RESEARCH MEMO

Building Around a Position

Whether a separately managed account can diversify a concentrated holding depends on inputs the client either has or does not

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Framework memo. Illustrative throughout; no client facts are described. Nothing here is tax advice. The mechanics and lifecycle of direct indexing specifically are developed in a companion memo.

1 · SUMMARY OF CONCLUSIONS

A separately managed account is frequently proposed as the answer to a concentrated position. The client keeps the holding, a manager builds a diversified portfolio around it, losses are harvested to fund the unwind, and the concentration resolves over time. Described that way it sounds like a vehicle choice.

It is not. The vehicle can do all of those things, but only if the client brings the raw material. Where that material is absent, the same structure produces an expensive wrapper around an unchanged position.

> The question is not whether a separately managed account is a good vehicle. It is whether this client has what the vehicle needs to work: room to transact, capital to build with, and the operational control to act at the lot level. A client with none of these has paid a management fee to relabel their concentration.

Findings

1 · The diagnostic runs before the product conversation, not after it. Three families of input determine whether the structure can work. They are knowable in an afternoon and they frequently rule the approach out, which saves the client a long evaluation of managers who cannot help them. (§3)

2 · The position generally has to sit inside the account. A managed portfolio running alongside a concentrated holding held elsewhere is a portfolio next to a problem. The manager has to see the position to build around it, which raises custody, reporting, and mandate questions that are rarely addressed in the initial conversation and occasionally rule out the preferred manager. (§4)

3 · Basis dispersion inside the position is an asset in its own right. A holding accumulated over years through purchases, grants, or reinvestment carries lots at widely varying basis, and the high-basis lots can be unwound at modest cost to fund the complement. A position acquired in a single transaction offers no such flexibility, and the same market value presents a materially harder problem. (§3.1)

4 · New capital is the only input that reduces concentration at no tax cost. A client still earning, still receiving grants, or expecting a liquidity event can dilute rather than sell. This is the most powerful of the inputs and the one most often overlooked, because it does not involve the position itself. (§3.2)

5 · Where none of the inputs are present, the honest answer is that this is the wrong tool. That answer is available quickly and it is more useful to the client than a structure that charges a fee to produce a result they could have had for free. (§6)

Three standing rules

1. **Run the diagnostic before evaluating managers.** Manager selection is a real exercise and it is wasted if the approach was never going to work.
2. **Confirm the position can actually be held in the account.** Custody, in-kind acceptance, and mandate flexibility are operational questions with hard answers, and they should be asked first.
3. **Size the expectation to the inputs.** A transition funded by a modest gain budget and a thin loss harvest takes years. Presenting it as faster sets up a conversation nobody wants to have in year three.

What would change these conclusions

- **A position at high basis.** Where little gain is embedded, the position can simply be sold and the structure is unnecessary. The framework applies to positions whose tax cost is the binding constraint.
- **A tax-deferred account.** The entire problem disappears. The position can be sold and reallocated with no consequence, and a managed account built to work around it is solving nothing.
- **A client who will never sell.** Where the disposition is bequest or charitable gift, the concentration is being carried deliberately and the correct structure is built around that, not around an unwind. The step-up and charitable memos treat those cases.

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2 · WHAT THE STRUCTURE OFFERS

Worth stating plainly before assessing whether it applies, because the advantages are real.

A separately managed account holds individual securities in the client's name rather than shares of a pooled vehicle. Three consequences follow, and all three matter here.

Lot-level control. The client owns specific tax lots with specific basis and acquisition dates. Losses can be harvested selectively, gains realized deliberately, and particular lots gifted or retained. None of this is available inside a fund, where the client owns a single position with a single basis.

Exclusions and customization. A managed account can be instructed to avoid particular securities, sectors, or exposures. For a concentrated position this is the mechanism that makes the rest of the portfolio complementary rather than additive.

The ability to accommodate the existing holding. Depending on the manager, the concentrated position itself can sit inside the account and be treated as part of the portfolio rather than as something external to it. This is what distinguishes a genuine transition from a portfolio built beside a problem.

Against those, the account carries a management fee, accumulates tracking error against its benchmark as constraints build up, and introduces reporting and oversight that a fund does not require. Whether the advantages justify that is the question the rest of this memo addresses.

3 · WHAT THE CLIENT HAS TO BRING

Three families of input. None is individually required, but a client with none of them cannot make the structure work, and a client with all of them has a straightforward project.

3.1 Room to transact

Basis dispersion within the position. The first thing to look at, and it is frequently not looked at. Two positions of identical market value and identical aggregate basis can present completely different problems depending on how that basis is distributed across lots. A holding built up over fifteen years through regular purchases, vesting events, and reinvested dividends carries lots ranging from near cost to deeply appreciated. The high-basis lots can be sold at modest tax cost, and the proceeds fund the complement.

A position acquired in a single transaction has no such ladder. Every share carries the same basis, every sale costs the same, and the only lever is how much gain the client is willing to recognize.

Annual gain capacity. How much realization the client can absorb in a year, set by their bracket and the thresholds around it. This is the subject of the gain budget memo and it is the governor on the whole transition. A sleeve harvesting losses expands that budget; it does not replace it.

Restriction status. Whether the shares can be transacted at all. Insider status, trading windows, lockups, existing trading plans, and employer holding requirements each constrain what is possible, and any of them can override everything else in this section. Cheap to confirm and worth doing first.

3.2 Capital to build with

New money arriving. The most valuable input available, because it reduces concentration without recognizing any gain at all. A client still working, still receiving equity grants, or anticipating a liquidity event can direct that capital into the complement and watch the concentrated position shrink as a share of the whole without selling a single share.

