Larchmont resident Ian A. Post, is the Principal of Fifth Set Investment Advisors LLC. Fifth Set is the result of his evolution of thought in regard to conventional investment management. His experience and education led to research for a smarter approach to portfolio management and financial planning. Prior to Fifth Set, Ian conducted fundamental equity research at Citigroup, Credit Lyonnais and CIBC Oppenheimer. Ian earned a BS in Engineering and Public Policy from Washington University and an MBA with concentrations in Finance and Statistics from NYU and is a holder of the Charted Financial Analyst designation, a member of CFA Institute and a CERTIFIED FINANCIAL PLANNER™ certificant.

Hold or Diversify: *The Low Cost Basis Stock Conundrum*

By Ian A. Post, CFA, CFP®

A common conundrum at the onset of a client relationship is the situation where the client has a large position in low cost basis stock. The stock might have been a gift from a parent or grandparent from many years ago, or just a smart buy and hold of a stock that turned out to be a big winner. **The dilemma is whether to continue to hold the stock or sell it, pay the taxes and use the proceeds to invest in a diversified portfolio.**[1]

First, let's look at a few common objections to diversifying concentrated stock positions.

- "It's a great company, why should I sell?"
- "I don't want to sell now because the stock has recently gone up"
- "I will be worse off if I have to pay capital gains taxes"
- "I work at the company so I know that things are going great"

Setting aside these and other objections for the moment, how can we approach the underlying question of which alternative is better? We can approach this question by looking at what we know and don't know and use statistical techniques to give us a better understanding of how to proceed.

	Individual Stock	Diversified Portfolio
Future Return	Unknown	Unknown
Expected Volatility	Higher	Lower
Risk of Ruin	Non-zero	Practically zero
Exposure to Market Risk	Yes	Yes
Exposure to Company-Specific Risk	Yes	No

Future Return

In both cases, the future return is unknown. However, using financial models such as the Three-Factor Model[2], we can estimate expected future returns. Through this process, we can implement an investment in a broad market fund that is "tilted" toward higher expected return securities, something that cannot be done with individual stocks.

Expected Volatility

Broad market funds have lower volatility than individual stocks due to the diversification effect of having many individual stock return sequences offset each other. The reduced volatility of the diversified fund will, over time, increase wealth relative to the more volatile individual stock position, assuming similar average returns.

Risk of Ruin

Individual companies can go bankrupt (think Enron, WorldCom, Bear Stearns, Lehman Brothers, etc.), leaving stock holders with worthless securities. Short of end-of-civilization type scenarios, diversified market funds do not go to zero.

Exposure to Company-Specific and Market Risk

Academic research has shown that investors are compensated only for risks that cannot be diversified away (i.e. market risk). Risks that are diversifiable, such as those associated with an individual stock, are not compensated. This means that when investors hold individual stocks, they are taking additional risk for which there is no additional expected return.

What About the Taxes?

The final question is, given all the advantages of the diversified portfolio, is it enough to overcome the upfront tax payment caused by selling the concentrated stock position? The answer, like much in personal finance, is there is no way to know for sure ahead of time. We can, however, use statistical methods such as Monte Carlo simulation[3], to make projections that, in many cases, show that selling and diversifying is the better approach even after paying the upfront taxes.

While in many cases, selling and buying the diversified portfolio is the smart strategy, there can be scenarios where different approaches might make more sense. As in all areas of personal finance, the specifics matter so take care to consider all the relevant information before you decide to hold or diversify.

Fifth Set Investment Advisors LLC is a registered investment adviser. Information presented is for educational purposes only and does not intend to make an offer or solicitation for the sale or purchase of any specific securities product, service, or investment strategy. Investments involve risk and unless otherwise stated, are not guaranteed. Be sure to first consult with a qualified financial adviser, tax professional, or attorney before implementing any strategy or recommendation discussed herein.

[1] This scenario looks only at the choice between holding and selling to diversify. There are a variety of other strategies that deal with concentrated low cost basis stock positions that may offer additional benefits to investors depending on their unique circumstances. [2] A subject of a future article [3] Monte Carlo simulation is a mathematical technique that generates random variables for modelling risk or uncertainty of a certain system.