► **Greycourt White Paper**

White Paper No. 19 – *Concentrated Security Positions: Four Commonsense Principles*

Many wealthy families hold all or most of their wealth in one highly appreciated security. Sometimes that stock represents a control position in a family company, but more often the holding has resulted from a sale of the family company for stock in a public company. If the sale occurred just prior to a bull market, the family may believe that owning one concentrated security is an excellent way to create significant wealth. This was certainly the case with many families who sold their companies in stock deals during the 1980s and 1990s. Unfortunately, periods like those two decades come along far less than once in a lifetime.

The purpose of this white paper is to suggest a commonsense approach to dealing with large, concentrated stock positions, having in mind that there is a difference between a bull market and a sound investment strategy.

Analytical approaches

Quantitative analyses of concentrated stock positions are designed to inject a measure of rationality and objectivity into what can be a very emotional decision for a family. Typically, a quantitative analysis of a concentrated position begins by generating forward-looking estimates of the likely return, risk (price volatility, expressed in terms of Standard Deviation, or S.D.), and correlations of the security at issue. The time horizon of the family will be an important consideration, as will its tolerance for risk. Once these "facts" have been prepared, the concentrated position can be analogized to an "asset class" and used to attempt to create a sensible portfolio. Working with net-of-tax numbers, optimizations can be run and Monte Carlo or similar simulations can be prepared to suggest likely pre- and after-tax outcomes of portfolios containing various percentages of the security, from 100% to 0%.

Unfortunately, however, quantitative analysis is itself highly problematic, for the reasons discussed below. While quantitative analysis should be a part of the solution to a concentrated stock position, we suggest that commonsense approaches are likely to prove more fruitful for most families.

Commonsense principal #1: Accurate long-term return expectations for an individual security are virtually impossible to generate

For a quantitative analysis of a concentrated position to be useful, families must estimate with great accuracy the very long-term return on the security they hold. (Family time horizons will typically be in the ten-to-twenty year range, or even longer.) While it is possible to estimate with very rough accuracy the long-term return on an entire asset class, estimating the very long-term future return for an individual security is, well, impossible. Very long-term return estimates founder on many shoals. First, asset class returns tend to be *easier* to estimate as time horizons expand, while estimating the return on a specific stock works in the opposite direction: short-term return estimates can be quite accurate, but accuracy declines dramatically as the time period stretches out.

A few years ago Sanford C. Bernstein & Co., Inc. looked at the data on this issue and came up with unsettling results.[1] For example:

- Of the ten "Most Admired" companies on Fortune magazine's list in 1988, only one (one!) made the 1998 list. (Merck, which went from #1 to #10.) How many on the 1998 list will appear on the 2008 list?
- Only four of the ten companies on the 1988 "most admired" list outperformed the S&P 500 Index between 12/31/88 and 12/31/98. 40% may not seem low, but keep in mind that these were the most admired companies in America at the start of the period.
- An alarming number of well-regarded, well-performing companies at the start of the long bull market in 1982 devastated their stockholders over the years 1985-98. Ames Department Stores appreciated almost 300% between 1982 and 1984, but then went bankrupt. Other disasters: Circle K, up 205% between '82 and '84, went bankrupt; Pan Am, up 68%, went bankrupt; Wang Laboratories, up 58%, declined 92%; Zenith, up 80%, declined 99%.

A few years ago, former Stanford Business School Professor Jim Collins and his research team looked at every stock listed on the New York Stock Exchange to identify companies that were "sustainably great," that is, that outperformed their peers for at least fifteen years (roughly the time horizon for a family). He found exactly eleven.[2]

Second, families can expect to receive little assistance in estimating long-term returns for the stock they hold. Assessments prepared by research analysts employed by the large Wall Street firms are worse than useless, both because they are strongly upwardly biased (as a result of the conflicts of interests in those firms) and because they are very short-term in nature (typically being concerned with the next quarter or two). Money managers looking at the stock can sometimes be helpful, but even the most patient managers are looking at holding periods of 3-to-5 years, not the decade or more that families will likely own the stock.

Third, we simply cannot know the economic environment a decade or more into the future, cannot estimate price-earnings multiples, cannot know who the management team will be, cannot know what conditions in the industry will be like, and so on. And, finally, whoever

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[1] Sanford C. Bernstein & Co., Inc., *Trading Off Taxes and Risk: A Guide to Decision-Making on Concentrated Low-Basis Stock Positions* (1999).

[2] Jim Collins, *Good to Great*, HarperCollins (1st ed. 2001)

is performing the analysis will likely be biased, either consciously or otherwise. If the analysis is being performed by the family and the stock has performed very well for a considerable period of time, the family is almost certain to *over*-estimate the future return, setting themselves up for serious disappointment. If the analysis is being performed by a bank, broker or investment bank, the firm is almost certain to *under*-estimate the future return, simply because the firm wishes to encourage the family to engage in a profitable (for the firm!) transaction to sell or hedge the security. (Or the firm wishes to manage the funds generated by a sale or hedge. Or both.)

