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SUMMARY

- Concentrated positions are associated with high portfolio risk.
- Covered call strategies can generate income to help diversify concentrated portfolios.
- Financial advice is key to solving issues like concentration.

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Complex Problems Require Custom Solutions, Part 2

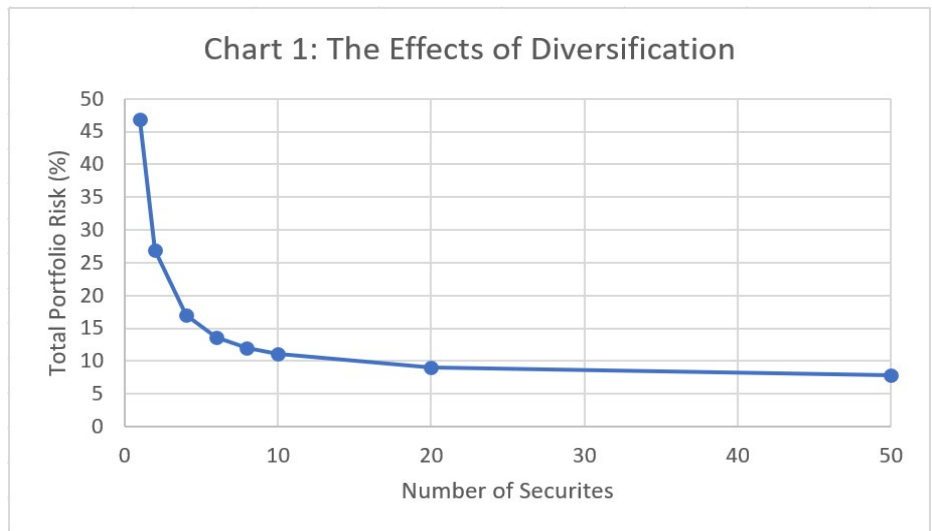
One Way to Approach Concentrated Position Risk

A couple of months ago, we discussed in our [Strategic View](#) how more nuanced investment problems require equally nuanced investment solutions. That piece focused on income-oriented portfolios within a goals-based framework. This week, we are tackling another complex challenge: concentrated stock positions.

The Risk of Concentration

When a single stock becomes a large portion of a portfolio, the investor's goals become inextricably tied to that stock's performance. This 'concentration' risk manifests in two primary ways: elevated portfolio volatility and increased underperformance risk.

First touching on **volatility risk**, research by Edwin J. Elton and Martin J. Gruber in *Risk Reduction and Portfolio Size: An Analytical Solution* examined the relationship between the number of holdings and total portfolio risk. Chart 1 illustrates their findings.



Source: Adapted from Elton & Gruber © 1977 The University of Chicago Press). Chart shown for illustrative purposes only. Past performance is no indication of future results.

According to the study, diversifying from a single concentrated position to a diversified basket of roughly twenty stocks reduces expected portfolio risk from just under 47% to under 9%, removing much of the idiosyncratic (company-specific) risk, though systematic market risk remains. Put more simply, a single stock portfolio is expected to have a much larger year-to-year variance in returns. This variance equates to large fluctuations in an investor's wealth, when a single stock makes up a large portion of their portfolio.

Moving to **underperformance risk**, we must take a long-term view on our concentrated stock. If the goal is to hold this position for 20 or more years, we must consider both the risk of the stock having negative returns, as well as the opportunity cost of holding the stock instead of a more diversified portfolio. In fact, let's step back in time twenty years or so years to 2005. At the time the largest companies in the S&P 500 were GE, Exxon Mobil, and Citi. The decade prior to 2005 was a good one for this trio, with an average total return of 20.5% per annum. This creates a nice parallel between these stocks and several modern-day growth stocks.

Now, let's step forward through time. Due to GE splitting into three entities, we will set them aside. If we look at the returns of Exxon and Citi from the start of 2005 until today, we end up with a mixed bag. Exxon averaged an annualized return of 13.3%, while Citi's annualized return was -5.6%. So, holding a concentrated position in one name would have most likely allowed an investor to reach their goals, while the other would have caused a loss of wealth. However, when we introduce the S&P 500 into the mix we begin to see the total risk. Over this same period, the S&P 500 averaged 17% per annum. Even the successful concentrated position was unable to keep up with the diversified basket. We can conclude from this anecdotal exercise that even if a stock has a strong bull run, its future returns are not guaranteed, especially when considering them relative to a diversified basket¹.

The Added Complexity of Taxes and Emotions

Given the risks we have laid out, it may seem simple to say, "let's trim or completely sell this concentrated position." Unfortunately, taxes often create a major hurdle. For the vast majority of concentrated positions, the position became concentrated through outsized price appreciation, rather than an intentional purchase at that weight at the outset of investment. As a result, the cost basis is typically much lower than the current market value, meaning even a modest trim could trigger a significant capital gains tax liability.

