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STEPS for Reducing Concentrated Stock Exposure



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Financial advisors typically recommend diversifying low basis¹ concentrated positions, but many clients don't take their advice due to tax costs and psychological reasons. We find that many investors likely underappreciate the benefits of diversification and risk reduction, while overemphasizing a one-time tax cost.

This paper is intended for advisors and families evaluating how to reduce concentrated equity risk and provides a quantitative and qualitative framework for doing so through our STEPS framework:

1. **Structuring**
2. **Tax efficiency**
3. **Exchange**
4. **Planned giving**
5. **Stacking**

Stock-specific risk

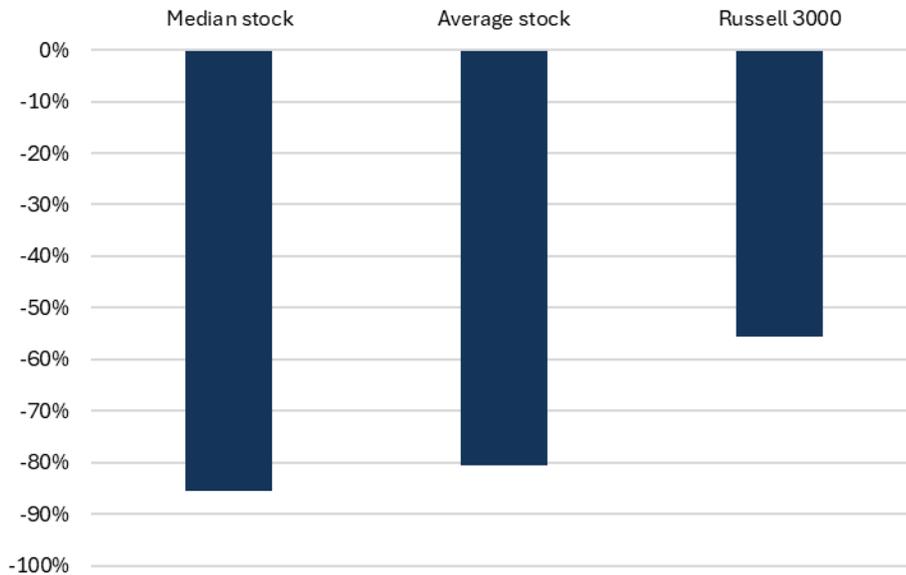
We define a concentrated equity position as one that comprises more than 10% of a portfolio, but the guidance in this article is relevant for any investor with a low-basis position that has a greater impact on their portfolio than they would prefer. At 10% of a portfolio, the volatility from a concentrated position begins to push overall portfolio volatility higher, resulting in more-significant drawdowns and significantly impacting overall portfolio return.

Some data points that might be instructive for understanding how risky individual stocks can be²: Between 1985 and 2024, the average (median) US stock experienced a drawdown of -80.7% (-85.4%) and about 54% of stocks never returned to their prior peak value after experiencing a major decline. For comparison, the worst peak-to-trough decline for the Russell 3000 Index, which consists of large cap, mid-cap, and small-cap US stocks, was -55.7%.

¹ A low basis position is one with a current value that is significantly higher than the purchase or acquisition price.

² Mauboussin, Michael and Dan Callahan. "Drawdowns and Recoveries." Counterpoint Global Insights (MSIM). May 21, 2025.

Fig. 1: Maximum drawdowns for US Stocks, 1985-2024



Source: Counterpoint Global, Bloomberg, Mill Creek. As of 12/31/2024.

