Understanding Concentration Risk

First Ascent Asset Management

There are many ways an investor can end up holding a large, concentrated stock position. There are also many reasons why an investor may be reluctant to diversify away from that position. But holding a large, concentrated stock position comes with significant risks.

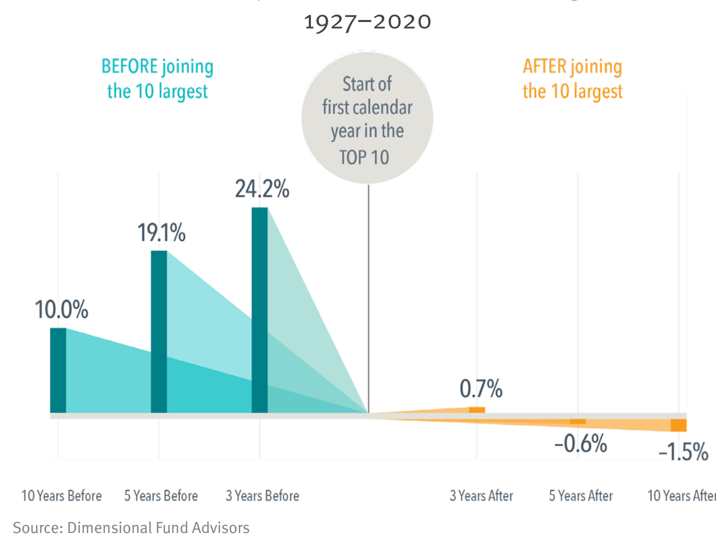
These risks include:

- **Volatility.** A high likelihood that the concentrated position will be significantly more volatile than a broadly diversified portfolio.
- **Poor Returns.** A high likelihood that the long-term return of the concentrated position will be lower than the return of a broadly diversified portfolio.
- **Significant Decline.** A higher likelihood that the concentrated position will experience a very serious decline in value (-50% or more), or even a complete loss, than for a broadly diversified portfolio.

These risks also apply to concentrated positions in a single industry, sector, or investment style.

Even if the concentrated position has performed well in the past, there is a high likelihood that its superior performance will not continue in the future.

As the following graphic shows, from 1927 to 2020, the average annualized return for top-10 stocks over the three years before they became top-10 stocks was almost 25% higher than the return of the market itself. For the three years after joining the top-10, the edge was less than 1%. In the subsequent five years, on average, those stocks underperformed the market.



Source: Dimensional Fund Advisors

The Message Is Clear

Investors who want to improve their odds of reducing volatility, increasing returns, and avoiding catastrophic loss should liquidate their concentrated position and invest in a diversified portfolio.