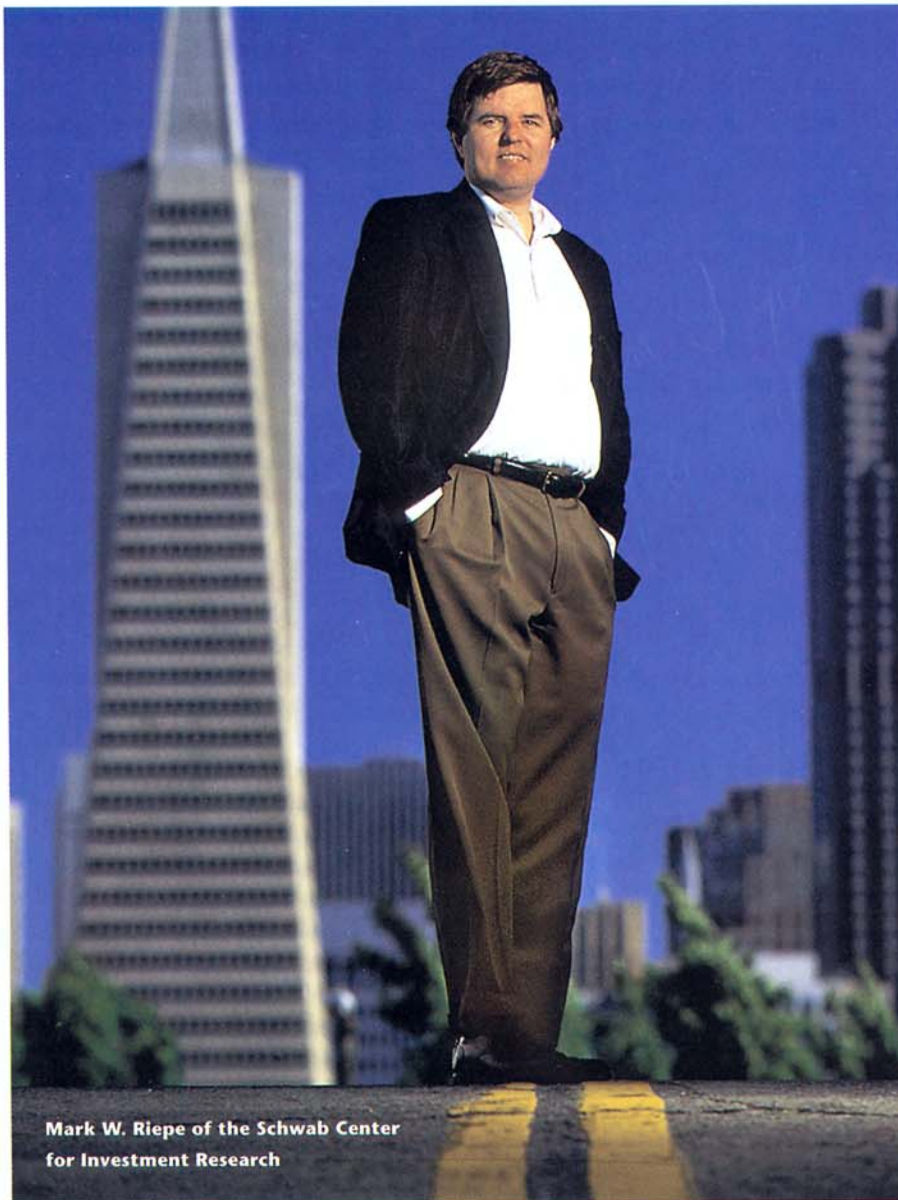
The Dangers of Concentrated Equity

Is your portfolio overloaded with one stock or sector? If so, it may be time to diversify.

By Mark W. Riepe, CFA



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PHOTOGRAPH BY RICHARD MORGENSTEIN

If the "tech wreck" of 2000 illustrated why diversification is essential to the success of your investment portfolio, then the Enron debacle—followed by Kmart, Tyco, and Williams Cos.—provides an even more poignant lesson on the dangers of concentrated equity. And while the past has seen less-dramatic examples of the risks of concentrated positions—what I refer to as the antithesis of diversification—the media attention around the aforementioned four should be enough to make many investors take a second look at their portfolios.

What Is Concentrated Equity?