Beyond taxes, concentrated positions often carry sentimental value. Most common paths to concentration - inheritance, long-term accumulation, or equity compensation - leave investors understandably uneasy about selling. Additionally, investors may worry that when they sell a concentrated position, they are missing out on the upside potential of that stock ("FOMO" as it is colloquially known). As such, having a diversification plan - and sticking to it - is important to help remove these emotions from the decision-making process.

Using Covered Calls: The Skinny

We would like to briefly provide a very high-level explanation of covered calls before providing a deeper dive. In the simplest terms, **a covered call swaps a stock's future upside for income today**. This can be attractive to an investor that has a concentrated position and the need for income or diversification. With any covered call strategy, there is a risk that an investor must sell their stock (and incur capital gains), though certain strategies can mitigate this risk. If this sounds intriguing, your financial advisor can discuss this further with you, as options can sound complicated at first blush. We will now do a deeper dive into the mechanisms of how they work.

Covered Calls: A Deeper Dive

Providing a little more color to our above comments, a covered call is when the holder of a stock 'writes,' or sells, call options on that stock. These call options give the buyer of that option the right (but not the obligation) to 'call,' or purchase, a security at a pre-specified price (known as the 'strike price') before the option's expiration date.

This means when an investor initiates a covered call position, they are sacrificing future upside on the stock above the strike price. In return for limiting their upside, they receive income at the initiation of the option. **In other words, a covered call strategy can transform the total return expectations for an individual stock by capping the price appreciation opportunities, while increasing the income generated by the position.** It is important to note that covered calls do not eliminate the downside risk of owning the underlying stock; the investor remains fully exposed to declines in the stock's price, less the income received. Additionally, there is always a risk that the security on which the call is written will be purchased by holder of the option. While this risk is able to be mitigated through purchasing an identical option to the one

¹ Stocks mentioned are for illustrative purposes and not intended as recommendations. You cannot invest directly in an index.

they sold (“buying to close”), this transaction will reduce portfolio income and may require cash deposits to cover the cost of the transaction. Even with this mitigation, risk of the stock being purchased cannot be eliminated.

The income generated by covered calls can then serve as a tool for gradual diversification. Each income payment can be reinvested into a diversified basket of stocks or an ETF, creating a systematic dollar-cost-averaging stream. While this method of diversification tends to be gradual, it can fit well within a 10–15-year timeline (or longer, depending on the investor’s preferences), with the options income providing some volatility dampening in the interim.

For investors willing to trim their concentrated position directly, options income can also help offset the resulting capital gains taxes. That is, the income from the covered call strategy can be earmarked for tax liabilities, and a corresponding portion of the concentrated position sold at year-end so that the income covers the incremental tax obligation.

Adjusting the Pace of Transition

One of the key features of a covered call strategy is the ability to adjust the strike price relative to the current market price, which controls the aggressiveness of the transition:

- Strikes closer to the market price (“closer to the money”) generally produce higher premium income, offer less upside capture, and increase the probability that the stock will be “called away”. This approach may suit investors willing to accept a larger near-term tax burden in exchange for a faster transition.
- Strikes further from the market price (“further from the money”) generally produce lower premium income, preserve more upside participation, and reduce the probability of being “called away”. This approach may appeal to investors who prefer a more gradual transition or who want to retain more exposure to the stock’s potential appreciation.

Regardless of which approach is chosen, it is important that the diversifying investments complement (rather than replicate) the exposures of the concentrated position. For example, if the concentrated position is in the technology sector, the diversifiers should lean toward other sectors or styles to help avoid inadvertently doubling down on the same risk factors to which tech is exposed.

Risk Management of Covered Calls

Covered call strategies require frequent monitoring and a thorough understanding of options markets. Without active management, there is a risk of unintended assignment, meaning the stock could be called away at an inopportune time, potentially creating adverse tax consequences. While proper risk management can significantly reduce the likelihood of unintended assignment, it cannot eliminate this risk entirely. Additionally, in rapidly rising markets, a covered call strategy will underperform an uncovered position because the stock’s upside is capped at the strike price. Investors should also consider the transaction costs associated with writing and managing options positions, as well as the tax treatment of options premiums, which may differ from the treatment of long-term capital gains.

The Value of Advice: Complex Problems Require Custom Solutions

Concentrated positions create undue idiosyncratic risk. In our view, thoughtful diversification can help reduce this risk and increase the likelihood of an investor reaching their long-term goals. Covered call strategies provide one potential avenue opportunity to generate income to help fund the diversification process over time.

