

Uphill Climb

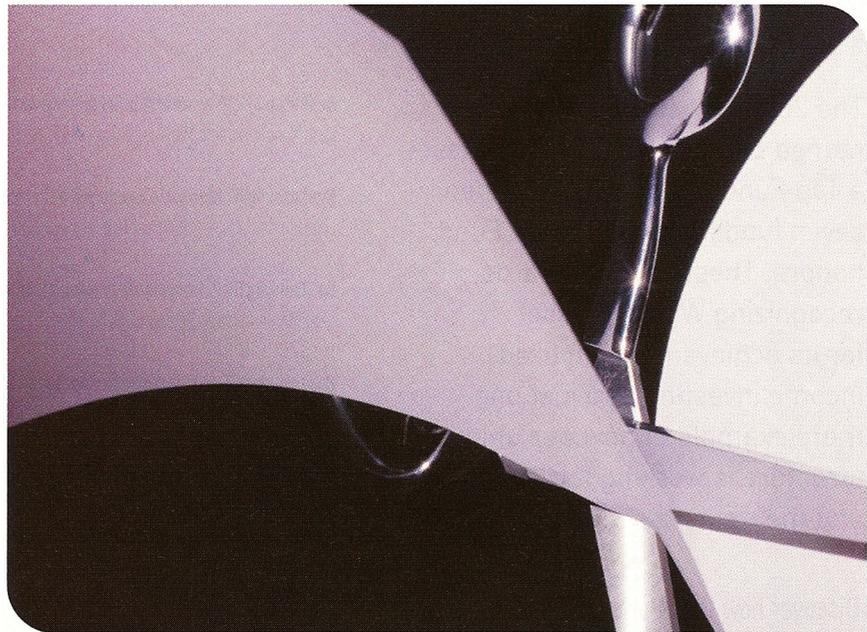
THE CATASTROPHIC LOSSES SUFFERED by Bear Stearns employees should serve as a wake-up call for all financial advisors. Investment portfolios intended for retirement must be adequately diversified.

While the job losses are distressing, most have found or will eventually find employment elsewhere. Replacing the losses in decimated 401(k) and ESPP plans (employee stock purchase plans) is quite another matter.

While the media's focus has been to foist blame on the greed and hubris of the firm's senior management, the real tragedy involves the majority of Bear's 14,000+ employees—support workers who owned one-third of the firm with their stock holdings but did not amass personal fortunes during the subprime mortgage bonanza. Years of soaring paper profits evaporated from employee savings plans as the company's stock plunged 80% in less than a year, culminating in a final implosion over a single hellish weekend. Lacking adequate diversity, their portfolios had little or no protection.

Bear employees now face a retirement with far less promising prospects than they did several months ago. This is especially true for older workers who face a double whammy: competing for employment with younger, typically lower-paid workers and trying to replace years of lost savings.

The tragedy at Bear is yet another example of why, as advisors, we have to make certain our clients' retirement portfolios are shielded from overconcentration in a single issue or market sector. That may sound like asset allocation



tion 101, but in practice, getting clients to recognize what constitutes appropriate diversification can be an arduous proposition. Client resistance is often the paramount obstacle.

Client Resistance

There are a variety of reasons why clients resist diversifying their portfolios.

Many have an emotional attachment to their holdings. A sense of loyalty prompts them to overload with company stock. Those who inherit stock favored by a revered family member may feel an obligation to hang on to it. Surviving spouses may associate certain portfolio holdings with treasured memories or milestones in their marriage. In some cases, the profits from a stock may have provided seed money to

Convincing clients to sell off concentrated positions, particularly in their own company's stock, can be an arduous task.

By Andrew Dodds

start a business or funding for a child's education, and so hold a special place in the investor's heart.

Those who have been managing their own money are sometimes unwilling to admit their mistakes and sell losing stocks or rebalance their portfolios by selling big winners. Often, investors resist selling a stock because they want to avoid capital gains taxation.

Whatever the reason for the opposition, clients simply may not be amenable to taking the necessary steps to rebalance and diversify their portfolios. I've found that even when a favorite stock has dropped precipitously, some investors can't bring themselves to sell off. They rationalize that somehow the stock will eventually rebound. For retirees, this can be an exceptionally dangerous delusion.

