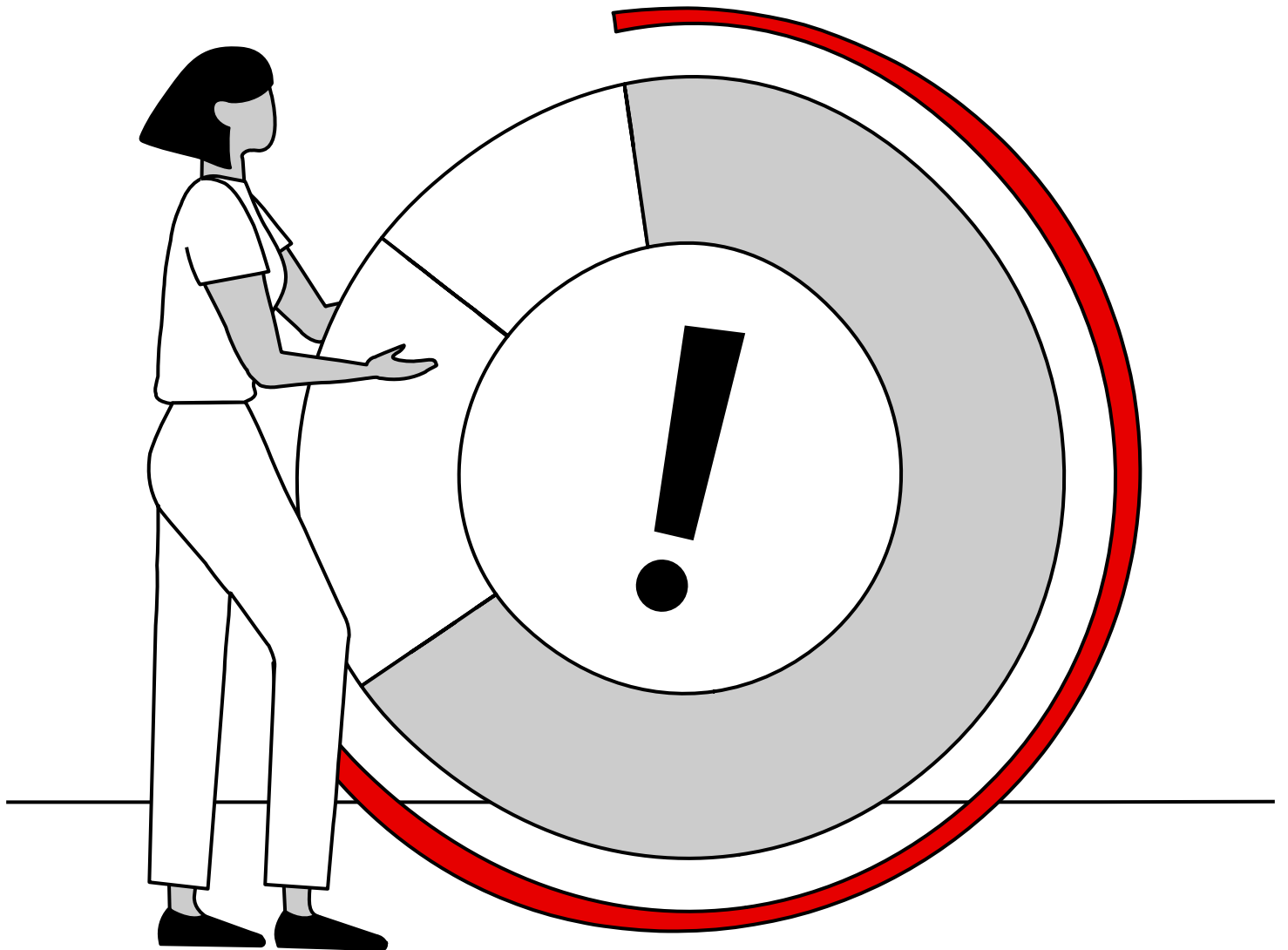


Concentrated positions

How to **manage the risks**



Erratum: A previous version of this report incorrectly stated that the SEC restricts all insiders from using put options to hedge concentrated positions. This version clarifies that these strategies can be an option for some insiders as long as they do not violate the company policies filed with the SEC.

Prologue

The path to wealth creation can take many forms. For those fortunate enough to have generated wealth through equity growth, there are few experiences better than reflecting on the journey and the successes along the way.

Often, success results in an accumulation of wealth in a concentrated equity position. Historically, owning a concentrated equity position has been a high-risk, high-reward strategy that can build enormous wealth; however, all too often, those who avoid diversifying risks after achieving such wealth see their wealth diminish.

In other words, “what got you here is unlikely to get you there.”

As prudent investors contemplate how a concentrated equity position can impact their personal situation, generally the primary focus should shift from “aggressively growing” wealth in a single position, to diversifying their portfolio to manage risks with the goal of right-sizing opportunities that can “maintain and grow” wealth with more certainty.

The first half of this report goes through the risk and reward of holding a concentrated position—a trade-off that should be evaluated carefully relative to your goals, risk tolerance, and objectives.

We explore the critical topics of:

- 1 How can holding a concentrated stock position influence your financial goals? ([Jump to section](#))
- 2 How can you think about concentrated stock positions? ([Jump to section](#))
- 3 Why do you hold a concentrated equity position? ([Jump to section](#))

The second half of this report outlines what you can do to manage the risks of your concentrated position ([Jump to section](#)),



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with specific actions, depending on investor preferences, that we view as critical steps in the pursuit of maintaining and growing long-term wealth. In order to maximize the likelihood of success, effective management of the position is crucial and generally comes in the form of three options:

- 1 Reduce the concentrated position to right-size risks and diversify the total portfolio
- 2 Thoughtfully diversify around the concentrated position with a complementary portfolio
- 3 Hedge downside risks

Diversification across industry, sectors, geography, and style is the best way to reduce the breadth of outcomes that the investor will likely experience. Throughout this paper, we’ll outline the influence that concentrated positions have on achieving financial goals, how you can think about your concentrated stock position, and what can be done to manage risks.