This input is routinely overlooked because the conversation starts with the position and stays there. The relevant question is not only what to do with the holding but what else is coming, and over what period.

Other assets already held. A client with meaningful assets elsewhere may already own much of the complement. The task then is coordination rather than construction: ensuring the managed account is built against the whole balance sheet rather than against its own benchmark, and that the existing holdings are not duplicating what the manager is buying.

Harvesting capacity elsewhere. Losses realized anywhere in the taxable portfolio offset gains realized here. A client running an unwind should have every other taxable account harvesting actively, because those losses are worth more to this client than to one with no planned realization.

3.3 Operational control

Specific identification. Everything above assumes lots can be selected. Default treatment at many custodians is average cost or first in, first out, neither of which reliably selects the lot the analysis identifies. This is a standing account election, not a per-transaction decision, and it should be confirmed before a structure is designed around lot selection.

Visibility of lot detail. The election is necessary and not sufficient. Whoever is placing trades has to be able to see acquisition dates and basis at the lot level, and that information has to survive any transfer between custodians. Basis detail is lost or corrupted in transfers more often than anyone expects, and reconstructing it after the fact ranges from tedious to impossible.

Coordination across accounts. Where the client holds assets with several managers or at several custodians, harvesting in one place and realizing gains in another only works if someone is looking at both. This is an ordinary requirement and it is frequently nobody's explicit job.

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4 · THE POSITION HAS TO BE INSIDE

This deserves its own section because it is the practical failure most likely to go unnoticed until the structure is already running.

A managed account built to complement a concentrated position has to account for that position. If the manager cannot see it, they will build a portfolio against their benchmark, and the client will end up holding a diversified portfolio and a concentrated position side by side. The combined exposure will be nothing like what either party intended.

Three things follow.

Custody. The position generally needs to sit in the managed account, which requires the manager to accept it in kind and the custodian to support the transfer. Some managers will not hold securities outside their mandate at all. Others will hold it but exclude it from their performance calculation, which is workable provided everyone understands it.

Mandate flexibility. A manager running a standard index replication may have no mechanism for accommodating a large legacy holding or for systematically underweighting the sectors it sits in. The capability to build a genuine complement is a real differentiator between managers and it should be assessed directly rather than assumed from the fact that the account is separately managed.

Benchmarking. If the position is inside the account, the account will not track its benchmark, by design. Agreeing in advance how performance will be measured prevents a conversation in year two about tracking error that was the entire point of the arrangement.

5 · THE RISK SIDE

Most of this memo is about tax, because tax is what makes the problem difficult. The risk problem is separate and simpler, and it is worth keeping distinct.

A complement portfolio is built to offset the exposures the concentrated position carries. If the position is a large technology holding, a complement that is itself technology-heavy has diversified the ticker and not the exposure. The useful construction underweights the sectors and factors the position already supplies, so that the combined holding resembles the intended allocation rather than the intended allocation plus a tilt.

Two cautions. The offset is approximate, because a single security carries idiosyncratic risk that no complement can hedge, and the client remains exposed to whatever is specific to that company. And the complement's tilt is itself a position: a portfolio deliberately underweight a sector will underperform when that sector leads, which is precisely when the client's concentrated holding is doing well. That is the structure working as intended, and it should be explained before it happens rather than afterward.

6 · WHEN THE ANSWER IS NO

The framework is useful mainly because it produces a negative quickly.

Consider a client whose concentrated holding represents most of their investable wealth, acquired at once so the basis is uniform and low, with no new capital arriving, no meaningful assets elsewhere, and a position that cannot be freely transacted. Every input is absent.

A managed account changes nothing for that client. There is no material to build a complement with, no room to transact into it, and no lots to select among. What they would be buying is a fee, a quarterly statement, and the same concentration.

The honest alternatives are a staged sale against whatever gain budget exists, a structure that provides protection rather than diversification, a disposition that avoids recognition entirely, or an explicit decision to carry the risk. The concentrated positions framework memo treats the choice among them.

> Recognizing that a sophisticated tool does not fit is part of the analysis rather than a failure of it. The client is better served by a clear no in week one than by a structure that takes a year to reveal it was never going to work.

7 · WHERE DIRECT INDEXING FITS

Direct indexing is one implementation of a separately managed account, distinguished by tracking a specified index and harvesting systematically within a tracking error tolerance. Everything in this memo applies to it, and it carries additional considerations of its own: the harvest decays as the sleeve appreciates, the strategy manufactures a low-basis position over time, and the exit path determines much of its value. Those are developed in the companion memo.

The relevant point here is narrower. Direct indexing is a good answer to the question of what the complement should hold. It is not an answer to whether the client can fund one, which is the question this memo addresses and the one that should be settled first.

8 · LIMITATIONS

Manager quality varies and is not assessed here. The capability to run a genuine tax-managed transition differs substantially across providers, and the diagnostic in §3 assumes a competent manager rather than establishing how to find one.

Fees are not modeled. A managed account carries a cost that must be set against the benefit it produces, and for a small position or a thin transition that comparison can fail on its own.

The framework is static. Inputs change. A client with no new capital today may have a liquidity event in three years, and a transition that was impossible becomes straightforward. The diagnostic should be re-run rather than treated as settled.

Framework memo prepared for illustrative purposes. Not tax advice. Lot identification elections, restriction status, and the tax consequences of any transition depend on individual circumstances and should be confirmed with qualified tax counsel.

Part of a Series

This memo is one of a set on concentrated positions. The framework that determines which tool applies is in Concentrated Positions.