Perception Is Not Reality

In some instances, getting clients to diversify is not a question of resistance but, rather, one of recognition. Lots of successful people are unaware of how concentrated their portfolios have become. Corporate executives or business principals who own shares in options, for example, often fail to recognize the full value of their holdings.

Consider the executive whose options control a block of 100,000 shares of company stock selling at \$10 with a strike price (the option to buy the stock) of \$7. Her perception is that her holdings are worth \$300,000 less taxes—\$3 per share differential times 100,000 shares—and indeed she did have \$300,000 in net equity.

But she controlled 100,000 shares. If the stock continues to rise to say, \$20 per share, it becomes a \$1.3 million asset (100,000 shares times \$10 gain per share, plus her existing \$300,000 appreciation). Conceptually, executives don't always recognize the leverage their options provide. They don't have to buy the stock, but they control it.

So if our executive believes her company stock is going to do well, her options are the best place to keep her shares because they don't require any out-of-pocket money to purchase.

But our executive also owns compa-

ny stock worth \$100,000 in her firm's ESPP and another \$100,000 in stock in her 401(k). Therefore, her equity in company stock totals \$500,000 but she controls a total of \$1.2 million. Assuming the cumulative value of her total portfolio is about \$2 million, she has more than 50% of her portfolio assets tied up in a single stock in various places. She likely has no idea she is this highly concentrated and vulnerable.

When this is clarified, it can help you support the argument that she should gradually unwind her position. She should retain the upside potential provided by her options and that's a sufficient concentration of company stock. To protect herself on the downside, we would recommend she diversify out of the remaining stock. We use sophisticated aggregation software to demonstrate the potential impact of the concentration. It's a great tool to help clients see the total picture more clearly so that they can embrace diversification and control their risk.

Regardless of other issues, when heavily appreciated stock is involved, the tax ramifications are almost always a concern.

For some clients, liquidating large stock positions requires a discipline such as dollar cost averaging, where we agree to sell off a small portion of the holding each month, perhaps 5%, until it is liquidated.

Where's The Value?

It's easier to help clients rebalance when you avoid dogmatic adherence to traditional asset allocation when performing portfolio value analysis. Sometimes, we can exchange appreciated issues for something that appears to be undervalued in a 3, 4 or 5 to 1 ratio that increases the number of shares held, and hence, the opportunities for future appreciation.

You can also avoid investment pigeonholing and instead compare diverse asset classes with one another. For example, some years back, a popular technology

company's stock was trading at 95 times earnings with no dividend. The building it was in, however, was selling at just eight times earnings and offered a 10% cash dividend. Tech stocks were hot; real estate was not. It would have taken ten years of stock earnings to equal one year of earnings on the real estate dividends. I thought that represented a relative bargain, and so we sold some of the stock and bought some of the real estate.

As of this writing, real estate stocks are down significantly from their highs of a few years ago. Government bonds are currently paying about 3%. But you can get 8%-10% cash flow out of some of the buildings where government is housed. So there are some attractive mispricings in the depressed real estate market. Of course, getting clients to embrace this for their own portfolio can be a tough sell, but investor perception and resistance is what helps create market inefficiencies. This relative value proposition can help motivate clients to diversify by selling off highly appreciated stock and using the money to buy something that appears underpriced.

Clients create wealth with concentrated bets and keep wealth through diversification. As trusted financial advisors, it's our role to help clients do what is best for them: which is to avoid overconcentration of core money intended to fulfill their financial plan and their goals. For recalcitrant clients, the trauma of selling off an overgrown position may be akin to cutting off a finger. For advisors, it can be a valuable lesson in behavioral finance.

Whatever surgical procedure is chosen, whether it is the use of dollar cost averaging, OTM calls, the substitution of an unpopular asset class, or simply the use of limits and stop orders, it's vital that we help ease decisions for our clients so they can rebalance, pay the tax and move on. Helping clients overcome the emotional attachments and blocks associated with oversized individual stock holdings is one of our great challenges as advisors. [irll

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