This report has been prepared by UBS Financial Services Inc. (UBS FS). Please see the important disclaimers at the end of the document.

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Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

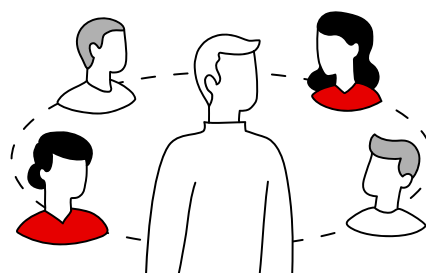
What is a concentrated equity position?

Although there is no single definition of a concentrated stock position, a common description is a single equity stake that is 10% or more of a total portfolio allocation.

For investors with concentrated positions beyond listed equities, we propose the following broader definition:



A position whose return, risk, or other characteristic dominates overall portfolio performance and can meaningfully interfere with an investor's ability to achieve their financial goals.



What types of people hold concentrated equity positions, and why do they hold them?

There are generally three broad categories of people who hold concentrated equity positions. Their general attitudes to return and risk typically differ, resulting in various approaches to managing these positions. The three categories are:

- 1 An executive or entrepreneur who owns a business or receives a significant portion of compensation in (restricted) shares.
- 2 A leader or a beneficiary who has built or inherited a stake in a company.
- 3 An investor in a company who had, or continues to have, high conviction in its financial potential.

Despite the origins of a concentrated position, the disproportionate allocation of wealth exposes individuals to undue risk that should be understood and properly managed.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

How can holding a concentrated stock position influence your financial goals?

Past performance is no guarantee of future results; this is especially true for concentrated positions. A forgiving regulatory environment, generous central bank monetary policy, positive investor sentiment, and business-specific tailwinds may all have contributed to company outperformance.

But when valuation levels are elevated, the hurdle for meeting or exceeding earnings expectations appears daunting, and further increases in stock prices become more difficult. In addition, if macroeconomic, regulatory, or political conditions change, a concentrated stock position can look more vulnerable to underperformance or excessive volatility.

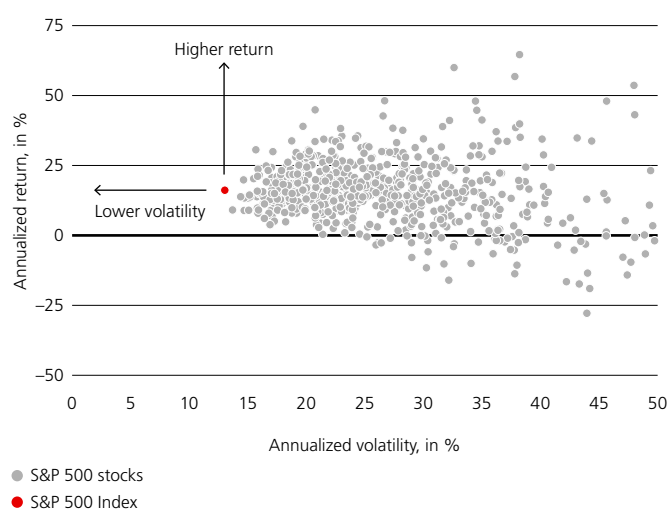
Concentrated stockholders can increase the likelihood of meeting future spending needs by mitigating risk while not necessarily compromising on returns.

Due to these factors, owning a concentrated stock position may result in a portfolio with undesirable levels of risk that could jeopardize current wealth and the ability to achieve long-term goals. In Fig. 1, we illustrate the inefficiency of concentrated stock positions relative to the market. Essentially, this analysis shows that over the last two decades, there were no stocks in the S&P 500 whose annualized volatility was

Figure 1

Holding a diversified portfolio offers better risk-return trade-off

Annualized return and volatility for the S&P 500 and its constituents. Analysis considers data from 1990 to 2022 and contains current index constituents since 1990.



Source: Bloomberg, UBS, as of March 2022

lower than that of the market. Additionally, no stocks had returns that were repeatedly more reliable than the aggregate index through a variety of market regimes. In other words, the graph above suggests that concentrated stockholders can increase the likelihood of meeting future spending needs by mitigating risk while not necessarily compromising on returns.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

Diversification is essential to creating long-term wealth. Even if an investor can tolerate the higher volatility of a concentrated position, larger swings in overall wealth can significantly reduce the compound growth of portfolio assets. For example, Fig. 2 illustrates the growth of two hypothetical investments that both have the same average annual return, but with different volatilities. One investment has the median volatility of a single stock in the S&P 500, 24%, while the other has the long-term volatility of the S&P 500, 12%. Even though both investments have the same year-to-year average return, the investment with higher volatility experiences larger losses over the time period.

While it may seem that the larger potential gains that can occur after a loss would allow the high-volatility investment to keep pace, the impacts of losses are not symmetrical. For example, the high-volatility stock has a higher chance of a 50% loss, and if this loss occurred, it would take a 100% return to recover. This dynamic results in a volatility drag on wealth that causes the lower-volatility asset to compound at a higher growth rate and create more wealth over time. Our report "[Different returns, same investment](#)" provides deeper insights into the wealth-destructive effects of volatility.

