

# ASK THE INSTITUTE



## What Is a Concentrated Position?

Typically an allocation of more than 10 percent to a specific security or subsector connotes a concentrated position.

### How Do Concentrated Positions Accumulate?

- ▶ An executive is compensated in company stock
- ▶ A business owner sells a company and receives proceeds in stock
- ▶ An investor has a large real estate portfolio
- ▶ An individual inherits a large position in a particular asset

### What Are the Risks of Holding Large Positions in a Portfolio?

- ▶ Concentration risk (the risk associated with having a large portion of holdings in a particular investment, asset class, or market segment relative to the overall portfolio, which may amplify losses)
- ▶ Nonsystematic risk (company-specific or property-specific risk)



## How Do Concentrated Positions Affect a Portfolio?

### Key Takeaways

- ▶ Holding a large position in a single security, sector, or asset class, such as real estate, poses risks.
- ▶ There are a variety of reasons why positions accumulate in a portfolio.
- ▶ Certain strategies can help investors manage concentration risk.

Occasionally portfolios become concentrated in a single asset or subsector, particularly one that was instrumental in building wealth. Yet, a concentrated position can have a devastating effect on a portfolio if it underperforms, as experienced by some investors who held internet and technology stocks in the early 2000s and real estate investors in 2008.

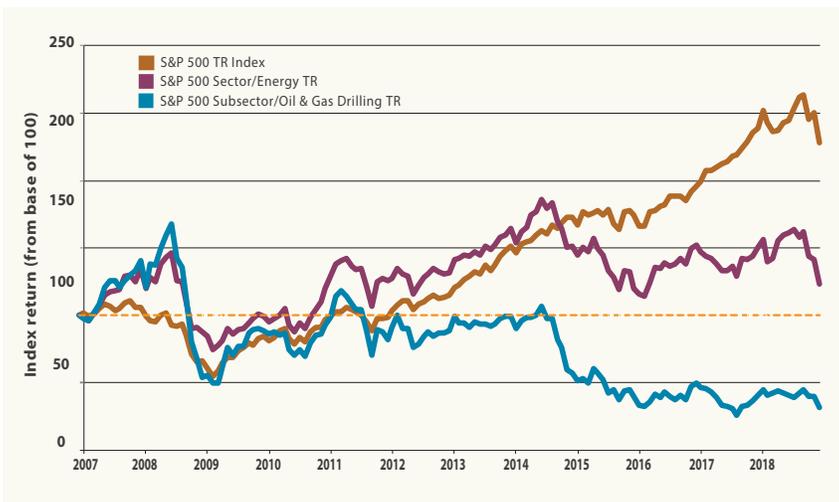
Therefore, investors often look for ways to:

- ▶ Reduce a portfolio's concentration risk
- ▶ Monetize holdings to meet cash-flow needs
- ▶ Optimize tax efficiency of concentrated positions

### Concentrated Positions and Performance

Although stocks within a broad market index often move in concert, stocks within different sectors, subsectors, or industries can have moments of volatility that put them well ahead—or behind—a broad market index. Being concentrated means less diversified. Even though at times it may seem beneficial to be concentrated, investors usually fail on timing to make adjustments once the benefits cease. Therefore, portfolio diversification seems most prudent. Yet, investors can take advantage of short-term market dislocations to seek to enhance performance potential using techniques we discuss below.

#### Performance of an Index, Sector, and Subsector Varies Over Time



Source: Morningstar Direct, monthly data from 1/31/07 to 12/31/18. For illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions and do not reflect deduction for fees, expenses, or taxes applicable to an actual investment. An index is unmanaged and not available for direct investment. **Past performance is no guarantee of future results.** Please see the end of the report for the definitions of the indices.

