NEW WAYS TO LOOK AT CONCENTRATED LOW-BASIS HOLDINGS

NEPC Private Wealth

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The issue of concentrated low-basis holdings is a challenge that has vexed wealth managers and their clients for decades. Put simply, it goes like this: If a large majority of your wealth is concentrated in a single position, should you sell some of it and move the proceeds to a more diversified portfolio of investments?

On the one hand, it may seem obvious that diversifying your wealth is the right thing to do. It reduces risk and opens up a wider range of investment and planning opportunities. But there's a snake in the grass – oftentimes, the position carries enormous unrealized capital gains, so a sale would incur a huge tax liability.

It's a dilemma that comes up fairly frequently among the NEPC Private Wealth team, because so many wealthy individuals and families achieved their position by founding a family-owned business. Executives whose compensation included large stock awards also face this challenge. There are several classic techniques the team recommends for concentrated positions. But in recent years, new ideas have evolved that might be a better fit for some wealthy families.

CLASSIC TECHNIQUES, CLASSIC CHALLENGES

The traditional playbook for concentrated positions includes techniques that neutralize the tax liability by, essentially, giving the stock away. For example:

- **Donate the stock to a nonprofit or charity.** If philanthropic giving is a part of your wealth plan, appreciated assets are ideal assets to donate. They provide a tax deduction for the fair market value of the donation while avoiding capital gains taxes.
- **Give the stock as an inheritance.** This is an excellent tax-saving technique because those who inherit the stock on your passing typically get a full step-up in cost basis. That wipes out the tax liability for your heirs.

Wealth managers also advise balancing an appreciated single-stock position with other investments that are either more diversified, more tax efficient, or more likely to meet an immediate financial need. For example, families that need income have sometimes used options on their single-stock holdings to generate that income.

Realistically, however, there are limits to how beneficial these techniques can be. For example, the advantages of a tax-managed fund don't often measure up to the scale of unrealized appreciation in a

single-stock holding. Planning to give away the stock as an inheritance isn't a workable plan for every family, especially since doing so could trigger estate taxes.

STRATEGIES FOR KEEPING THE STOCK

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One of these is the *exchange fund* (not to be confused with the exchange-traded fund). Exchange funds are private investment partnerships that allow investors to contribute appreciated securities in exchange for an interest in a diversified portfolio managed by the fund. This contribution is typically done on a tax-deferred basis, meaning you don't trigger immediate capital gains taxes. Exchange funds originated in the 1990s and have improved over time. For example, many earlier funds suffered from selection bias, but today's options include funds that provide broad market diversification.

The other is called a *completion portfolio*. A completion portfolio is a strategy designed to complement and diversify one heavily concentrated in a single stock. Conceptually, diversification approaches have been around a long time. But the specific term "completion portfolio" has become more prevalent recently as academics and professionals have sought to refine the strategies these portfolios use.

The technique works like this: the completion portfolio would be constructed alongside the single stock and funded with cash. Instead of matching an index, it would be customized to take into account the concentrated position – so, for example, the account wouldn't hold the stock in question or possibly any stock in its industry. Stocks that are bought with the cash are then actively harvested for losses, which can be used to offset some of the gains in the low-basis stock.

It can take time to build a completion portfolio, but its chief advantage is that it can be fully customized to meet short-term financial needs and can incorporate a long-term wealth preservation strategy for the client who creates them.

These tools have high minimums and are only available to high-net-worth investors. But for many investors and their families, they provide a more robust and meaningful solution to a concentrated low-basis holding.

MOVING FORWARD

Once investors have created wealth through concentration, it often makes sense to preserve that wealth through diversification. But it's not always easy, and there's a chance it can be costly. If you want to examine your options for diversifying your single-stock holdings, please reach out to your NEPC consultant. We can help you assess your tax liability and evaluate the options that will work best for you.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques are not guaranteed to ensure profit or protect against losses.

This memo should not be considered customized investment advice. Please contact NEPC for advice specific to your investment program.

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