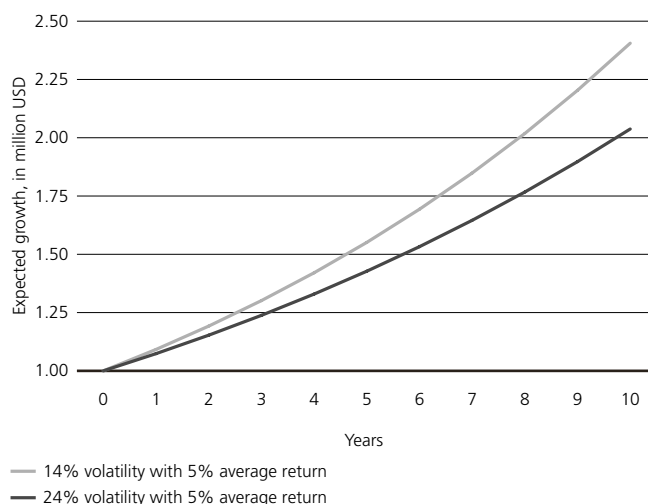
Conclusion

A concentrated stock position may expose an investor's wealth to a wider range of outcomes and longer periods of loss than holding a well-diversified equity index. This may,

Figure 2

High volatility can diminish the potential growth rate of an investment

Expected cumulative growth of two investments with a 5% average annual return



Source: UBS. For illustrative purposes only.

often unnecessarily, put current wealth or spending plans at greater risk, while potentially reducing the long-term growth rate of wealth.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

How can you think about concentrated stock positions?

If you are a concentrated stockholder in a private company, you should also consider how performance may change in the event of going public. While liquidity may be significantly improved, initial public offerings (IPOs) tend to underperform a broad market index following their listing. This finding has been repeatedly studied in academia, with the median IPO underperforming by 14%, according to Bank of America Global Research.

Concentrated stockholders should therefore ask themselves whether a concentrated position is the best means of achieving their objectives, whether that be saving for retirement, building a legacy for others, or raising capital for investment in their business.

An investor can consider three aspects of holding a concentrated stock position:

Concentrated stock positions generate less reliable returns

It does not necessarily follow that past success in a single stock will continue. The ability to meet future spending needs may be harder when relying on a concentrated position and stock-specific risk over broad market exposure.

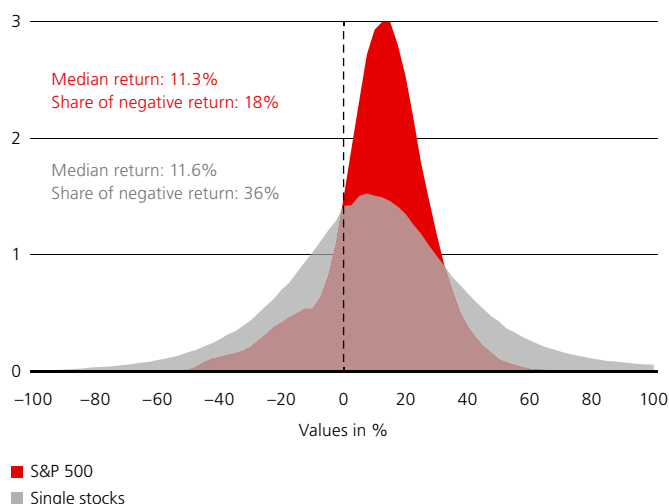
If you intend to use a concentrated stock position to meet a future spending need, it will be important to have the money you need, when you need it. Most investors prefer the path to achieving their wealth target to be as smooth as possible. That translates into an investment strategy with the narrowest possible band of outcomes, the highest possible share of positive outcomes, and the most potential return for the lowest level of risk.

Historically, holding a broad equity index rather than a concentrated stock position has led to a narrower range of outcomes

Figure 3

Concentrated stock positions have a higher probability of negative returns

Probability distribution of one-year monthly rolling returns on the S&P 500 and its constituents, since 1990



Source: Bloomberg, UBS, as of March 2022

and a greater share of positive ones. This is because a diversified allocation tends to result in significantly lower risk.

Analyzing monthly rolling annual return data for the S&P 500 between 1990 and 2022, we observe that holding the whole index (Fig. 3) would have led to a greater number of observed annual returns around the median, with fewer outliers. By contrast, holding a concentrated position in the median volatility stock of the S&P 500 would have exposed the investor to a higher chance of very large positive and negative returns. This is colloquially described as a distribution with fatter tails.

In this instance, it's important to stress that control of a company cannot offset company- or industry-specific risks, for example the failure of a key supplier, the loss of a key employee, or a changing regulatory environment. In our view, the most reliable way to mitigate and manage these business-disrupting risks is to reduce or diversify around a concentrated equity position.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

Concentrated stock positions are less resilient to external shocks

The likelihood of having enough money for current and future spending often depends on portfolio volatility. Swings in portfolio value matter. If asset prices fall prior to a financial commitment, an investor may have to delay spending until markets recover or sell assets at depressed prices before prices have time to recover.

A concentrated stock position has a far higher likelihood of underperforming a broad index in a market decline and lagging during a recovery.

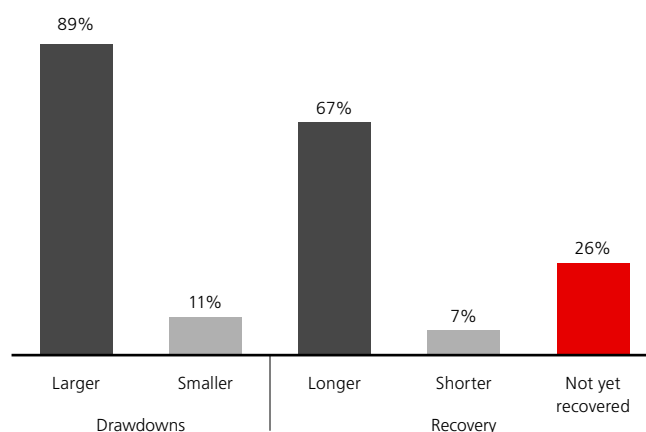
In simple terms, individual stocks are generally more susceptible to extreme drawdowns (peak-to-trough losses) than broad equity indexes. This is because holding a single security exposes investors to company-specific risks from both internal and external shocks and does not benefit from the risk-reducing effects of a diversified allocation. Examples include a key commodity price increase; reputational and litigation damage from an environmental disaster; a shift in government regulation that suddenly undermines a holding's business model; or potential internal scandals from fraudulent or unethical employee behavior.

