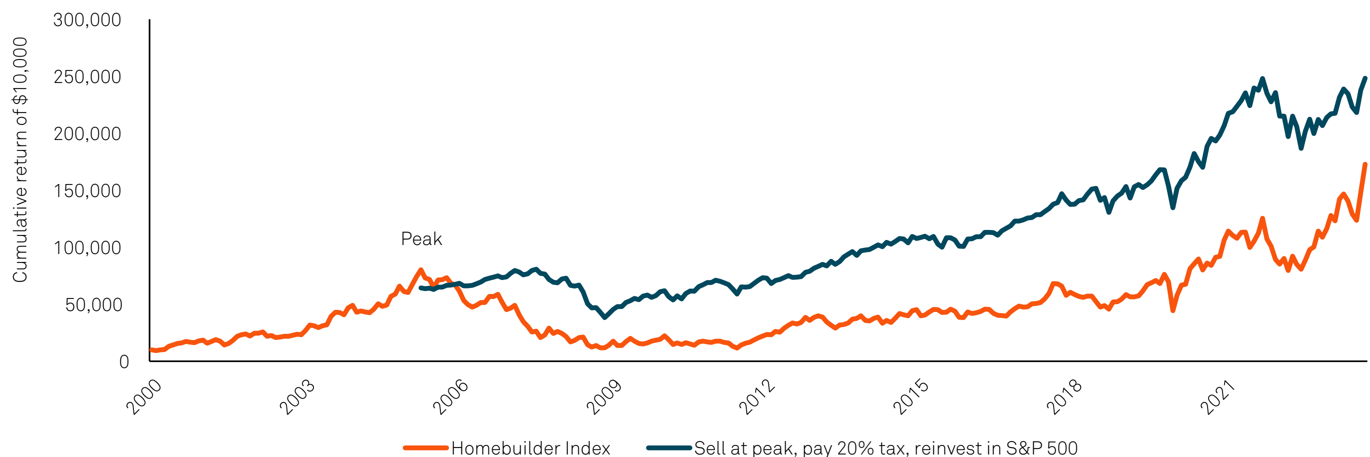
EXHIBIT 8

Case Study: Housing Boom

Concentrated Position



Benefits of Diversification



Source: Bloomberg. Data as of December 31, 2023.

The Risk/Reward Trade-off of a Concentrated Position

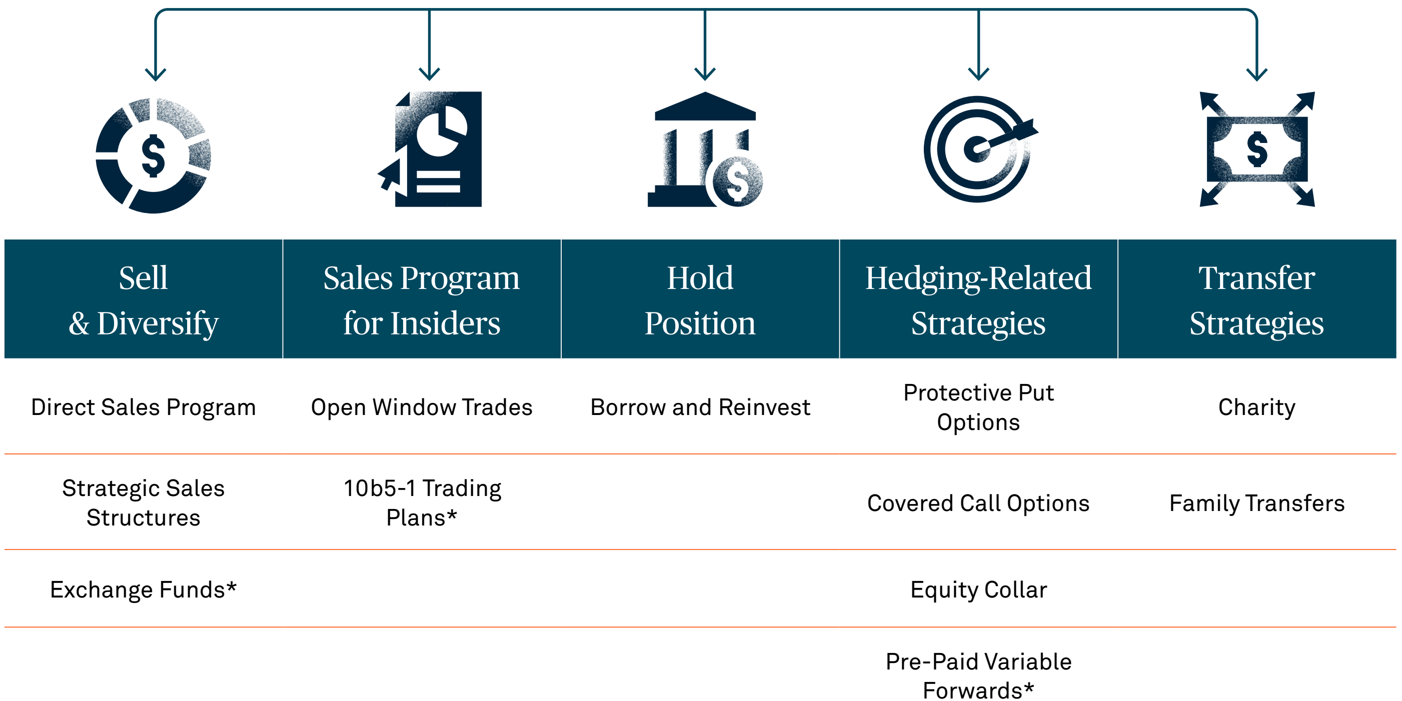
It's crucial for investors to be aware of the risk/reward trade-off of holding a concentrated stock position. Although a single stock can provide strong annual returns, its higher volatility will reduce the long-term cumulative benefit of those returns. Further, a significant loss from a concentrated position can weigh on long-term investment goals. And as market forces change, so does leadership across companies and sectors. These changes make it more likely that a concentrated portfolio will miss out on new stock market leaders.