Before I go any further, I think it's important to define what comprises a concentrated position. Words like "concentrated" are subjective—there's no magical definition that everyone agrees upon. In my opinion, a concentrated equity position occurs when an individual stock makes up roughly 20% or more of your total portfolio. This kind of benchmark is important because it helps investors determine when the performance of their entire portfolio is at risk of being significantly affected by a single stock. If you have a concentrated position, you may be exposed to a higher degree of risk than you're comfortable with.

While I'm stressing single equity positions, the same concept holds true for sectors and industries. The so-called tech wreck is a recent example, but it's not the first. Defense stocks performed badly in 1998 as federal defense spending dropped; home-builder stocks suffered greatly in 1994 as interest rates climbed; and health-care stocks were clobbered in 1992 in response to concerns about the Clinton administration's proposed health-care reforms.

The traditional approach to studying diversification and individual stocks is to look at how the level of investment risk

declines as the number of stocks in a portfolio increases. In our research, we considered a typical portfolio. Our hypothetical investor would have a number of mutual fund holdings, but also might own a large number of shares in one company through employee stock options, restricted stock, or employer matches from a defined-contribution plan. He might have also loaded up on company stock through an employee stock-purchase plan.

We reviewed data from 1926 to 1998, examining 25,000 investment simulations in which increasingly larger amounts of a randomly selected stock were combined with an otherwise diversified portfolio (defined as a total stock market index). We then measured how the risk of the overall portfolio changed as the individual stock portion became larger and larger.

Why Concentration Is Risky

The results demonstrated that, on average, overall portfolio risk really started to ratchet up once the individual stock reached the 20% barrier. What exactly are these heightened risks that come with a concentrated equity position?

Volatility The returns on a portfolio with a concentrated equity position are typically more volatile than the returns of a diversified portfolio. The reason is simple—the performance of that single large position can have a dramatic impact on the portfolio's overall performance. When that company is flying high, chances are that the portfolio will too. But if that company experiences a downturn, or is simply limping along, the portfolio performance will likely follow suit. On the other hand, if you hold a wide variety of equities, you'll likely experience smoother returns.

Portfolio Underperformance A portfolio's risk of significantly underperforming the stock market rises with a concentrated position. This is a more subtle effect. Imagine you have a child with a grade point average of 3.0 (a solid B), and that the child has tended to receive Bs in most of her classes over the years. The risk of this child receiving an extremely poor grade is pretty low. Compare that with another child who also has a 3.0 GPA. This child's transcript is littered with As, but also with several Ds, which drag down the average to a B. In any given class, the risk of this child receiving a poor grade is higher. Think about this from the standpoint of an investment portfolio. A concentrated portfolio is like the latter student: It may shine from time to time, but the risk of bad performance is greater.

Missing Your Goals The resulting implication if you hold a large concentrated position is that your portfolio performance could become an unpredictable roller-coaster ride. Even worse, you could miss significant life goals, such as educating a child or grandchild, starting a business, or retiring early.

ARE YOUR INVESTMENTS AT RISK?

The first step in determining if your portfolio is too concentrated in a particular stock or sector is to take a comprehensive view of all your financial assets. Here's where to look:

- ❑ brokerage accounts
- ❑ IRAs
- ❑ 401(k)s
- ❑ 403(b)s
- ❑ 457 plans
- ❑ other deferred-compensation savings plans
- ❑ stock options
- ❑ annuities

Schwab can help you evaluate your entire portfolio—including your holdings in employer plans and at other firms—and compare it with a model portfolio that best aligns with your goals and risk tolerance. Go online and take the Schwab Portfolio Checkup™, or call 800-435-8804 to make an appointment with a Schwab Investment Specialist.

Reviewing Your Own Situation

So how can you avoid these potential pitfalls? The answer is to know your portfolio. The reality is that many people acquire concentrated positions without realizing it. These are the investors who sensibly sign up for their company's 401(k) plan, but work for firms that provide a matching contribution in the form of company stock. At first their exposure is small, but over time it can add up to a bundle. Some firms offer a separate employee stock ownership program in which the company, at its discretion, will make contributions—again in the form of company stock. Other employees receive stock options. Many employees, feeling confident about the future of their employer, exercise their options and hold the underlying stock. Still other investors have no current connection to the company at all—how many beneficiaries of deceased loved ones have reviewed account statements to find much of the inheritance tied up in the stocks of a handful of companies?

