Tax Aware

When Fortune Doesn't Favor the Bold: Perils of Volatility for Wealth Growth and Preservation

May 12, 2022

Successful entrepreneurs and executives often hold much of their wealth in a highly appreciated single stock and thereby face a difficult financial dilemma. On the one hand, the high idiosyncratic volatility of a concentrated single stock position can lead to significant risk of catastrophic losses; on the other hand, selling the stock can result in an immediate and punitive tax burden.

This paper develops an analytical framework for evaluating this choice and explains how it relates to classic betting strategies and economic theory. Calculations suggest that for many investors a full and immediate liquidation of their appreciated single stock might be optimal from the perspective of long-run wealth growth and preservation. In fact, the findings demonstrate that in absence of diversification most investors must expect catastrophic losses of wealth over reasonable investment horizons.

For investors reluctant to incur an upfront tax burden, tax-efficient techniques for disposing of appreciated single stock might strike the balance between the urgency to diversify concentrated risk and aversion to taxes. Whereas for median and mode cumulative wealth the primary effect likely comes from diversification, be it tax-efficient or not, for mean cumulative wealth tax efficiency of diversification can yield a tangible improvement.

eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.