It has done well, so why sell it?

Managing Your Money

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This is a follow up to last month's article about concentration risk. I received a few calls from people who have ridden the decade-long bull market and are now in a position where some of their investments just take up too big a piece of the pie. So, what to do? There are a few reasons why investors might be hesitant to sell or reduce a position in a particular investment. "It's done well, why sell it?" "I don't want to pay taxes on the gain." "But it's a safe investment, why diversify?" Let's tackle each of these concerns.

"It has done well, so why sell it?"

If you have more than 10-15% of your holdings in any one investment, you may be significantly increasing the overall risk of your portfolio. An investment that has done very well is one of the main culprits of concentration risk. Trimming back successful positions and rebalancing portfolios should be done regularly. Diversification is one of the fundamentals of investment risk management. The key to diversification is that it helps reduce volatility and risk. However, it's all about finding the sweet spot between under diversified and over diversified. There is often little difference between owning 20 stocks and owning 1000 stocks.

"I don't want to pay taxes on the gain."

As a financial planner, taxes are always factored into any recommendation or decision I make. However, it's not advisable to make investment decisions purely because of tax reasons. I remember clients who were holding Nortel, and not wanting to sell because of the capital gains tax. After its collapse they would have happily reversed time and paid the capital gains tax before the crash. Today, we have strategies such as share exchanges to diversify out of a stock, without paying the taxes. It doesn't mean you'll never pay the taxes, but at least it allows you to diversify a holding, while deferring the taxes to a future year when you decide to trigger them. Other tax strategies that could mitigate the tax bite are: unused capital losses, tax loss selling, spread the gains over a few calendar years, and selling first in registered accounts. The point being, if it is a prudent investment decision to reduce a holding, don't let taxes stop you. Instead, consider other tax planning strategies to offset the taxes.

"But it's a safe investment, why diversify?"

It is rare that one asset class repeatedly stays on top. This "quilt", as I call it, shows how, from year to year, the top and bottom performing categories are constantly changing. Take any sector or index, and follow it through the years, and you will notice that the performance is not consistent from year to year. Everything has it's good years (green) and it's bad years (red). Diversifying though these categories can significantly reduce investment risk. Even the "safest" investments hit bumps along the road.

I'm not necessarily saying that you shouldn't hold large positions in one stock or company. There are sometimes good reasons for that too. If you recognize the risk, and are comfortable with it, then there's no problem. What I am pointing out is that sometimes the risk is not recognized by the investor. Concentration risk can sometimes serve investors well during good times, but it is rarely a successful strategy during bad times. As the investment landscape changes, and we witness the significant transformation of trends in pension fund management and institutional money, it should be guiding us as to how we manage our own money. Many investors are missing this boat. There are many new and great alternatives to diversify within a portfolio. Don't wait until it's too late.

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Market Quilt

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	YTD
TSX Composite	14%	24%	17%	10%	-33%	35%	18%	-9%	7%	13%	11%	-8%	21%	9%	-9%	23%	6%	11%
S&P 500	11%	5%	16%	5%	-37%	26%	15%	2%	16%	32%	14%	1%	12%	22%	-4%	31%	18%	12%
NASDAQ	9%	2%	10%	11%	-40%	45%	18%	-1%	17%	40%	15%	7%	9%	30%	-3%	37%	45%	9%
US Small Cap	18%	5%	18%	-2%	-34%	27%	27%	-4%	16%	39%	5%	-4%	21%	15%	-11%	26%	20%	15%
Europe	12%	26%	20%	3%	-44%	32%	11%	-8%	17%	20%	7%	8%	3%	10%	-11%	26%	-3%	11%
Japan	8%	40%	7%	-11%	-42%	19%	-3%	-17%	23%	57%	7%	9%	0%	19%	-12%	18%	16%	5%
Developed World ex U.S.	17%	12%	21%	9%	-41%	33%	14%	-6%	17%	27%	5%	0%	9%	24%	-9%	28%	17%	10%
Developed World	22%	17%	26%	13%	-44%	37%	12%	-12%	17%	21%	-4%	-1%	4%	27%	-14%	23%	11%	8%
Emerging Markets	26%	29%	39%	42%	-53%	85%	20%	-21%	19%	-1%	1%	-14%	11%	36%	-14%	20%	16%	6%
Canadian Short Bonds	4%	2%	4%	5%	8%	2%	2%	3%	1%	1%	1%	1%	0%	0%	2%	2%	3%	0%
Canadian Long Bonds	10%	15%	3%	5%	12%	-5%	12%	20%	5%	-9%	17%	6%	-1%	2%	4%	8%	13%	-14%
Canada Agg Bonds	7%	7%	4%	4%	7%	4%	7%	10%	3%	-2%	9%	4%	1%	2%	1%	7%	8%	-5%
US Short Bonds	1%	2%	4%	7%	7%	1%	2%	2%	0%	0%	1%	1%	1%	0%	2%	4%	3%	0%
US Long Bonds	8%	6%	2%	10%	25%	-13%	10%	29%	4%	-13%	25%	-1%	1%	9%	-2%	15%	18%	-11%
Gold	6%	18%	23%	31%	6%	24%	30%	10%	7%	-28%	-1%	-10%	8%	14%	-2%	18%	25%	-7%
S&P/TSX Venture	4%	23%	34%	-5%	-72%	91%	50%	-35%	-18%	-24%	-25%	-24%	45%	12%	-35%	4%	52%	9%
Global Balanced	7%	8%	8%	4%	-17%	16%	8%	-2%	5%	10%	6%	-2%	9%	7%	-4%	13%	5%	6%

Source: Bloomberg, Richardson Wealth Limited