# Psychological Considerations in Addressing a Concentrated Portfolio

There are a variety of reasons a portfolio becomes overconcentrated in a single asset in the first place. A number of well-known behavioral biases often affect the decision-making of investors who hold concentrated positions. These cognitive and emotional biases include:

<p><b>ANCHORING AND ADJUSTMENT</b></p> <p>▼</p> <p>An investor assumes that past performance is indicative of future performance and makes portfolio adjustments from this reference (anchor).</p>	<p><b>OVERCONFIDENCE/ ILLUSION OF CONTROL</b></p> <p>▼</p> <p>An investor overestimates the actual control over the performance of a company or stock. This frequently is exhibited by corporate executives with large holdings of their company's stock.</p>	<p><b>FAMILIARITY BIAS</b></p> <p>▼</p> <p>An investor prefers to invest in familiar stocks or assets and may be uncomfortable investing in assets they have little or no knowledge about.</p>	<p><b>STATUS QUO BIAS</b></p> <p>▼</p> <p>An investor prefers to make no decision about their holdings.</p>	<p><b>REGRET AVOIDANCE</b></p> <p>▼</p> <p>An investor has more regret for taking action than for taking no action at all.</p>
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## Overconcentration vs. Overweighting

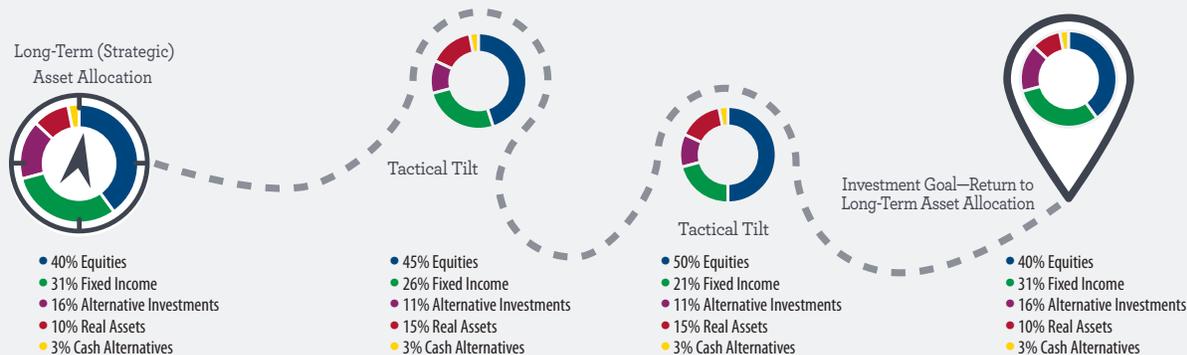
Concentrated portfolios lack diversification. We recommend that investors diversify portfolios broadly across different asset groups, asset classes, and geographies. An asset allocation strategy that is aligned to an investor's unique investment objectives, risk tolerance, and time horizon can help mitigate against downside risk and smooth out portfolio returns over time. Essentially it can alleviate some of the volatility that an individual security, asset class, or



sector might experience. Depending on market conditions, it may make sense to exploit tactical opportunities and increase exposure to overweight a favorable asset class for a period of time. Under the appropriate market conditions, adding a tactical overweight within the context of a diversified portfolio can enhance overall performance.

Diversification does not guarantee investment returns or eliminate risk of loss

## Using Tactical Overweights and Underweights in a Diversified Portfolio



Strategic asset allocation is the longer-term (10- to 15-year) approach to the mix of investments in a portfolio designed to help investors pursue their investment goals.

Tactical overweight and underweight decisions are designed to take advantage of shorter-term (6- to 18-month) opportunities in specific asset classes by temporarily adjusting strategic asset allocation mixes. The ultimate goals are to maintain diversification and return to the long-term (10- to 15-year) asset allocation.

Source: Wells Fargo Investment Institute. Allocations are hypothetical and for illustrative and information purposes only. They do not represent the composition of any portfolio and are not a recommendation to invest in any particular asset class or strategy. Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stocks** may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Cash alternatives** typically offer lower rates of return than longer-term equity or fixed-income securities and may not keep pace with inflation over extended periods of time. **Bonds** are subject to market, interest rate, price, credit/default, call, liquidity, inflation, and other risks. Prices tend to be inversely affected by changes in interest rates. **Real assets** are subject to the risks associated with real estate, commodities, and other investments and may not be suitable for all investors. Alternative investments trade in diverse complex strategies that may expose investors to considerable risks.