In Fig. 4, we use the same S&P 500 data set from before to show that nearly nine out of 10 single stock positions experienced steeper drawdowns than the overall index.

Figure 4

Single stocks with higher drawdowns and longer time to recovery

Comparison of the maximum drawdowns of the S&P 500 and its current constituents. The maximum drawdown is measured over the past 10 years using monthly total net return data.



Source: Bloomberg, UBS, as of March 2022

However, an investor with both the appetite and capacity for risk may care less about drawdowns and more about the time needed to recoup losses to evaluate missing a spending or portfolio target. Even in this scenario, the data speaks out against concentrated stock positions: Single stocks typically require longer to recover from a drawdown. Only 6% of constituent stocks in the S&P 500 recovered more rapidly from their troughs than the index over the last two decades (Fig. 4).

Conclusion

A concentrated stock position is less resilient to external shocks than a broad index. It has a far higher likelihood of underperforming the index in a market decline and lagging during a recovery.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
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Concentrated stock positions may deliver less repeatable results

Concentrated stockholders may have enjoyed strong absolute and relative performance in the past. This experience can provide a false sense of confidence that the position can deliver outperformance year after year. However, data on the broader risk and return of single stocks and the market suggest this is unlikely to be the case.

Holding a concentrated stock position may assume that the stock's past outperformance is repeatable.

In Fig. 5, we use the same S&P 500 data set to show that outperformance typically does not persist. Over the last two decades, an average 46% of stocks have outperformed the S&P 500 in a given year. There have been some periods—such as the early 2000s—when this share has been higher.

However, the share of stocks that have outperformed the S&P 500 in two consecutive years falls to only 22% on average. The share of stocks outperforming over two years has not exceeded 50% over the last 20 years.

Concentrated stock positions may perform well under certain macroeconomic and sector- and company-specific circumstances. But financial theory (and practice) says diversifying across different types of financial assets can help investors reduce company-, stock-, sector-, or geography-specific risks. Put differently, diversification maximizes the chance of delivering a stable return throughout economic and market cycles.

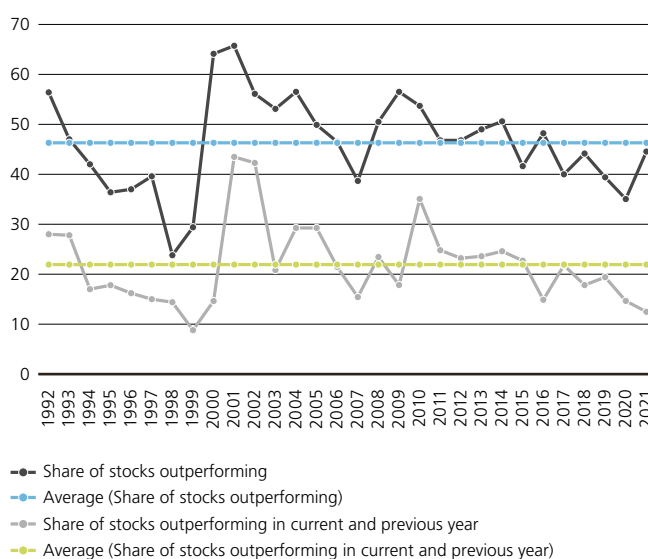
Banking on a concentrated stock position can cause two main problems for business owners and investors.

First, to compensate for the higher uncertainty associated with a less diversified portfolio, a concentrated position may lead an investor to hold more cash than they need over a longer

Figure 5

Outperformance typically does not persist

Share of stocks outperforming the S&P 500 in a given year, and share of stocks outperforming the S&P 500 two consecutive years using total net return data, in %



Source: Bloomberg, UBS, as of March 2022

period of time. Over time, inflation can erode the purchasing power of this cash, reducing the likelihood of meeting long-term spending needs.

Second, depleting cash to meet spending needs while maintaining a concentrated position leads to an increase in portfolio risk as spending goals get closer. The share of cash in the portfolio falls while the share of the concentrated asset rises. This is the opposite approach to traditional financial planning, where investors derisk their portfolios as they approach a spending goal like retirement.

Conclusion

Holding a concentrated stock position may assume that the stock's past outperformance is repeatable. Data shows that investors can achieve more replicable results over a market cycle, without compromising financial returns, through diversification. A concentrated stock position can be seen as taking on excessive levels of risk or not being adequately compensated for the risk taken compared to other investments.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

Why do you **hold** a concentrated equity position?

An investor may have had great success in holding a concentrated stock position, but past performance is no guarantee of future success. In particular, investors who are approaching retirement or life events during which they will rely more heavily on their accumulated wealth should evaluate whether keeping concentrated equity positions will preserve their wealth.

Financial needs are also not static, nor is the plan needed to meet them. We therefore believe concentrated equity holders should regularly question why they hold a concentrated position. We identify three initial questions:

1. What is its role in achieving your goals?

Do you hold a concentrated position for nonfinancial reasons? Examples include retaining control of a company, working as an activist shareholder, preserving family ownership, or maintaining a job with a particular employer. In these instances, ask whether these nonfinancial motives require trade-offs to your financial goals, and whether you are still happy to accept these opportunity costs.

Do you hold a concentrated position for financial reasons? If so, do you have a set return target, or are you seeking the greatest possible returns? What worked in the past may not work in the future. Do these financial motives still hold—such as expected outperformance of the concentrated position versus the rest of the market? And is your bulk holding the most efficient way to maximize your chances of achieving your short-term spending and long-run saving and giving goals?