How to Diversify a Concentrated Portfolio

BNY Mellon Wealth Management offers a full range of strategies that can help reduce risks associated with concentrated positions, including selling shares in a tax-efficient manner, and hedging and gifting shares (see Exhibit 9). Our team of specialists can help determine what strategy, or combination of strategies, best fits your long-term planning goals, income requirements and charitable intentions. Each individual's situation is different, and the best option(s) may depend on the value of the shares, unrealized gain, regulatory constraints, the investor's time horizon and perhaps our outlook for the stock(s) and/or sector(s).

EXHIBIT 9

Strategies for Concentrated Equity Positions



Sell & Diversify	Sales Program for Insiders	Hold Position	Hedging-Related Strategies	Transfer Strategies
Direct Sales Program	Open Window Trades	Borrow and Reinvest	Protective Put Options	Charity
Strategic Sales Structures	10b5-1 Trading Plans*		Covered Call Options	Family Transfers
Exchange Funds*			Equity Collar	
			Pre-Paid Variable Forwards*	

*Third-party providers

WHY YOU SHOULD CONSIDER DIVERSIFYING CONCENTRATED STOCK POSITIONS

While each situation is different, we outline five strategies that can lower the risk of concentrated positions, reduce the overall tax burden and improve portfolio diversification.

1 SELL & DIVERSIFY

One of the most common ways to reduce concentration risk is to sell a portion of the stock and reinvest the proceeds into other investments. Of course, concentrated positions often carry a low-cost basis, so it is important to consider the tax consequence and whether that would push an investor into a higher tax bracket. In order to be mindful of taxes, creating a sales program designed to reduce exposure over a pre-determined period of time can help to mitigate taxes and the risk of a stock-specific decline, and the time it takes to recover any potential loss.

Individuals may also consider exchange funds that pool multiple investors' concentrated stocks together in a fund in exchange for a proportional share of the fund. Since the investor isn't selling the concentrated stocks, they can defer capital gains while diversifying their stock holdings.

2 IMPLEMENT A REGULATORY SALES PROGRAM

If you are a holder of affiliated or restricted stock, or considered a control person, you can utilize regulatory sales programs, like a 10b5-1. This creates an automated plan designed to sell their concentrated holding over a pre-determined period of time. In addition to helping manage taxes, systematic selling takes away the risk of choosing the right time to sell, such as after a significant decline in the stock or overall stock market.

3 OPEN AN INVESTMENT LINE OF CREDIT

Investors may be limited as to when they can diversify if they are subject to a holding period (these can vary in length of time/situation). In these situations, opening an investment line of credit on the concentrated holdings is another way you can use leverage to diversify away from a concentrated position without realizing gains and thus incurring taxes. An investor could use the borrowed proceeds to diversify assets or to fund liquidity needs. If, for example, a tax liability was due, the investor could avoid having to liquidate a portion of their concentrated position at an inopportune time and paying capital gains taxes.