## Concentration Risk

Investors with shorter time horizons or with an increased need for income face heightened risks from a concentrated portfolio. We encourage investors to consider strategies that help mitigate the risk of concentrated positions based on their circumstances. For example, if an investor is considering bequeathing their assets, the tax consequences to their heirs also might be considered. Whether investors' goals involve increasing liquidity needs or preserving wealth for beneficiaries, we recommend they work with financial professionals to develop a strategy that meets their unique financial needs.

## Check Indexed and Country-Specific Funds for Overconcentration

Exchange-traded funds and mutual funds often can be influenced by the market capitalizations of their underlying holdings. As the market capitalization of some holdings rises, they can become the largest holdings in a fund. This eventually can lead to an overconcentration in a specific security or sector. Likewise, if investors hold commodity-based funds or emerging markets funds with significant exposure to commodity-producing countries, their portfolios could end up having too much exposure to a single commodity such as oil or copper. Therefore, it's important for investors to look beneath the hood and understand how an investment vehicle's composition evolves and, more important, the overall effect it can have on their portfolios.

## Tax Consequences of Capital Appreciation

In some cases, concentrated assets could have appreciated greatly from their original cost basis. Choosing to sell the position could trigger a taxable event and quite possibly a significant tax liability for the investor. Therefore, reducing or postponing a capital gains tax is a primary goal for many investors who hold concentrated positions.

Wells Fargo and its affiliates are not tax advisors. Be sure to consult your own tax advisor and investment professional before taking any action that may involve tax consequences. Tax laws or regulations are subject to change at any time and can have a substantial impact on your individual situation.

## Key Strategies for Managing Concentrated Positions

### ► Sell and diversify portfolio holdings.

This strategy can be done in stages to help alleviate the tax consequences. The decision of how much to sell depends on several factors, including risk tolerance, time horizon, liquidity needs, and tax costs.

### ► Monetize.

These strategies provide investors with funds to spend or invest without triggering taxable events.

### ► Make use of hedges.

Depending on the situation, hedging strategies might help mitigate price volatility and offset potential price declines.

### ► Consider charitable giving.

Those investors with philanthropic aspirations may consider strategies such as a charitable remainder trust.

## What if an Investor Is Constrained From Selling a Concentrated Position?

Every investor has a unique set of circumstances. Sometimes an investor is not permitted to sell a concentrated position for legal or family dynamic reasons, such as a restricted stock. In such circumstances, certain monetization strategies might be allowed. For these types of complex matters, it is recommended to work with an investment professional, tax accountant, or legal advisor.



### Now It's Your Turn ...

*Take a moment to assess the concentration risk of your current holdings by answering the following questions:*

- Does a single security in your portfolio represent more than 10 percent of your total assets?
- Are you a residential or commercial real estate investor?
- Do you own a business?

If you answered *yes* to any of these questions, your assets may be at risk of holding a concentrated position. We recommend that you work with your investment professional and/or tax accountant or legal advisor to determine the most appropriate course of action for your circumstances. They will help you assess the tax, legal, and personal consequences of moving out of a concentrated position into a more diversified portfolio or help you determine the most appropriate strategy to manage the concentrated position.

#### Other Risk Considerations:

All investing involve risks, including the possible loss of principal. There can be no assurance that any investment strategy will be successful. Investments fluctuate with changes in market conditions due to numerous factors, some of which may be unpredictable. The concentration strategies discussed in this report may not be suitable for all investors. The individual risk factors associated with each strategy should be considered carefully before making any investment decision. Keep in mind, diversification and strategic asset allocation are investment methods used to help manage risk. They do not ensure a profit or protect against a loss.

#### Index Definitions

**S&P 500 Index** is a market-capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the U.S. stock market. Returns assume reinvestment of dividends and capital gain distributions.

**S&P 500 Energy Index** comprises those companies included in the S&P 500 Index that are classified as members of the GICS® Energy sector.

**S&P Oil & Gas Exploration & Production Select Industry Index** comprises stocks in the S&P Total Market Index that are classified in the GICS oil & gas exploration & production subindustry.

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