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Concentrated Positions

Solve the Concentration Conundrum with Exchange Funds

By: Holly Swan | February 14, 2024

Investing in a single stock or concentrated position is both exciting and risky—offering the potential for substantial returns while simultaneously exposing investors to significant volatility. Therein lies the conundrum of concentrated positions.

Your job as a financial advisor is to help clients mitigate risk and preserve their capital. Diversifying concentrated positions can come at a steep tax cost if the concentration is highly appreciated.

Enter exchange funds. As the name implies, exchange funds allow investors to exchange their concentrated positions for shares in a diversified pool of securities held by the fund. Investors can spread their risk across multiple assets and potentially reduce the impact of a single stock's performance on their overall portfolio.

Here are a few questions you should think through to gauge whether your clients are candidates for an exchange fund:

What's the client's risk tolerance?

Understanding a client's risk tolerance is crucial when considering the suitability of exchange funds. Some investors are comfortable with the risks associated with concentrated positions, while others may prefer a more diversified approach.

What are the tax implications of selling the concentrated position?

Selling a concentrated position can trigger capital gains taxes, especially if the position has appreciated significantly. Financial advisors should evaluate the potential tax consequences of selling the concentrated position and compare them to the benefits of diversifying through exchange funds. This analysis will help determine the most tax-efficient strategy for the client.

How does the client's concentrated position align with their overall financial goals?

Diversification might not be necessary if the concentrated position aligns with the client's long-term goals and they have a high conviction in the stock's potential. Diversification is crucial if the concentrated position poses a significant risk to achieving their financial goals.

Bottom Line: You can help clients in a concentration conundrum understand the benefits of a well-diversified portfolio and the tax-efficient strategy of exchange funds.

Diversification does not eliminate the risk of loss.

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