4 HEDGING STRATEGIES

In light of the higher volatility of individual stocks versus a diversified portfolio, many investors choose to hedge the risk a stock will decrease in price by using options. Put options limit downside returns for a cost that can be determined economically with cash. Collars mean giving up some of the upside potential in exchange for that same downside protection. Writing covered calls does not directly limit the volatility of a stock concentration, but can provide a steady stream of income, which in dollar terms can provide a similar benefit if returns were to decrease.

5 GIFT OR DONATE TO CHARITY

If a stock has a low-cost basis and if an investor has charitable intentions during their lifetime or after their death, they may want to gift shares to a charitable trust, donor advised fund (DAF) or directly to a charitable organization. Based on an understanding of an investor's legacy goals, we can develop the right vehicles and structures to enable the most tax-efficient transfer of these assets and greatest growth potential over time. For example, a charitable trust can be funded with low-cost basis stock that immediately gets sold and diversified. The trust can then provide an annuity to the donor or charity during the donor's lifetime.

One other strategy that can be employed for a stock expected to appreciate in value is to place the concentrated position in a Grantor Retained Annuity Trust structure to minimize taxes on gifts to family members. Strategies like this can ensure lasting wealth for generations to come and place an emphasis on thinking toward the future.

Next Steps

A concentrated stock position may have helped build wealth, but can pose unnecessary risks to a portfolio and long-term goals. Many investors recognize the value in taking steps to preserve that wealth by diversifying away from the concentrated position(s).

At BNY Mellon Wealth Management, we have a team of specialists that can analyze the specifics of each client's situation and recommend a plan to de-risk the portfolio, manage taxes and help preserve wealth now and into the future.

@BNYMellonWealth | bnymellonwealth.com

This material is provided for illustrative/educational purposes only. This material is not intended to constitute legal, tax, investment or financial advice. Effort has been made to ensure that the material presented herein is accurate at the time of publication. However, this material is not intended to be a full and exhaustive explanation of the law in any area or of all of the tax, investment or financial options available. The information discussed herein may not be applicable to or appropriate for every investor and should be used only after consultation with professionals who have reviewed your specific situation. The Bank of New York Mellon, DIFC Branch (the "Authorized Firm") is communicating these materials on behalf of The Bank of New York Mellon. The Bank of New York Mellon is a wholly owned subsidiary of The Bank of New York Mellon Corporation. This material is intended for Professional Clients only and no other person should act upon it. The Authorized Firm is regulated by the Dubai Financial Services Authority and is located at Dubai International Financial Centre, The Exchange Building 5 North, Level 6, Room 601, P.O. Box 506723, Dubai, UAE. The Bank of New York Mellon is supervised and regulated by the New York State Department of Financial Services and the Federal Reserve and authorized by the Prudential Regulation Authority. The Bank of New York Mellon London Branch is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. The Bank of New York Mellon is incorporated with limited liability in the State of New York, USA. Head Office: 240 Greenwich Street, New York, NY, 10286, USA. In the U.K. a number of the services associated with BNY Mellon Wealth Management's Family Office Services–International are provided through The Bank of New York Mellon, London Branch, One Canada Square, London, E14 5AL. The London Branch is registered in England and Wales with FC No. 005522 and BR000818. Investment management services are offered through BNY Mellon Investment Management EMEA Limited, BNY Mellon Centre, One Canada Square, London E14 5AL, which is registered in England No. 1118580 and is authorized and regulated by the Financial Conduct Authority. Offshore trust and administration services are through BNY Mellon Trust Company (Cayman) Ltd. This document is issued in the U.K. by The Bank of New York Mellon. In the United States the information provided within this document is for use by professional investors. This material is a financial promotion in the U.K. and EMEA. This material, and the statements contained herein, are not an offer or solicitation to buy or sell any products (including financial products) or services or to participate in any particular strategy mentioned and should not be construed as such. BNY Mellon Fund Services (Ireland) Limited is regulated by the Central Bank of Ireland BNY Mellon Investment Servicing (International) Limited is regulated by the Central Bank of Ireland. Trademarks and logos belong to their respective owners. BNY Mellon Wealth Management conducts business through various operating subsidiaries of The Bank of New York Mellon Corporation.

©2024 The Bank of New York Mellon Corporation. All rights reserved. | WI-510297-2024-03-07