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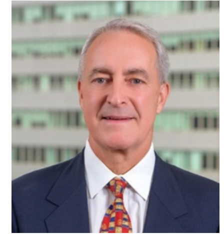

Thoughts for Investors

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Concentrated Stock Positions - Good or Bad?

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In 1976, Ronald Wayne, Apple's third co-founder, sold his 10% share to Steve Jobs and Steve Wozniak for $800. As of this writing, he left over $200 billion on the table.[1]

Many stock investors dream of owning a "concentrated position," a stock or stocks that dominate a portfolio and create wealth. How do you get a concentrated position? Is it good to have one? In this newsletter, I will outline the opportunity and challenge of building and keeping a concentrated position(s).

There are various ways to build a concentrated position such as being a founder, executive, board member or buying via an employee stock purchase plan or 401(k). In these cases, your job and your savings are intertwined. Or you can inherit. Obviously, these doors are open to fewer people.

A "back door" method happens when, to generate cash, an investor sells stocks with less opportunity and keeps ones with more. This is often viewed as controversial. While inadvertently concentrating the portfolio in better stocks, it lessens diversification.

One method we don't recommend is to "roll the dice," investing a disproportionate amount of savings in one stock. Well, maybe $800 is OK.

Perhaps the best way for most investors to build a concentrated position is to <u>buy a personally meaningful amount of a stock you believe has great potential</u>. This forces you to "do your homework." That doesn't often happen if you are too spread out and own an inconsequential amount of any stock. That's why we are not index fund fans. Owning 500 stocks via an S&P 500 index fund/ETF or 3,531 stocks via a Total Stock Market Index fund/ETF and you aren't "invested" in any stock in particular. Studies have shown that a well-chosen portfolio of at least 30 stocks gives 86% of the diversification of the S&P 500.[2] It isn't necessary to own every stock in every industry. Also, you don't need to buy that meaningful amount all at once. No one knows when they are getting the lowest price. Consider "dollar-cost-averaging" (adding more over time) until you get to that "personally meaningful amount."

"I've lost more money on the stocks I sold than the ones I bought."

-Steve M.

If a stock succeeds, let it keep growing! Don't sell simply because it has "gone up." Let management navigate the political, regulatory, competitive and business cycles. In our experience, many investors are better than they think at identifying great stocks, just not as good as they think at continuing to own them.

"In bull markets, investors think with their hearts. In bear markets, they think with their stomachs. We are here to help them think with their heads."

-Boris/Kaplan

So why are so few investors able to get or keep a concentrated position? Often it is a lack of patience with the volatility of a concentrated position's value. "I can't stomach these swings in my net worth." Volatility is not risk. Risk is the potential for a permanent loss of capital. Volatility is the fluctuation of stocks and the market, in part, based on emotions.

"Volatility is not risk unless you don't know the difference. We define risk as not meeting your goals."

-Boris/Kaplan

To settle their stomachs, investors often become pre-occupied with "diversification." There is a natural conflict between <u>concentration</u> and <u>diversification</u>. Both have a role in building wealth. Not every stock will be a big success. In fact, most will be average. You need to patiently stay invested in the great stocks you find, not just add more

hoping you will stumble upon a great one.

"Patience is an investor's greatest friend and emotion their greatest enemy."

-Boris/Kaplan

How do you diversify properly? Diversification is optimally achieved by saving more. Asset Allocation or "rebalancing" what you already have are, in our opinion, overly lauded strategies to get you "off the hook" from saving! In part, these strategies encourage selling some of your best performing stocks, often too early and because you have "too much." Imagine if Jeff Bezos or Bill Gates sold their stock simply because they were overweighted. Famed value investor Seth Klarman, author of "Margin of Safety" is heavily concentrated, with the "top three positions accounting for ~49%" of his 13F portfolio.

Arguably, not everyone is willing or able to save more. But diversifying by selling too early extinguishes any chance for a concentrated position. Adding too many stocks leads to over-diversification, dilution and ownership of stocks you may know less about and be less confident in. Owning multiple mutual funds also extinguishes your chance as each fund owns dozens if not hundreds of stocks.

"Has anyone ever pointed to a person and said, 'He made his fortune in an index fund'?"

-Boris/Kaplan

Some suggest there is little "cost" with respect to wealth creation by more diversification. Not so. If you own $100,000 of an S&P 500 ETF, you only own $6,400 worth of Apple stock today after its historic rise. Clearly no concentrated position. Further evidence for the wealth creation value of a concentrated position is a 2018 Journal of Financial Economics study, which found that from 1926 to 2016, just over 4% of the top performing stocks accounted for all of the net wealth creation in the stock market. So the outsized influence of the FAANG stocks (Facebook, Amazon, Apple, Netflix and Google) on the stock market's returns, and your portfolio if you own one, is not a new phenomenon.

When streaming video rose to prominence, Netflix stopped mailing CDs (compact disks) which put them in competition with Amazon and Apple. Between 2002 and 2018, Netflix stock spent 94% of its time below its previous all-time highs, taunting investors with the possibility that it couldn't compete. Yet between those dates, for patient investors who didn't sell, 100 shares of Netflix valued at $1,500 on their May 23, 2002, IPO became $53,251, a 35,000% return. Yet even after this spectacular rise, Netflix today is still less than 1% of the S&P 500 index, clearly not a needle-mover for index fund owners. The challenge of a concentrated position is that all around you will be politics, the economy, the stock market, experts and fellow investors advising you to rebalance and diversify, doing their best, wittingly or unwittingly, to discourage you from concentration.

"Which is easier, two correct decisions: when to buy and when to sell or four correct decisions: when to buy, when to sell, when to re-buy and when to sell again?"

-Boris/Kaplan

It is common for stocks to succumb to the Rip Van Winkle effect. The longer they sleep, the greater the urge to sell. We often hear "It's not done anything for a while. We can always buy it back later." In short, that is trading. For a majority of investors, trading doesn't create long term wealth, though it does for Wall Street. That's because taxes, commissions and arbitrage must be paid. This is capital not working for the investor. It also requires multiple correct decisions.

"Fortunes need to be created before they can be kept."

-Boris/Kaplan

In summary, you will undoubtedly remind me that "Fortunes are created by being concentrated and kept by being diversified." Unfortunately, there seems too many investors who haven't created enough wealth for tuition or retirement and take unwise risks to catch up. Maybe they should rethink their views on a concentrated position. As for whether a concentrated position is ultimately good or bad, ask someone who has one. Ronald Wayne never gave himself the chance. So when do you sell? That's a topic for another newsletter.

[1.] https://www.cnbc.com/2017/09/12/apples-third-co-founder-ronald-wayne-sold-his-stake-for-800.html

[2.] http://ppca-inc.com/Articles/DiversByNumbers.pdf (Surz & Price used R-squared to measure diversification as the percent of variance attributed to the market as well as tracking error [variance of portfolio returns vs. benchmark])

[3.] https://www.sec.gov/Archives/edgar/data/1061768/000156761920015100/0001567619-20-015100-index.htm

[4.] https://portfolioconstructionforum.edu.au/obj/articles_perspectives/Portfolio-Construction-Forum-HB_Do-Stocks-Outperform-Treasury-Bills.pdf (see page 3, page 33)

[5.] hBased on IPO at $15/share on May 23rd IPO and closing value on 8/26/20 at $547.53/share.

[6.] Wealth creation is defined as accumulation of market value in excess of the value that would have been obtained if the invested capital had earned one-month Treasury bill interest rates.

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Hear the Other Side

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