



## Concentrated Positions

*2009 Rally Presents Opportunity to Address A Major Portfolio Risk*

In our opinion, concentrated positions present one of the biggest obstacles to investors being able to achieve their long-term goals. We believe the outsized risks that these positions bring to investment portfolios are almost never worth the tax savings an investor hopes to recognize by holding them. With the long-term capital gains tax rate set to rise to 20% on or before 2011, and the market (as measured by the S&P 500) having rallied 26.5% last year, we believe the window of opportunity to adjust these positions is closing.

### What is a concentrated position?

The term “concentrated position” could mean different things to different people. We define concentration as any single position that is three or more times larger than an average position in a portfolio. (Our definition does not apply to mutual funds, exchange-traded funds [ETFs] or other diversified investment vehicles.) Concentrated positions can end up in a portfolio for many different reasons: they can come from a successful investment; they can be inherited from a parent or grandparent; or, more commonly, they can represent a percentage of ownership in a current or former employer.

### The problem with concentrated positions

Concentrated positions generally have two things in common. First, most concentrated positions were accumulated at relatively low prices. Second, because of the low cost basis, many investors tend to treat these holdings more passively than anything else in their portfolios. Anecdotally, financial advisors often tell us that their clients have directed them to ignore a low-cost-basis concentrated position or to manage a portfolio *around* a concentrated position. While we can sympathize with an investor’s desire to minimize their tax bill, we also worry that this justification could potentially lead to investment behavior that is irrational and potentially dangerous.

### Why Concentrated Positions Can Be Dangerous

1. **Concentrated positions can make portfolios more susceptible to “lightning strikes”:** A concentrated position can be like a tall tree in a lightning storm. The more a single position stands out from the rest of the portfolio, the greater the portfolio’s chance of being struck, in our view. While this risk may be obvious, what might surprise investors is the frequency at which portfolio lightning strikes occur. The risk that a single position could underperform the market by a significant margin -- say 15% annually -- is not minor. For example, over the last 12 years, 40% of the S&P 1500 (the 1500 largest domestic companies) underperformed the aggregate index by more than 15% (see Table 1 on the following page). **Said another way, two years out of five (40% of the time) it has been better to take the certain 15% capital gains hit than to risk a greater than 15% punishment by the stock market.** It is for this reason that concentrated positions are not only non-permissible in the institutional (pension fund, endowment, etc.) world, they are generally viewed as a breach of fiduciary duty when present in a portfolio.

**Table 1**

Time Period	Percentage of S&P 1500 Companies Underperforming by 1500 bps* or more
2009	20%
2008	30%
2007	58%
2006	34%
2005	42%
2004	33%
2003	34%
2002	31%
2001	32%
2000	45%
1999	45%
1998	71%
<b>Average:</b>	<b>40%</b>

Data Courtesy FactSet

\* Basis points = 1/100<sup>th</sup> of 1%

2. **Concentrated positions in the stock of one’s employer can be especially dangerous.** We invest for many reasons, but one of the primary objectives is as protection against an uncertain future. A properly structured investment portfolio can act as an income supplement during periods of wage softness or unemployment. For this reason, we think a concentrated position in the stock of an employer is especially dangerous. There is typically a strong correlation between the performance of a company’s stock and the compensation and job security of that company’s employees. During those periods when job security is low and compensation most under pressure, an investor with a portfolio dominated by the stock of their employer will likely find their financial hardships exacerbated. Recently, the prior and current employees of Bear Stearns, Lehman Brothers, Washington Mutual and General Motors have had to learn this lesson the hard way.
3. **Concentrated positions can force sub-optimal strategies:** Simply put, an investment plan with significant limitations and restrictions will generally produce sub-optimal risk-adjusted performance. Investors who ask their financial advisors to manage around or ignore a concentrated position are making a choice to hold a potentially inferior portfolio and accept inferior risk-adjusted returns, in our view. This is the case when a concentrated position is performing well and not detracting from the portfolio, and becomes increasingly apparent in an environment in which the performance of that holding sputters. The more a concentrated position underperforms, the more difficult it becomes to execute a well-devised investment plan. Concentrated positions present the greatest risk to those investors who regularly rely on withdrawals from their portfolio to supplement their income. An investor who takes systematic withdrawals will be forced to increasingly eat into the healthy portions of their portfolio to compensate for the decline in their concentrated position.
4. **There is a threat that the current tax environment could become significantly less favorable.** We believe the current capital gains tax rate of 15% is a gift with an expiration date. Since 1916, when the capital gains tax was first introduced, it has changed 21 times and has only been 15% or below 19 of those 93 years. The rising societal costs of an aging America, the ongoing war in the Middle East, and an economy in Recession (as classified by the National Board of Economic Research [NBER]) create a situation for Federal and state governments in which revenue (tax proceeds) are falling while costs continue to rise. Ultimately, either costs must fall or revenue must rise for governments to stay solvent. We believe the latter is more likely. Historically, when the government has needed to tighten its belt, the burden has been disproportionately distributed between those who have money and those who don’t. Thus, the taxes saved by not recognizing a capital gain today may be more than offset by significantly higher tax rates tomorrow. The current 15% capital gains rates are set to “sunset” in 2011, reverting back to 20%.

**Bottom Line:** We believe that the most important advice we can offer investors is to avoid holding concentrated positions in their portfolios. The most sophisticated financial planning tools and products and the most capable portfolio management teams can never insulate an investor completely from the risk of these positions. It is startling and sad how quickly the fortunes of major “blue-chip” companies can change in today’s dynamic investment environment. There is typically no warning alarm, and very little time for an investor to recognize a problem before the market has fully incorporated it into a troubled company’s share price. A 20% position in a stock that underperforms the market by 20% in a single year puts the entire portfolio at a 400-basis-point deficit that would be difficult to overcome, no matter one’s investment prowess.

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