Feast or famine

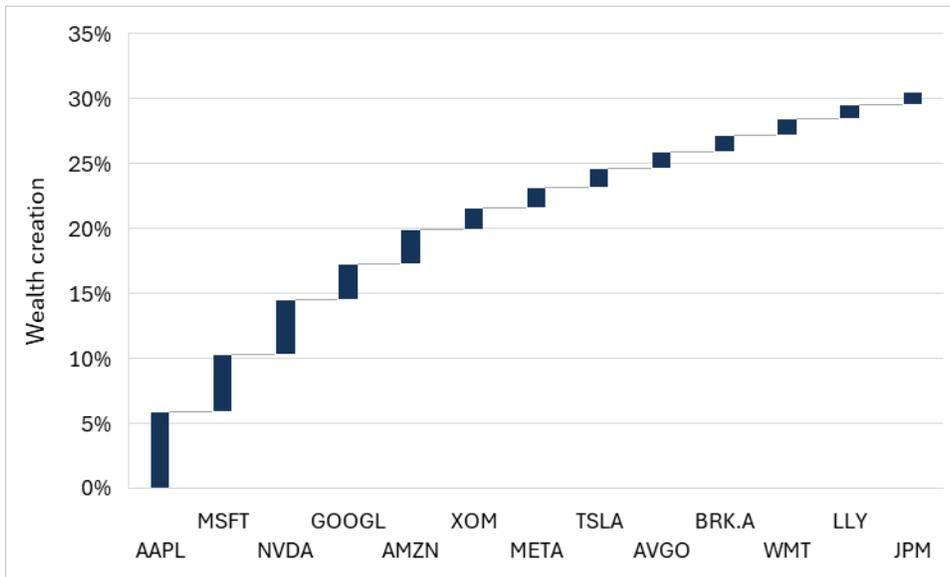
Individual stocks can create tremendous wealth, and many concentrated positions are due to single-stock holdings that exhibited performance far in excess of the general stock market. Between 1926 and 2019, a limited number of stocks accounted for most of the wealth creation in the US and international stock markets³. Out of over 25,000 listed US stocks that were traded since 1926, 13 stocks produced nearly a third of the wealth creation in the US stock market (Fig. 2), and only 86 stocks produced half of the wealth creation. Approximately 1,000 companies, or 4% of the total, were responsible for all of the net wealth creation, whereas the other 96% of stocks produced a return that collectively matched cash. These trends have been similar, but even more exaggerated, outside of the US.

There are two sides to every coin, and individual stock performance isn't an exception. Since a limited number of stocks have driven wealth creation, the vast majority of stocks have significantly underperformed the broader market. Even if we limit the universe to the 3000 largest publicly traded companies in the US, the median 10-year return on an individual US stock relative to the equity market has been -7.9% (Fig. 3). From 1926 to 2023, stocks that have recently outperformed (defined as top 20% of the market over a 5-year period) have exhibited a median 10-year underperformance of -17.8%.⁴

³ Bessembinder, Hendrik (Hank), *Wealth Creation in the U.S. Public Stock Markets 1926 to 2019* (February 13, 2020). Available at SSRN: <https://ssrn.com/abstract=3537838>.

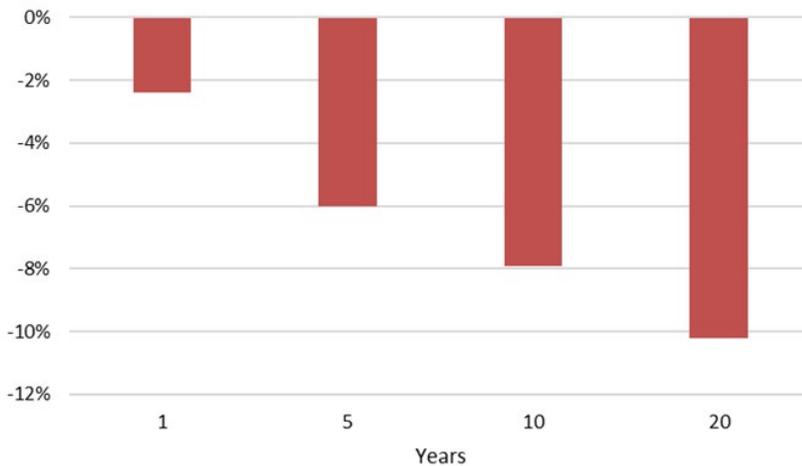
⁴ Petajisto, Antti, *Underperformance of Concentrated Stock Positions* (June 30, 2023). Available at SSRN: <https://ssrn.com/abstract=4541122> or <http://dx.doi.org/10.2139/ssrn.4541122>

Fig. 2: Thirteen stocks have created 30% of wealth in the US stock market since 1926



Source: Bessembinder, Hendrik (Hank), *Wealth Creation in the U.S. Public Stock Markets 1926 to 2019* (February 13, 2020). Available at SSRN: <https://ssrn.com/abstract=3537838>.