2. Which particular types of goals do you aim to meet using your concentrated stock position?

Do you need your concentrated equity position to meet your day-to-day spending needs (a Liquidity strategy)? If so, your main aim may be to raise liquid funds from your position, even if your stake is held in a seldom-traded or untraded company. Additionally, if you hold cash to meet spending needs, do you

hold an excessive amount that could reduce your future spending power?

Will your stake ultimately fund your lifetime spending, such as retirement or paying for college (a Longevity strategy)? If so, you may seek to balance return generation against volatility management, so you match your assets with your liabilities and reduce shortfall or sequence-of-return risks.

Or do you intend to use your concentrated equity position for goals beyond your lifetime, like bequests to family or charity (a Legacy strategy)? In this instance, what is your ambition? To maximize financial returns so your chosen beneficiaries have the largest possible capital pool, or to give heirs particular assets to retain company control or familial ties to a business?

3. What constraints do you face on your concentrated equity position?

Did you choose a concentrated stock position, or did it choose you? Many executives face potential restrictions on their company stock, such as minimum holding size requirements or lockup periods. Business owners may need to hold a certain proportion of their business's equity in order to retain the control they desire. Family offices may be asked to run a portfolio and include the performance of a concentrated equity position but have no fiduciary authority to run the position itself. And some stockholders may face family pressure to hold a position for historic or sentimental reasons.

Others may face restrictions on how much they can allocate away from their concentrated position. Market liquidity may limit the amount that can be bought or sold without having a material impact on the share price. Stock purchases or sales may trigger regulatory disclosures that lead to a loss of privacy, reputational damage, or even have an adverse effect on the overall business value.

UBS Wealth Way is an approach incorporating Liquidity, Longevity, Legacy, strategies that UBS Financial Services Inc. and our Financial Advisors can use to assist clients in exploring and pursuing their wealth management needs and goals over different timeframes. This approach is not a promise or guarantee that wealth, or any financial results, can or will be achieved. All investments involve the risk of loss, including the risk of loss of the entire investment. Timeframes may vary. Strategies are subject to individual client goals, objectives and suitability.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

Putting it all together: What can you do to **manage** the risks of your concentrated position?

Right-sizing your concentrated equity position

The first and most important decision when holding a concentrated position is how much of the position to hold going forward. We argue that the optimal amount to hold comes from a few different considerations:

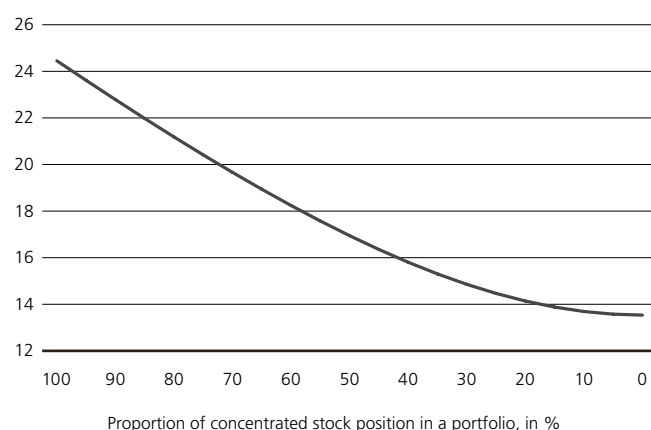
- 1 How much you would hold in an ideal portfolio, i.e., what weighting would you give this security if you were building a portfolio from the beginning?
- 2 What additional risks does holding a concentrated position entail, and are you likely to be properly compensated relative to the risk and return of other investment options?
- 3 How much must you hold based on portfolio constraints (e.g., liquidity or tax purposes)?

Investors face several options to manage their concentrated risks.

Figure 6

Reducing a concentrated position quickly reduces portfolio volatility...

Portfolio volatility of a blend of the median concentrated single stock position with the S&P 500, in %



Source: FactSet, UBS, as of March 2022. For illustrative purposes only.

Option 1

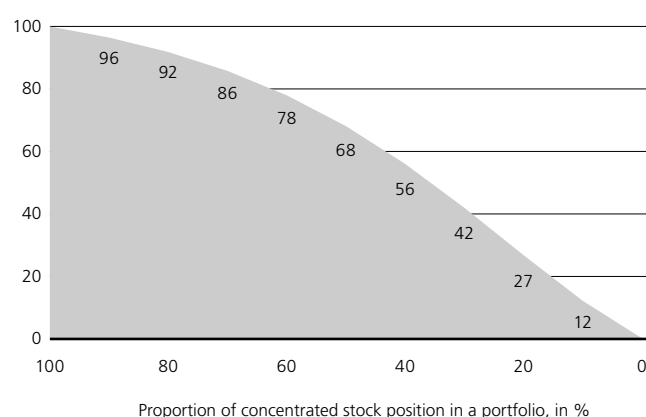
Reduce and diversify your concentrated position

If you are willing or able to reduce your concentrated position, relatively small adjustments are likely to have a meaningful impact on risks. In Fig. 6, we show the volatility of a portfolio that holds a concentrated position blended with the S&P 500. The concentrated stock has the median volatility and correlation of a stock in the S&P 500 to the index. As the investor reduces a large concentrated position and invests proceeds in the S&P 500, diversification effects reduce volatility quickly until the median concentrated stock is below 20% of the total portfolio. Fig. 7 illustrates that the higher volatility of a concentrated stock position typically comes with a higher proportion of risk being driven by the single security than the nominal allocation. Therefore, it is essential to evaluate the impact of any reductions relative to the specific attributes of your concentrated holding to find the optimal size. As we saw previously, reducing concentrations with a diversified index not only tends to narrow the distribution of wealth outcomes,

Figure 7

...however, the proportion of wealth fluctuations driven by the concentrated position can pose significant risk to capital without large reductions

Concentrated stock position contribution to total portfolio volatility, in %



Source: FactSet, UBS, as of March 2022. For illustrative purposes only.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

but has historically also increased the resilience of the asset's long-term growth.