The most sensible solution is to assume that the security held by the family will generate a return no higher and no lower than the return on the equity market in general.

Commonsense principle #2: Price volatility matters a lot

Stocks whose prices are highly volatile must generate far higher returns than low volatility stocks to achieve the same wealth outcome. The iron laws of mathematics work powerfully against volatile stocks. Consider a simple example. A $100 stock that appreciates 70% in year one and then declines 50% in year two will have a terminal value of $85. A $100 stock that appreciates 7% in year one and declines 5% in year two will have a terminal value of $102.

Moreover, individual stocks are dramatically more volatile than the market as a whole. Between 1970 and 1998, for example, the volatility of the S&P 500 Index (measured in terms of S.D.) was about 15, while the average volatility of the individual stocks in the Index was over 27.[3] Obviously, any individual stock would have to generate a very significant out-performance to justify holding it in any significant concentration. But as we have just seen, it is extremely rare for such out-performance to occur on a sustained basis.

Finally, while individual stock returns are notoriously unstable (as discussed above), the price volatility exhibited by individual stocks tends to remain rather stable over time. Hence, the most sensible solution is to assume that the historical price volatility of the security held by the family will continue into the future, regardless of the return it generates.

Commonsense principle #3: Time horizon matters

Because the sale of a low cost-basis stock will be a taxable event, only about 80% of the initial value of the securities will be available for reinvestment. Hence, if the time horizon of the family is relatively short (five years or less), it will often make sense to hold the concentrated position. Keep in mind that, barring a change in the taxation of estates, many concentrated securities positions will receive a stepped-up cost basis at the death of the owner. On the other hand, if the time horizon of the family is relatively long (ten years or

[3] Op. cit., note 1.

more), it will usually make sense to diversify the concentrated position, both because the reinvested portfolio will have time to overcome the tax drag and because the level of confidence we can have in the future performance of the security declines precipitously over time. Of course, these general guidelines assume that you are agnostic about the future value of the security.

Commonsense principle #4: The family's wealth position is crucial

Positive and negative outcomes of holding concentrated positions can be dramatically skewed in the family's favor or against its interests. Consider, for example, a family that is wealthy and for whom the concentrated position represents all or most of the family's wealth. If the concentrated stock position does well, all that happens is that the family becomes wealthier. A happy outcome, to be sure, but not a life-changing event. On the other hand, if the concentrated position does very badly, the family's wealth could be destroyed. In other words, the unhappiness generated by a negative outcome is vastly greater than the happiness generated by a positive outcome. For such a family, failure to diversify the concentrated position is equivalent to gambling with the family's fortunes.

On the other hand, if the family is wealthy wholly aside from the large concentrated position, the family is in a position to enjoy the wealth increase generated by a positive outcome without worrying about being devastated by a negative outcome. In such a case, diversification should be viewed with a more jaundiced eye.

The idea that, while we cannot precisely predict the outcome of inherently uncertain situations, we can judge the severity of the likely outcomes, is as old as Pascal's Wager (1660).[4] The two towering figures of behavioral finance, Daniel Kahneman and Amos Tversky, have examined the emotional and psychological aspects of investment decision-making via so-called Prospect Theory, a conceptual framework for analyzing how we manage uncertainty and risk. It is far beyond the scope of this paper to discuss Prospect Theory in any detail, but suffice it to say that human beings engage in irrational decision-making both because emotion destroys the self-control required for it and because all too often we fail to understand the full outlines of the problem confronting us.[5] It is crucial that families possessed of very large, concentrated securities positions evaluate carefully how they are likely to feel about positive and negative outcomes respecting the future value of those securities.

Summary

A discussion of the specific techniques available to a family to diversify away from a large, low-basis stock position are beyond the scope of this paper. But those techniques – buying puts, selling calls, creating collars (which involves the simultaneous purchase of a put and

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[4] "God is, or he is not. Which way should we incline?"

[5] An excellent summary of Pascal's Wager and Prospect Theory appears in *Against the Gods: The Remarkable Story of Risk*, by Peter L. Bernstein (John Wiley & Sons, Inc. 1998), p. 68-70 and p. 270 ff.

sale of a call), prepaid forwards, exchange funds, charitable remainder trusts, etc. – all carry with them complex baggage. While each technique should be fully evaluated, many families will find that an outright sale, payment of the tax, and reinvestment of the proceeds in a well-diversified portfolio will make the most sense. This strategy will appeal in particular to families who recognize that their wealth must always be viewed as being, ultimately, net of tax.

We will be happy to discuss this memo at your convenience.

GREYCOURT & CO., INC.
May 2002

(This paper was written by Gregory Curtis, Greycourt's Chairman.)