Fig. 3: Cumulative median individual-stock underperformance over rolling periods since 1926



Source: Petajisto, Antti, *Underperformance of Concentrated Stock Positions* (June 30, 2023). <https://ssrn.com/abstract=4541122> or <http://dx.doi.org/10.2139/ssrn.4541122>

Quantifying the tax-cost of diversification

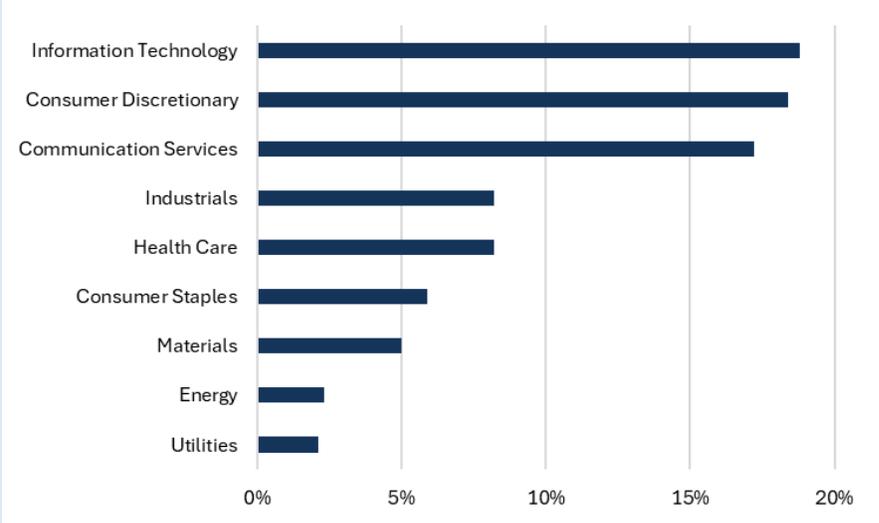
The explicit cost of selling a low-basis position is the tax cost, which is generally the capital gains in the position taxed at appropriate federal (Fig. 4), state, and local capital gains rates. All-in capital gains tax will vary by state. For example, the maximum capital gains rate for a California resident is currently 23.8% federal plus 13.3% state for a total capital gains rate of 37.1%, whereas the maximum capital gains tax rate for a Texas resident, who does not incur state-level tax, is only 23.8%.

We believe the tax cost of selling should be amortized over multiple years, as the investor’s benefits from diversification and risk reduction are also realized over multiple years. A reasonable horizon might be five years, but we can make the case that younger investors (e.g., 30, 40, and 50-year-olds) should consider spreading their implicit tax burden over longer horizons.

For example, the 37.1% tax cost, amortized over five years and ten years, is 8.2% or 4.6% per year, respectively. A 23.8% tax cost, amortized over five years and ten years, is 5.3% and 2.9% per year, respectively.⁵ While still meaningful, these amortized tax costs don’t have the same shock value as the actual one-time payment since they spread the cost over a more relevant horizon.

The trend toward stock-based compensation for C-suite employees has unsurprisingly led to an increase in the number of wealthy individuals with concentrated stock positions on their balance sheets. The wealthiest 1% of American households hold about half of their assets in stocks, of which two-thirds are in private companies and one-third are in public stock. It is not uncommon for private stock positions to become public stock positions through acquisitions or initial public offerings, and venture capital-backed firms are currently more than 40% of the S&P 500’s market cap.

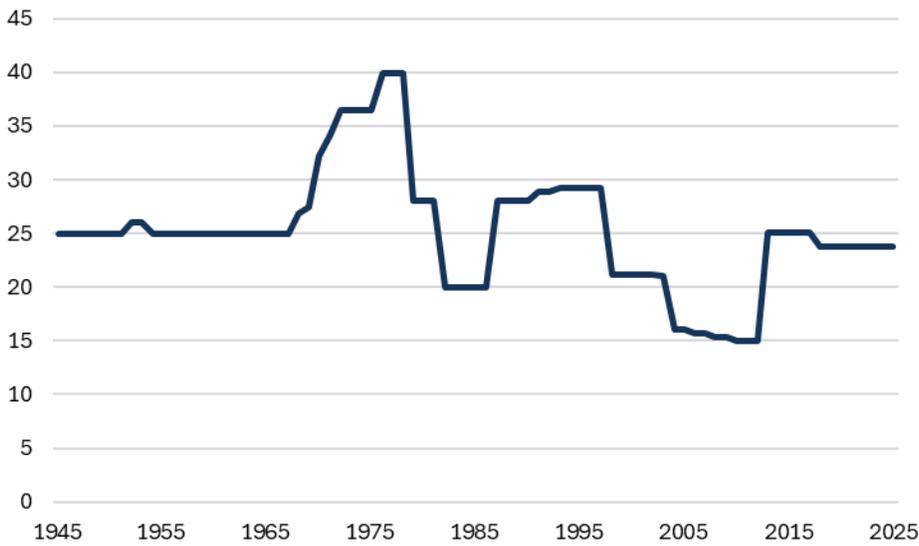
Stock based compensation as a percentage of operating cash flow, 2022



Source: Mauboussin, Michael and Dan Callahan. "Stock Based Compensation." Counterpoint Global Insights. April 18, 2023.