Any reductions should also consider the tax impact on your long-term wealth, with assets being sold in a tax-aware way. This will likely entail establishing a multiyear capital gains budget while allocating a "for-sale" portion of the concentrated position to a tax-loss harvesting strategy. Alternatively, individuals may want to earmark reductions for charitable giving (see "[Set up a Charitable remainder trust](#)" for more details).

Reducing exposures for executives and insiders with a 10b5-1 plan

If you are an executive or corporate insider (e.g., hold at least 10% of a company's voting shares) for a publicly traded company, the Securities and Exchange Commission (SEC) has stringent rules to prevent individuals from engaging in insider trading. Other investors may have material nonpublic information (MNPI) that prevents them from easily liquidating their concentrated position. In these situations, an executive can set up what is known as a 10b5-1 plan, which allows insiders of publicly traded corporations to set up a trading plan for selling stocks they own and avoid the appearance or accusations of insider trading. To do so, a broker documents specific predetermined prices to buy or sell, or sets a schedule for the broker

to sell securities to reduce concentrated risks. There are three criteria that need to be met in a 10b5-1:

- 1 Price and amount must be specified
- 2 There must be a formula or metrics given for determining the amount, price, and date
- 3 The plan must give the broker the exclusive right to determine when to make the sale or purchase

How can you manage concentration risk without reducing your position?

Do you retain your conviction in your concentrated stock position, or would you rather reinvest elsewhere? Are you unable to reduce your position? Generally, there are two strategies: to diversify around the concentrated position, or to hedge.

Option 2

Build a diversified factor completion portfolio that complements your concentrated risks

Investors who wish to retain their concentrated position can consider a factor completion portfolio approach to thoughtfully diversify risk and return drivers. Factor completion

Figure 8

Methods for managing the risks of your concentrated position

		Tax benefit	Exposure to upside performance	Protection against downside performance	Control over portfolio holdings	Liquidity of stock
Diversifying	Reducing	○	◐	◐	●	●
	Factor completion portfolio	◐	◐	◐	◐	●
	Exchange fund	◐	◐	◐	○	◐
Hedging	Equity collar	◐	◐	◐	●	●
	Prepaid variable forward (PVF)	◐	◐	◐	●	◐
	Charitable remainder trust (CRT)	◐	○	●	●	●

● Most ○ Least

Source: UBS. Impact is illustrative and may vary by situation.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

includes finding a mix of securities that complement and do not share the same types of risk drivers and exposures as the concentrated position. The attributes of the complementary portfolio are specifically tailored to diversify return drivers and reduce risks when combined with the concentrated stock.

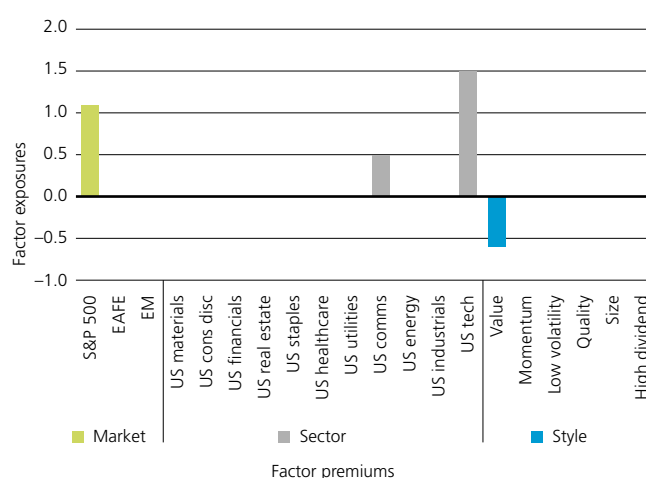
What is a factor? A factor is a common persistent driver of returns for an investment. Each factor comes with a unique set of properties. Generally, equity factors fall in three distinct groups: regional, sector, and style drivers. Style factors include companies with value or growth orientation, similar market capitalization (referred to as “size”), high dividend, low volatility, or quality, to name a few. Concentrated stock positions will have exposures to a specific set of these common factors in addition to company-specific risks.

By identifying the types of factors that drive your concentrated holding, you can avoid doubling down on the same risks. The diversified portfolio that is built around your concentrated position strives to complement your holding such that your total portfolio has the general properties of a diversified target portfolio or index that you would have invested in if you didn’t hold the concentration. This results in “completion” of the factors that were missing in the concentrated position.

To form a complementary portfolio, we start by using our proprietary equity factor model to analyze the common market factors that are driving performance of the concentrated

Figure 9

Hypothetical factor exposures of a stock



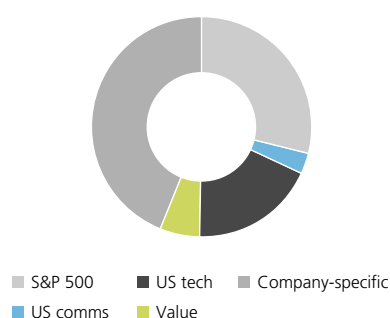
Source: UBS. For illustrative purposes only.

position (Figs. 9 and 10). We then identify a diversified complementary allocation, with the goal of replicating the factor exposures of a target allocation when combined with your concentrated position. The complementary portfolio therefore mitigates overexposure, or doubling-down on the factors inherent in the concentrated position while optimally sizing diversifying factors and overall risks (Fig. 11).

Figure 10

Factor contribution to risk within the stock

Factor risk drivers

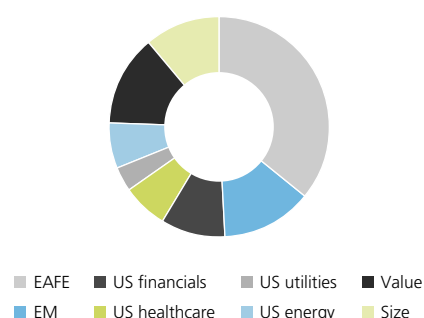


Source: UBS. For illustrative purposes only.

