ANXIETY OPTIONAL: YOU CAN ONLY LOSE WHAT YOU CLING TO

Invest in seven ventures, yes, in eight; you do not know what disaster may come upon the land. - Ecclesiastes 11:2

Taking risk is the fundamental underpinning that makes an investment an investment. As advisors, however, we want to make sure our clients' portfolios are only exposed to risks for which they can expect to be adequately compensated. In this quarter's letter, we'll specifically discuss two types of risks—idiosyncratic risks and market risks—and the ways in which portfolios can be structured to address them. Importantly, here at HH, we have developed nuanced approaches to helping clients manage and unwind concentrated stock positions, a type of idiosyncratic risk that can leave the holder exposed to significant financial pain.

Idiosyncratic risk, also known as unsystematic or diversifiable risk, is the risk imbedded in a specific investment: a company's stock for example. Bankruptcy, the CEO getting arrested, or a passenger getting beaten up and dragged off an airplane are all examples of idiosyncratic risk.

Market risk, also known as systematic or undiversifiable risk, is the broad risk of an asset class losing favor with investors. A stock market sell-off affects virtually all stocks, regardless of whether a company had strong earnings or launched a blockbuster new product.

By holding a large number of investments within an asset class, one can almost entirely remove the negative impacts posed by the idiosyncratic risk of a specific investment doing poorly. Further, by holding a variety of asset classes, one can spread out the market risk of holding too much weight in a specific market or asset class.

Harry Markowitz called diversification "the only free lunch in finance." By diversifying, in theory (and often in practice), an investor may earn the same return at a lower level of risk. Markowitz's work laid the foundations for Modern Portfolio Theory (MPT), and won him a Nobel Prize in 1990.

Undiversifiable market risks will always be with us, but one of the key tenets of MPT is that portfolio construction should attempt to eliminate diversifiable risk: If you can eliminate it, why wouldn't you?

FIRST, MARKET DIVERSIFICATION

With a global economy that is more connected than ever before, combined with the fact that correlations rise as markets become stressed, true diversification is becoming more difficult to find. We detailed our efforts to remedy this phenomenon in our paper last fall, "A Bed of Nails."

The investment world recently reached an interesting milestone when the number of indexes in the U.S. surpassed the number of stocks. Because of new technologies, the cost to develop and implement a new index has fallen dramatically and the result is a dizzying menu of investable "themes." Among these new products are a Whiskey & Spirits ETF, a Nashville ETF, and a Video Game ETF.

We're not going to delve into whether any of these would be a good investment or not, but the fact that more people are investing in indexes, rather than the individual underlying stocks, simply means that individual securities have a greater propensity to trade together. As a result, the tide that raises all boats can also mean that more babies will get thrown out with the bathwater.

THE AAPL DOESN'T FALL FAR FROM THE TREE

This brings us to our main point: Many investors underestimate the risk of holding concentrated stock. Even a seemingly "small" exposure (i.e., 10% of the portfolio) can dominate the risk in a portfolio. If the average return on a broadly diversified portfolio is expected to be in the 6% range, and you lose 33% on a single stock position that represents 10% of your portfolio, you've just wiped out half your expected gains.

In holding any one stock, you bear the risk that the market will go down, as well as the risk that that specific stock will go bankrupt. You're taking on both market risk and idiosyncratic risk. To refer back to our opening Old Testament quote: While you might have been able to achieve a satisfactory degree of diversification in only seven or eight ventures 3,000 years ago (Ecclesiastes has been attributed to King Solomon), that is likely not the case today.

REMEMBER, FOR EVERY AAPL, THERE'S AN ENRON AND A LEHMAN

At its peak, Enron was worth about $70 billion. In the same year that the company declared bankruptcy, it was ranked 7th highest by revenue of all U.S. companies—right between Citigroup and IBM. Nevertheless, it took less than 17 months for Enron's share price to collapse from a high of $90 down to $0.

