EXECUTIVE SUMMARY

The Agony and the Ecstasy:
The risks and rewards of a concentrated stock position

While there are many stories in the corporate world in which an entrepreneur or CEO has the right idea at the right time and executes brilliantly on a business plan, history also shows that forces both within and outside management control subsequently led many of their businesses to suffer serious reversals of fortune.

As a result, many individuals are known not just for the wealth they created through a concentrated position, but also for the decision they made to sell, hedge or otherwise take some chips off the table.

Over the long run, some companies do substantially outperform the broad market and maintain their value. However, the odds are stacked against the average concentrated holder. And while the risks of concentration are well publicized, we feel that they are still underappreciated.

Lessons from the S&P 500: Creative destruction

Studying the S&P 500 is useful, as it represents the largest, most successful companies in the U.S. We looked specifically at how many, and why, companies were removed from the index between 1980 and 2014. After setting aside the many deletions that were due to benign factors like mergers, companies being acquired at a premium, or re-incorporations outside the U.S., we focused on those companies that were removed due to business distress.

What we found was that, over the past 35 years, there was a lot of "creative destruction" taking place, with an estimated 320 companies removed for reasons of business distress. And while the rate does tend to pick up during recessions, there is a steady pulse of business failures even during periods of economic expansion. What this tells us is that companies, even very successful ones, face a steady drumbeat of competitive, regulatory and operational risks.

Concentrated risk: A historical perspective

We also broadened our empirical analysis, looking at the Russell 3000 Index (which represents approximately 98% of the investable U.S. equity market) between 1980 and 2014, and compared data on individual stocks vs. this broad index.

Here are a few of our key observations:

- **Risk of permanent impairment.** When looking at how often a stock has what we call a "catastrophic decline"—falling 70% or more and never recovering—we see that 40% of all stocks suffer this fate at some time in their history. And some sectors—like Telecom, Biotech and Energy—saw higher-than-average loss rates.
- **Negative lifetime returns vs. the broad market.** The data shows that two-thirds of all individual stocks underperform over their "lifetime," as compared to the Russell 3000. On average, the outcome for individual stocks was underperformance of about 50%.
- **The downside of single stock volatility.** When computing the optimal risk-adjusted return for a concentrated holder, we find that 75% of concentrated stockholders would benefit from some degree of diversification.

Factors outside management control

There are some great examples where, with 20/20 hindsight, management missed opportunities and made some mistakes. But, more often, we found that factors completely outside management control contributed to a catastrophic loss.

These exogenous factors include: commodity price risks, changes in U.S. or foreign government policy on tariffs and/or trade, unconstrained expansion by competitors, and technological innovation. Even the best management team is hard-pressed to cope with these types of unforeseeable challenges.

An issue worth addressing

Our analysis demonstrates that, all too often, continued concentration may ultimately destroy wealth. The study also clearly shows that, no matter how well you know your industry and your company, no one is impervious to event risk and industry changes, forces that have only grown in number and complexity since we first studied them a decade ago.

As a last step in our empirical analysis, we look at the percentage of stocks in each sector that succumbed to one of the three key risks we have examined: the risk of catastrophic loss, the risk of underperforming the Russell 3000 and the risk of heightened volatility that subjected concentrated holders with insufficient diversification to a very wild ride. With the benefit of hindsight, in around three-quarters of all cases, diversification could have played an important role in sustaining family wealth.

The first step towards addressing concentration begins with a look at your personal choices about risk and what you want to achieve with your wealth in the long run, and for future generations. And while no plan is ever perfect, taking no action could be worse.

We invite you to log-in to your account to access the full paper, *The Agony and the Ecstasy: The Risks and Rewards of a Concentrated Stock Position,* including insightful case studies. The paper is available as an interactive eBook complete with videos or as a traditional PDF.

To learn more about this paper and J.P. Morgan, we invite you to contact us and a J.P Morgan representative will be in touch with you.

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