Figure 11

Equity portfolio that complements the risk drivers in XYZ stock

Complementary portfolio



Note: EAFE = non-US developed markets; EM = emerging markets.
Source: UBS. For illustrative purposes only.

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

One important consideration when diversifying a concentrated position is to avoid investing in equities in the same sector or industry. Many concentrated equity holders are inclined to purchase shares of their competitor's stock because they are more familiar with the inner workings; but during times of stress for their company, it is likely that both companies will face similar pressures that result in a simultaneous price decline. This is why we want to "complement" the concentrated position with differentiated exposures that can manage risks and provide growth opportunities.

The combination of the concentrated position with the complementary portfolio enhances diversification and can provide a more robust, holistic wealth experience (Fig. 12).

Borrow to fund completion portfolio

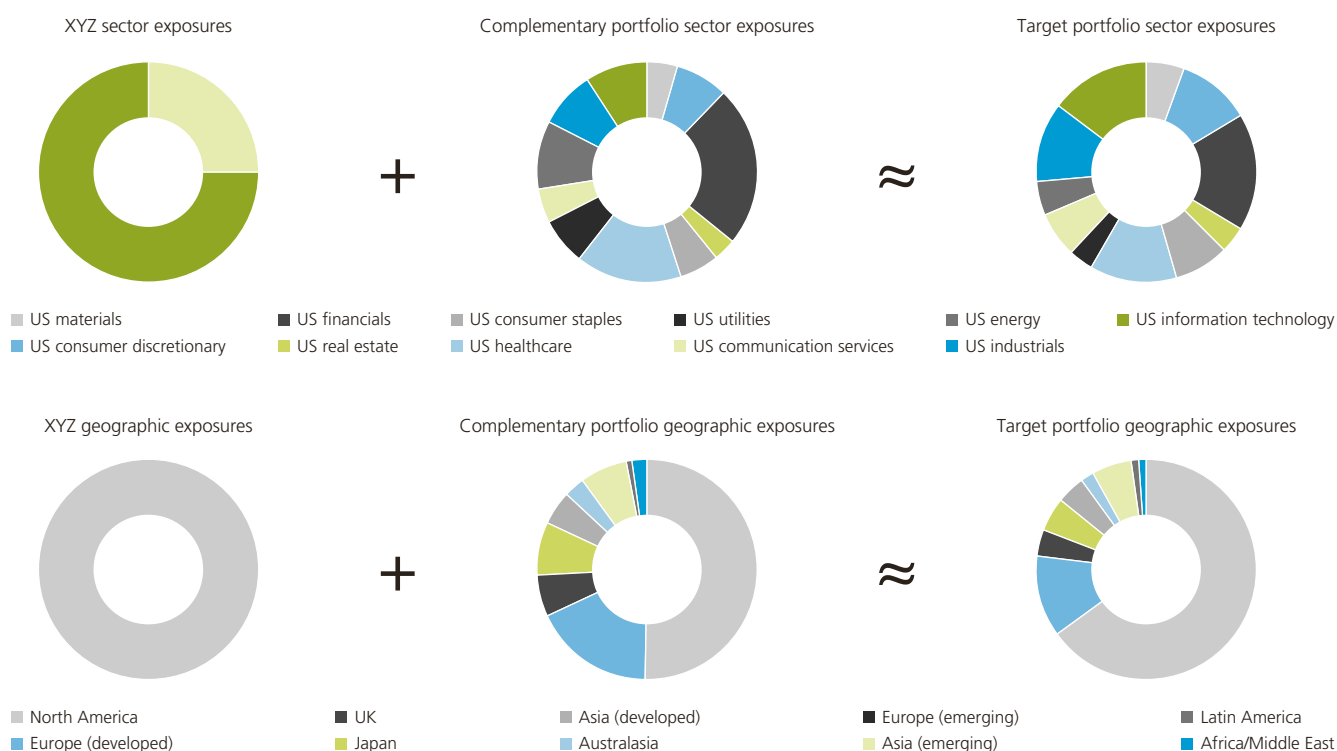
Funding the completion portfolio is straightforward if the remainder of the portfolio is in cash. This, however, isn't always

the case; sometimes the entirety of the client's wealth is in the concentrated equity position. This situation poses a problem for those who are restricted from selling. What can be done?

Investors may want to consider borrowing against the concentrated position to fund the completion portfolio while being mindful of borrowing capacity, prevailing interest rates for securities-backed loans, tax implications, and the need to be able to meet margin calls with other liquid assets. Adding investments that complement the concentrated position, through the careful use of leverage, can help to improve the risk-adjusted return on the investor's net worth and provide assets that can succeed even if the concentrated position struggles. Many individuals may also be able to offset a portion of the loan costs against income to increase the tax efficiency of a borrowing strategy. To evaluate the benefits of borrowing relative to your personal situation, we recommend consulting with your tax professional. (See more at www.ubs.com/leverage.)

Figure 12

XYZ stock paired with complementary portfolio to form total equity portfolio



Source: UBS

Action items

What can you do to manage the risks of your concentrated position? [Jump to a solution](#) to learn more.