In 2008, only five months after Lehman Brothers' CEO announced, "The worst of the impact on the financial-services industry is behind us," the 158-year-old firm declared bankruptcy and 27,000 employees were out of work. At the time the firm filed for bankruptcy that September, Lehman Brothers' assets were valued at $691 billion.

In a 2016 study of corporate longevity, Huron Consulting predicted that the average lifespan of an S&P 500 company would go from 33 years in 1967 to 14 years by 2026. Huron's study suggested that about 50% of the S&P 500 will be replaced over the next 10 years.

Of note, companies such as Eastman Kodak, J.C. Penney, Safeway, H.J. Heinz, Radio Shack, Dell Computer and the New York Times have all been recently removed from the index. Granted, not all companies are removed because they go belly up. But if you're holding onto a stock because you're afraid of realizing its gains, its acquisition or merger could force you to pay those taxes sooner rather than later.

WHY IS IT SO HARD TO LET GO?

What's the allure of holding onto large positions despite the obvious risks? For many people, a large single-stock holding in a portfolio is often an investment in the company where they enjoyed a long successful career (or their spouse, or one of their parents, etc.) In any case, there is often an emotional attachment to that company in some way.

This attachment is completely natural, and there is a term for it: the endowment effect. In most cases investors know they hold too much of a particular stock. But they might fear that they'll miss out if the price continues up, or what their late husband would feel about them selling it, or they don't want to pay capital gains taxes all at once, or … The rationales are many, but the risk persists.

A CAREFULLY CRAFTED SOLUTION

So what can an investor do when he or she holds too much of a single stock? The answer isn't simple—that's why we've developed a nuanced approach here at HH. It is necessary to determine how much of that client's future needs and goals depend on the cash from that position. If the stock in question's price were to go to $0 but the client would still be able to fund all her goals, the situation is less severe. But what if this stock makes up half of her liquid portfolio—and she could have serious cash flow problems if it drops by 20%? Clearly, this is a much more sensitive situation.

First, she needs a plan.

Most people know that they shouldn't hold a large portion of their wealth in a single stock for the obvious reasons, but there may be a kind of grief or sorrow associated with selling it. This may not be an emotionally easy step to take, even when clients know they need to spread out their risk. Great communications and thoughtful transitions matter. Once a financial goal plan is developed, we can fully determine the sensitivity of that position to funding their goals; a glide path to a target position can then be determined.

These are some of the solutions we might utilize:

We may employ a systematic sell strategy over a few years that incorporates elements such as earnings releases and taxes.

We may suggest divesting all or a portion of the stock using a Charitable Remainder Unitrust. Doing so would allow a client to diversify out of the stock in a tax-advantaged way while configuring, based on age, a lifetime distribution schedule. Such strategies are complex and require the support of a tax advisor and attorney.

We may hedge a position using put options and/or collars. If you are unfamiliar with collars, these protect the stock investor by limiting losses in an appreciated stock, while paying for that strategy by capping its upside potential. Likewise, we might, as a substitute tactic, implement a put-spread collar on a blue chip stock in order to reduce the hedging costs.

Which strategies are implemented are dependent upon a host of factors including the amount and type of options available, and company specific issues like historical volatility, earnings releases, and dividend schedule.

THE OBJECTIVE: LIMITING PORTFOLIO HOLDINGS TO RISKS WORTH TAKING

Our apologies for that diversion into investment management minutiae. The point of all this is that if you or someone you know is holding a large position in a single investment, it may represent more risk than you or they are aware of. We can help determine what level of risk is appropriate and create a plan for diversification, should that be the next appropriate course of action.

In reality, a single-stock risk-reduction strategy might incorporate several tools. Why limit your armamentarium when you can orchestrate a bespoke solution? The final solution needs to address not only clients' goals and circumstances, but to a degree, their preferences as well. Sensitivity to the unique situation of each client helps to ensure best-case outcomes.

We quip that true diversification means that we'll always have to say "I'm sorry"—in that we didn't own more of the specific investment that had the highest return in the portfolio over the last period. But keep in mind, the flip side of this is that we should never have to say "I'm sorry" regarding an even more critical circumstance—that your significant holding has become worthless.

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