Echoing our conclusion from our earlier [Strategic View](#), when facing complex financial issues, the importance of financial advice cannot be overstated. Without a financial advisor, identifying, quantifying and addressing these problems can be difficult. An experienced advisor can draw on a range of tools and strategies to craft a solution tailored to each client’s unique circumstances, risk tolerance, and objectives.

At RiverFront, we offer both model and custom portfolio solutions to support financial advisors and their clients in addressing complex issues. For concentrated positions specifically, our model portfolios offer diversified exposures, while in certain instances we are also able to employ covered call strategies designed to facilitate a transition away from concentration.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

Important Disclosure Information

The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

Information or data shown or used in this material was received from sources believed to be reliable, but accuracy is not guaranteed.

This report does not provide recipients with information or advice that is sufficient on which to base an investment decision. This report does not take into account the specific investment objectives, financial situation or need of any particular client and may not be suitable for all types of investors. Recipients should consider the contents of this report as a single factor in making an investment decision. Additional fundamental and other analyses would be required to make an investment decision about any individual security identified in this report.

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Chartered Financial Analyst is a professional designation given by the CFA Institute (formerly AIMR) that measures the competence and integrity of financial analysts. Candidates are required to pass three levels of exams covering areas such as accounting, economics, ethics, money management and security analysis. Four years of investment/financial career experience are required before one can become a CFA charterholder. Enrollees in the program must hold a bachelor's degree.

All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Dividends are not guaranteed and are subject to change or elimination.

ETFs are subject to substantially the same risks as those associated with the direct ownership of the underlying securities owned by the ETF. Additionally, the value of the investment will fluctuate in response to the performance of the underlying index or securities. ETFs typically charge and/or incur fees in addition to those fees charged by RiverFront. Therefore, investments in ETFs will result in the layering of expenses.

A covered call option involves holding a long position in a particular asset, in this case US common equities, and writing a call option on that same asset with the goal of realizing additional income from the option premium. Certain ETFs use a covered call strategy. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying index above the exercise price but continues to bear the risk of a decline in the index.

Covered calls provide downside protection only to the extent of the premium received and limit upside potential to the strike price plus premium received.

An option is a contract sold by one party to another that gives the buyer the right, but not the obligation, to buy (call) or sell (put) a stock at an agreed upon price within a certain period or on a specific date. A covered call option involves holding a long position in a particular asset, in this case US common equities, and writing a call option on that same asset with the goal of realizing additional income from the option premium. Certain ETFs use a covered call strategy. By selling covered call options, the fund limits its opportunity to profit from an increase in the price of the underlying index above the exercise price but continues to bear the risk of a decline in the index.

As the writer of a covered call option, a client's account forgoes, during the option's life, the opportunity to profit from increases in the market value of the security covering the call option above the sum of the premium and the strike price of the call but has retained the risk of loss should the price of the underlying security decline. In other words, as an account writes covered calls over more of its portfolio, the account's ability to benefit from capital appreciation becomes more limited. The writer of an option has no control over the time when it may be required to fulfill its obligation as a writer of the option. Once an option writer has received an exercise notice, it cannot affect a closing purchase transaction in order to terminate its obligation under the option and must deliver the underlying security at the exercise price.

Investment in options is not suitable for all investors. While describing some specific common risks to options are described above, before investing in a RiverFront solution which includes the use of options and options via ETPs, clients should consult with their advisor before participating. For additional risks, please refer to the Options Clearing Corporation Publication: "The Characteristics & Risks of Standardized Options," (<https://www.theocc.com/getcontentasset/a151a9ae-d784-4a15-bdeb-23a029f50b70/dfc3d011-8f63-43f6-9ed8-4b444333a1d0/riskstoc.pdf>;) for additional information.

There is no guarantee the tax loss harvesting strategy will generate the desired tax savings or that investments made will generate gains or losses as anticipated. RiverFront does not offer tax, legal or accounting advice.

High yield bonds are debt securities often referred to as "high-yield" or "junk" bonds issued by corporations. High-yield bonds tend to pay higher interest rates because they have lower credit ratings than investment-grade bonds. High-yield securities (including junk bonds) are subject to greater risk of loss of principal and interest, including default risk, than higher-rated securities.

In a rising interest rate environment, the value of fixed-income securities generally declines.

Technology and internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

Diversification is the strategy of investing in different asset classes and asset types to reduce portfolio risk associated with price volatility.

Municipal bonds are debt securities issued by state and local governments. The municipal market can be affected by adverse tax, legislative, or political changes, and by the financial condition of the issuers of municipal securities.

Opportunity cost is any gain you pass up by deciding on one use of your resources over others.

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