Right-sizing an equity position	>	Exchange fund	>	Prepaid variable forward (PVF)	>
Factor completion portfolio	>	Equity collar	>	Charitable remainder trust (CRT)	>

Option 3**Diversify and reduce your concentration with an exchange fund**

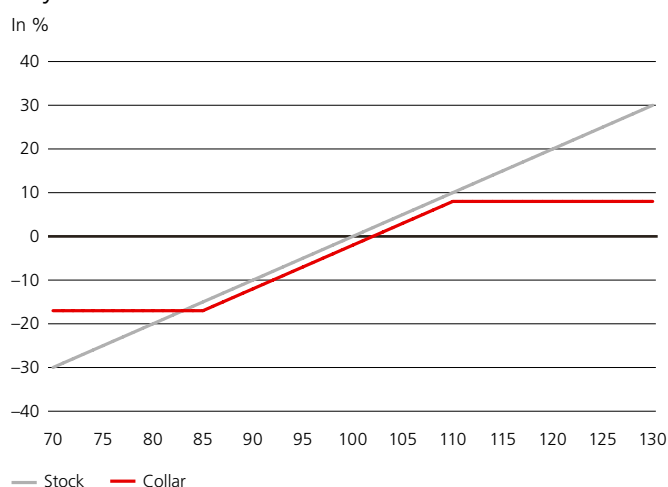
Investors also have a potential solution for achieving diversification of concentrated equity positions, while deferring taxation, through what is called an exchange fund. As the name implies, investors can exchange shares of selected stocks for shares in a professionally managed, diversified portfolio. There are a few considerations investors should evaluate before investing in an exchange fund:

- 1 Investments usually come with limited liquidity, with redemption windows typically on a monthly or quarterly basis.
- 2 In order to receive shares in a diversified basket of securities, there is a required holding period, typically seven years.
- 3 The basket does not remove market risks. Investors are trading the idiosyncratic risks of their holding for a broad basket of securities, which means the investor will likely face more beta risk than company-specific risks, and likely be more exposed to general market declines.

Option 4**Hedge downside risks with an equity collar**

For individuals who are unwilling or unable to reduce concentrated positions, it may be appropriate for them to protect the value of the concentrated position, yet to continue to participate in some of the potential price appreciation or dividends. In this case, investors may be able to form an equity collar by selling out-of-the-money calls and buying puts. This allows the concentrated position to appreciate up to a point, but also protects against downside. Depending on the amount of downside protection and upside potential, it may be possible to use the proceeds from the sale of the call to completely finance the purchase of the put. It is important to consider the maturity date and shape of the volatility curve. The longer the

Figure 13

Payoff of collar structure

Source: UBS. For illustrative purposes only.

maturity, typically the higher the cost for downside insurance provided by a put.

Insiders of companies are commonly subject to increased restrictions on what they can and cannot do with their concentrated equity holding. In 2018, the Dodd-Frank Act required individual companies to establish and disclose insider trading policies in full surrounding hedging transactions and if they are specifically permitted or disallowed. An insider is a director, executive, or a shareholder who owns more than 10% of the company's shares. If you are an insider, while you may not be permitted to apply a collar as a hedge on your specific stocks, a collar or hedging strategy on an industry-specific index may be an option. An index-hedging strategy is unlikely to perfectly offset the risks of any single security; however, it can mitigate many of the risks specific to an industry. Given this basis risk, it is important to understand how much company-specific risks can drive deviations from index returns.

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Option 5

Hedge risks with a prepaid variable forward (PVF)

Similar to the equity collar, investors can also enter into a private agreement with an investment bank to form an equity collar that also provides immediate liquidity and access to cash equal to the collar floor minus financing and collar costs. At maturity, the investor will need to pay back the floor value and can typically settle in either cash or shares. Both the equity collar and the prepaid variable forward allow the investor to maintain voting rights and receive dividends on the concentrated security. However, the advantage of the prepaid variable forward is that the cash can be used to finance a more diversified asset allocation.

Option 6

Set up a charitable remainder trust (CRT) for income, tax efficiency, and building a charitable legacy

For investors who are charitably minded and would like their investments to continue to provide them with lifetime income, CRTs can be an effective solution—especially when the investor's portfolio includes highly appreciated assets that they would like to diversify in a tax-efficient manner.

The first step is to fund a CRT with highly appreciated investments. When the donor establishes and funds the trust, they

will generally be entitled to a charitable deduction based on the present value of the charitable beneficiaries' remainder interest (the estimated amount that will be left over at the end of the trust term, which is generally the joint lifetime of the donor and their spouse or a term not to exceed 20 years).

CRTs are generally tax-exempt entities, so after the CRT is funded the trustee can generally sell the appreciated investments in the CRT without paying any capital gains taxes, reinvesting the proceeds into a more diversified portfolio.¹ Once established, the CRT will begin to provide income to a non-charitable beneficiary (including the donor, if desired), either for the donor's lifetime or for a period up to 20 years.² There are two main types of CRTs:

- 1 Charitable remainder annuity trusts (CRATs) pay income as a fixed percentage of the initial value of trust assets.
- 2 Charitable remainder unitrusts (CRUTs) make an annual percentage distribution equal to at least 5% of the trust's fair market value each year.³

At the end of the trust term, the trust's remaining assets will pass to one or more charitable organizations that the donor or the trustee designates.

**Conclusion**

A concentrated equity position can disproportionately affect your portfolio risk and return, which can have a significant impact on your ability to achieve your goals. The various strategies we have outlined in this report can help you better understand your concentrated position and the actions you can take to manage the position. Talk to your financial advisor to discuss which strategy can best help you.

¹Charitable remainder trusts may be subject to unrelated business income taxes and state income taxes.

²If the donor designates someone other than the donor or the donor's spouse as an income recipient, there are potential gift and estate tax implications.

³Generally this distribution will need to be made even if the trust's income is lower than the required distribution in a given year, requiring the trust to dip into principal. If the donor does not need the CRUT income for regular expenses, they may wish to set up a Net Income with Makeup Charitable Remainder Unitrust (NIMCRUT), which allows the trust to limit the distribution to the trust's income and potentially "make up" the distribution shortfall with a larger distribution in a future year.

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Right-sizing an equity position	➤	Exchange fund	➤	Prepaid variable forward (PVF)	➤
Factor completion portfolio	➤	Equity collar	➤	Charitable remainder trust (CRT)	➤

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