⁵ We have amortized the tax cost at their respective Treasury rates as of February 18, 2026.

Fig. 4: US Federal maximum tax rate for long-term capital gains (%)



Source: Treasury Department, Congressional Budget Office, Wolters Kluwer, Mill Creek. As of 12/31/2025.

Quantifying the value of a better portfolio

Assume you own your perfect portfolio – how much higher of a return would you require to add a concentrated stock to it? The answer to this question, which we call the Portfolio Efficiency Credit,⁶ is how we quantify the benefit of diversifying out of a concentrated position. Appendix 1 goes into the math of our model, but the intuition is sufficient for understanding why diversifying out of a concentrated stock is usually valuable. If you require an additional 2% return per year to willingly add a concentrated stock position to your portfolio, that suggests it's worth 2% per year to you to get out of the concentrated stock.

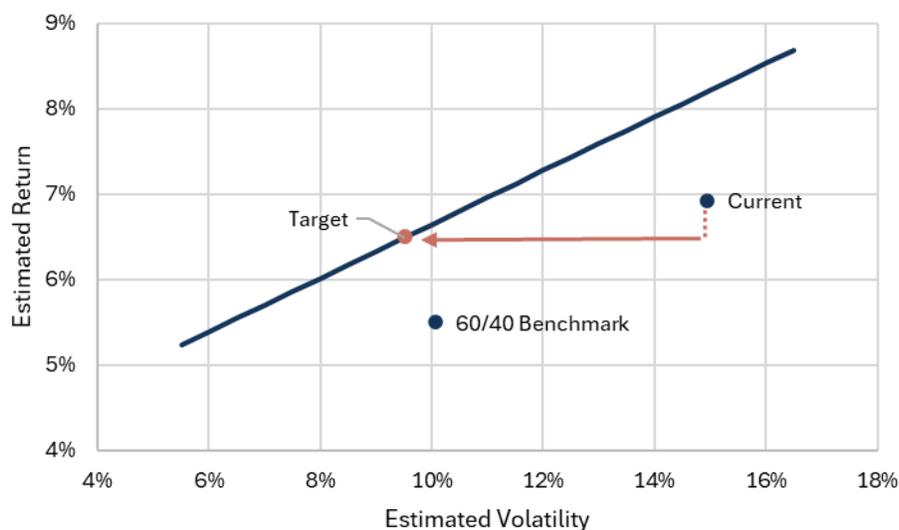
While the benefit of an improved portfolio might not immediately offset the tax cost of selling, diversification benefits can persist over long time horizons, and depending on future market outcomes, may meaningfully mitigate the economic impact of taxes, making the decision less one-sided. We believe investors should take this benefit seriously and mentally account for it as a counterweight to their tax costs.

⁶ Technically known as the "certainty equivalent."

As an illustration, we recently worked with a family in a low-tax state that wanted to diversify a large, volatile stock position on their balance sheet. The diversification allowed them to shift to a portfolio with substantially lower estimated volatility but also resulted in a slightly lower forward-looking estimated return (Fig. 5). Based on our capital market assumptions we estimated a Portfolio Efficiency Credit of approximately 3.2% per year⁷. This estimate reflects the modeled improvement in portfolio efficiency associated with diversification and is not a literal or guaranteed return. Under those assumptions, the projected diversification benefit could offset the realized tax cost over a reasonable number of years. While actual outcomes depend on future market conditions and may differ materially from projections, this framework helped inform the family's decision-making process and provided context for evaluating the tradeoff between tax costs and portfolio improvement.

A side note: our intention is to model the forward-looking risk and return characteristics of the concentrated position without bias. As a starting point, we assume its volatility and other risk characteristics will resemble the recent past and, despite the research presented earlier, we don't default to an assumption that individual positions will underperform or outperform the market on a risk-adjusted basis. However, our methodology is flexible enough to incorporate any views, positive or negative, that the holder might have on the future performance of the stock.

Fig. 5: Illustrative portfolio shift when exiting concentrated equity position



Source: Mill Creek.