The lesson in all this is to review your portfolio periodically and understand it inside and out. You should also have a clear understanding of your own personal tolerance for investment risk. And finally, remember that the key to successful, long-term investing is to build a solid foundation of well-diversified holdings. ◂

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New Bonds Are Beckoning

New-issue bonds may be just what you need to round out your portfolio—and now investing in them is easier than ever

Whether the stock market is moving up, down, or sideways, bonds can provide an attractive alternative for investors. It goes without saying that setting aside a portion of your portfolio for bonds can be a wise move. But here's where things get murky. With so many alternatives to choose from, and different ways of purchasing them, how can you determine which is best for you?

One alternative to consider is a new-issue bond. New issues are appealing to a broad array of investors for many reasons, but primarily because they often offer a better bargain than comparable secondary issues, which may ultimately impact your return. Perhaps even more important, they're becoming much easier to find and invest in.

Indeed, new bond issues are on the rise. According to the Bond Market Association, U.S. bond issuance hit a record $4.6 trillion in 2001, up from $2.7 trillion a year earlier. Meanwhile, Bloomberg reports that stock IPOs dropped from $107 billion in 2000 to $45 billion in 2001.

"New bond offerings are in great supply and come in a variety of classes," says John Ladensack, senior vice president at Schwab Capital Markets.

Why New Issues Are Attractive

1 Competitive Pricing New-issue bonds, including selling concessions and syndicate fees, are typically highly competitive to facilitate a quick distribution. The result is that new issues sometimes offer higher yields than do comparable secondary issues with markups, says George von Zedlitz, vice president of fixed-income sales and service at Schwab. When a new issue is priced, investors can be assured that the bond yield is primarily based on current interest rates and supply factors for existing bonds. "Depending on the investment, it can make a difference of anywhere from a few hundred dollars to several thousand dollars in the overall return," he says.

2 Access to Larger Lots Still another reason to buy new issues is that they often provide an opportunity to buy a sizable holding in a particular bond. By contrast, in some instances, the secondary issue might be in short supply from time to time, so buying it may prove difficult.

3 Better Liquidity New issues also tend to be more liquid than some bonds in the secondary market, and depending on the size of the issue, they sometimes offer a higher yield.

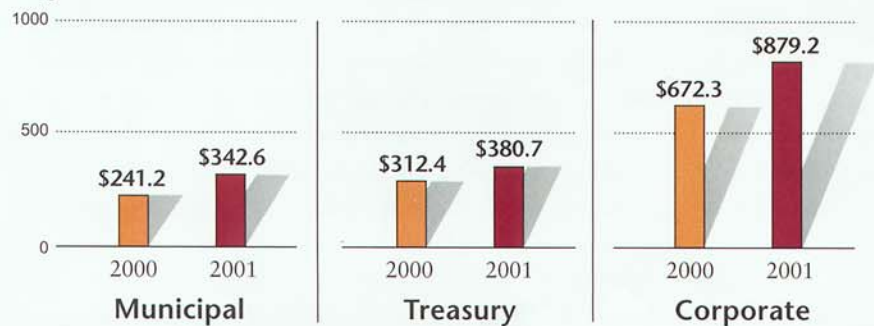
Another reason investors like new issues is that they often avoid accrued interest, or interest that has accumulated between the most recent payment and the sale of a bond. For example, when an investor buys a bond in the secondary market and it is between payment periods (for example, the transaction occurs in March and the bond pays out in January and July), the buyer must pay the seller the bond's price plus interest earned until that point. But it should be noted that the buyer gets the full periodic interest payment at the next interest pay date.

Today, many issuers of bonds cater to retail investors. While institutions tend to buy and sell bonds, individual investors frequently hold the securities to maturity, which can result in a more stable price. In fact, for municipal bonds, it is not uncommon for an issuer to create a so-called retail order period to help ensure that individual investors gain

U.S. Bond Market Soars

New Issues in 2000 vs. 2001 ($ billions)

The U.S. bond market hit volume records for new issues in 2001 as investors sought shelter from the volatile stock markets.



Source: The Bond Market Association, Research Quarterly, February 2002