⁷ The Portfolio Efficiency Credit is a model-derived estimate based on forward-looking assumptions regarding expected returns, volatility, and asset correlations. It is not a guarantee of future performance. Illustrations are hypothetical and intended for informational purposes only.

STEPS to Reduce Concentrated Positions

Once families have a clear sense of the costs and benefits of diversifying a concentrated position, many decide to simply sell, pay taxes, and move on with their lives, confident that their new portfolio will compensate for the tax cost over some number of years.

Other families prefer to further mitigate tax costs as they exit the position. Our STEPS framework is designed to help put (1) **structure** around the position to mitigate risk, create (2) **tax efficiencies** that can be used to reduce the impact of capital gains from selling the position, identify opportunities within the tax code to (3) **exchange** the concentrated position for a diversified position, use (4) **planned giving** to effectively meet charitable goals with the concentrated position, and (5) **stacking** these approaches together in an effective way that keeps a family's financial objectives at the forefront of decision-making.

The information below is meant to provide a general overview of the STEPS strategies. Please engage us to develop a custom analysis based on your specific circumstances.

Structuring

Structuring attempts to hedge the concentrated position and possibly borrow against it while implementing liquidation strategies. These strategies can involve complexity and counterparty risk.

Protective put options: Buying put options on the concentrated position as a form of downside protection to set a floor on how much you could lose if the price falls.

Covered calls writing strategies: Selling call options on the concentrated stock. This strategy generates income in exchange for giving up some of the potential upside. Downside isn't hedged.

Equity collars: A combination of protective puts and selling call options that pays for some or all of the cost of the protective put through the sale of the call option.

Prepaid variable forward (PVF): This sounds complex, but it is effectively a **collar strategy** combined with an **up-front cash advance**. *Prepaid* refers to an up-front cash advance, *variable* refers to the variable number of shares that will be due at maturity based on the stock's price, and *forward* refers to the stock transaction that will happen at a future point in time. At maturity, the investor can satisfy the PVF obligation by either delivering shares, delivering cash, or rolling into another PVF. PVFs are structured transactions that involve counterparty risk, liquidity considerations, tax complexity, and may limit upside participation.

Tax Efficiency

Tax efficiency is focused on (1) generating losses that can be used to reduce capital gains from selling the position or (2) liquidating the position in a tax-optimized way that reflects personal financial goals.

Tax-managed long short: An active strategy that uses leverage and shorting to (1) seek outperformance against a market benchmark, like the S&P 500, and (2) generate tax losses that can be used to offset capital gains from liquidating a concentrated position.

The specific amount of tax losses will vary depending on the amount of leverage and the success of the strategy, but they can be substantial. Conversely, tax-managed long short is a quantitative, complex investment strategy that is subject to tracking error, margin calls, short squeezes, and other operational and investment risks that shouldn't be taken lightly.

Tax lot selection: Investors who have multiple tax lots can allocate sales and transfers to best limit capital gains. This process typically involved selling higher-basis tax lots to raise capital and donating lower-basis tax lots for charitable purposes.

Exchange

The US tax code allows, with certain restrictions, investors to exchange their concentrated positions for a more diversified replacement asset.

Traditional exchange funds: A way to diversify is by contributing the position to a pooled fund that attempts to track a broader market benchmark. Investors typically have to hold the exchange fund for seven years before they can redeem, if desired, and receive a diversified basket of stocks in return. The original tax basis is transferred to the basket of securities that is returned to the investor. These funds can be relatively high-fee and can exhibit relatively high tracking error against their benchmarks.

351 exchange: The investor "seeds" an exchange-traded fund (ETF) with a basket of securities and receives shares of the ETF in return. Once the ETF starts trading, the fund manager rebalances the holdings to a diversified market benchmark. There are important limits to this strategy: no single security that is contributed by the investor can exceed 25% of the total value and the top five holdings combined must be less than 50% of the contribution. The original basis carries over to the ETF holdings.

Planned Giving

Planned giving involves donating the concentrated equity position to a qualified charity. Certain strategies enable the family to receive an income stream from the donated assets.

Donor Advised Fund (DAF): A way to donate highly appreciated stock to charity, avoid capital gains taxes, and receive an immediate charitable deduction. The donor no longer controls the assets, but as the advisor of the fund, the investor can make recommendations as to how the funds are invested and to which charities the funds are donated. These recommendations are generally accepted except in exceptional circumstances.

Private Foundation (PF): Similar to the DAF, but a PF is a standalone entity that provides for more control and family involvement than the DAF. PFs are generally more expensive and complex to administer than DAFs.

Charitable remainder trusts (CRT): A strategy that lets you transfer concentrated stock

into a trust, sell it tax-free inside the trust, receive income for life or a set term, and ultimately leave the remaining assets to charity. You receive a partial charitable income tax deduction at contribution and the income received from the CRT is taxed as it's paid out, typically as ordinary income or capital gains tax based on how it is invested.

Stacking

The strategies above can work best when stacked together rather than on a stand-alone basis. The exact combination will depend on the investor's specific circumstances and financial objectives, but common combinations include:

Prepaid variable forward (PVF) + Tax-managed long short: Using tax-managed long-short in combination with a PVF can provide tax losses that enable the concentrated position to be sold over time and an off-ramp from rolling the PVF in perpetuity.

Charitable remainder trusts (CRT) + Tax managed long short: Investors with charitable intentions frequently find that CRTs help accomplish the need for lifetime income while leaving a charitable legacy. Tax-managed long-short can help offset the taxation of income that is paid out of the CRT.

Prepaid variable forward (PVF) + Tax-managed long short + 351 exchange + DAF: This combination of strategies uses the PVF and tax-managed long short to hedge and work out of the position, while simultaneously contributing as much as diversification rules will allow to a 351 exchange and donating to a DAF for charitable purposes.

Combining multiple structured and tax-oriented strategies can amplify complexity and risk, including market, counterparty, liquidity, and tax-law risks. These approaches involve significant assumptions and trade-offs and should be evaluated carefully in light of an investor's specific circumstances.

Conclusion

There is a myriad of behavioral reasons investors maintain concentrated positions. The endowment effect⁸ leads people to prefer things they already have and loyalty⁹ to a company can lead to maintaining a concentrated position. Relatedly, an anchoring bias,¹⁰ where decisions are viewed in the context of the starting point, can make the reduction of a concentrated stock position feel like a radical change. Some investors show a tendency to

⁸ Kahneman, Daniel, Jack L. Knetsch, and Richard H. Thaler, 1991, Anomalies: The endowment effect, loss aversion, and status quo bias, *Journal of Economic Perspectives* 5, 193-206.

⁹ Cohen, Lauren, 2009, Loyalty-based portfolio choice, *Review of Financial Studies* 22, 1213-1245.

¹⁰ Sherif, Muzafer, Daniel Taub, and Carl I. Hovland, 1958, Assimilation and contrast effects of anchoring stimuli on judgments, *Journal of Experimental Psychology* 55, 150-155.

extrapolate recent performance into the future,¹¹ which would typically lead to sticking with recent outperformers despite the research that indicates most eventually underperformed. Finally, ambiguity aversion¹² is when investors feel like a concentrated position is less risky than the market itself because they have an insider's understanding of the company.

These reasons for maintaining a concentrated position are, by definition, irrational. Many investors have achieved great wealth through concentrated equity positions, yet most individual stocks underperform the market. Recent high-flyers tend to underperform by even more. Tax costs are an obvious hurdle, but hopefully we've been persuasive in explaining the concrete benefits of diversification and how the STEPS methodology can be used to further reduce tax consequences.

¹¹ Kahneman, Daniel, and Amos Tversky, 1972, Subjective probability: A judgment of representativeness, *Cognitive Psychology* 3, 430-454.

¹² Ellsberg, Daniel, 1961, Risk, ambiguity, and the Savage axioms, *Quarterly Journal of Economics* 75, 643-669.

APPENDIX

Certainty equivalent is calculated with the formula below. We've highlighted aspects of the formula below to explain it intuitively.

$$\Delta CE = CE_T - CE_C = (\mu_T - \mu_C) - (\lambda/2)(\sigma_T^2 - \sigma_C^2)$$

$(\mu_T - \mu_C)$ represents the estimated return on the target portfolio μ_T minus the estimated return on the current portfolio, μ_C . All we're doing here is accounting for the change in estimated return, which could be positive or negative.

$(\sigma_T^2 - \sigma_C^2)$ measures the change in estimated portfolio risk when shifting from current portfolio to the target portfolio. A reduction in risk is beneficial to the investor, whereas increasing risk would be seen as a negative.

Finally, λ tells us just how valuable that risk reduction is to the investor, as conservative investors value risk reduction more than aggressive investors.

When we put these terms together, we end up with (1) the return impact from making the change minus (2) the change in risk, scaled appropriately for the specific investor's tolerance for risk.

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