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MONITOR

TAX-EFFICIENT INVESTING

Tactics and Strategies

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Recent increases in tax rates have increased the importance of tax-efficient investing. Although investors can manage this impact by utilizing tax-management techniques to improve after-tax returns, for many it is an after-thought, performed occasionally and often relying on only one or two particular techniques. In this article, we distinguish the sporadic use of such techniques from a coordinated tax-management plan as tactics versus strategy. Although any type of tax management may help improve after-tax returns, we propose that investors can improve their returns even further by implementing a tax-management strategy that employs a full range of tactics, tailored for particular objectives, and executed over a long horizon. Based on our decades of experience, we estimate that a complete tax-management strategy potentially can add 1–2 percent to annualized after-tax portfolio growth.

Tax-Management Tactics

Investment managers generally employ any of five primary tax-management tactics to increase the tax efficiency of a portfolio. These are the building blocks for a comprehensive tax-management strategy. All these tactics either avoid or

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manage transactions to mitigate tax implications. Examples of events that might trigger a taxable transaction include changing benchmarks or managers, re-balancing an asset allocation, and charitable giving.

Below, we discuss the primary tax-management tactics and how each may be prioritized differently, depending on the investor's overall objective.

Defer the realization of gains. The government only taxes an investment gain when the asset is sold; the tax liability is deferred as long as you hold the appreciated asset. The increase in the value of an investment creates a tax liability, but you can defer the payment of that liability indefinitely and allow it to continue to compound over time. Sometimes the realization of gains is unavoidable or can

be offset by realized losses. However, deferring the realization of gains can be quite valuable. For example, when switching managers, if the portfolio is transferred in-kind rather than fully liquidated the investor can avoid realizing gains on securities that are common to the new manager.

Manage the holding period. Capital gains from the sale of a security are taxed as ordinary income unless the investment is held for longer than 12 months, after which it qualifies for a lower tax rate. Dividends also are taxed as ordinary income but qualify for a lower tax rate if the investor holds the security for more than 61 days. Although receiving the lower tax rate is generally preferable, it should not be the overriding consideration, such as when there is a need to raise cash quickly.

Figure 1: Core/Satellite Portfolio Structure



Harvest losses. A tax loss is realized when a security is sold for less than its purchase price (i.e., the market value is below the cost basis). This loss can be used to offset realized capital gains. Many investors harvest losses only in December, but the potential value of this tactic increases if it is done throughout the year, because these losses can be carried forward indefinitely. However, these losses are ultimately most useful when used against realized capital gains. Without such offset, this tactic may be of lower priority.

Pay attention to tax lots. Most managers that pay attention to taxes will use highest in, first out (HIFO) tax-lot accounting whenever a security is sold. Selecting a lot with a higher cost basis can reduce a realized gain or increase a realized loss relative to a lower cost basis lot. Selecting the highest cost basis lots will be especially useful for investors who need to generate cash flow from investments. However, in certain cases selecting a lower cost basis lot may be preferable. For example, investors in certain trust structures that cannot carry losses forward would find it beneficial to accelerate gains.

Avoid wash sales. When a security is repurchased within 30 days of its sale, part or all of the loss realized by the sale cannot be utilized at that time. Instead, the excess loss is added to the basis of the new shares, postponing its realization. Monitoring wash sales may be particularly valuable when constructing multiple-manager portfolios.

Depending on market conditions and investor objectives, any of these tactics may be valuable. However, the potential benefits of these tactics are maximized when utilized in a comprehensive tax-management strategy that is suited to the investor's particular needs.

Tax-Management Strategies

Our firm has two tax-management strategies: tax-managed indexing and tax management within a unified managed account (UMA). The first strategy, tax-managed core (TMC), is offered to clients who want flexible, tax-efficient equity index exposure. The second strategy, centralized portfolio management (CPM), is for clients who want to utilize tax-management tactics across an entire portfolio, including active managers.

A tax-managed indexing strategy uses all of the tactics mentioned above within a passive equity index portfolio. It is commonly used in a core-satellite equity allocation structure (see figure 1). The core of the allocation is passive and tax-managed. The strategy in this case is to enable the active satellite part of the allocation to focus on generating alpha with managers that are able to differ from the index and seek return patterns that are less correlated to the market. The core provides tax-efficient beta exposure and, potentially, excess losses that can be used to offset realized gains in the satellite. Stein (2001) shows that by using a core and satellite approach, investors can significantly reduce the cost structure of a portfolio in terms of fees, trading costs, and taxes. These savings may seem small—only a few percent per year—but they compound over time. Quisenberry (2003) suggests that 60 percent to 80 percent of the portfolio should be allocated to the passive core.

Traditionally, when an investor hired multiple active managers, each manager would require a separate account and would make trading decisions without regard to the tax consequences on the client's overall portfolio. The UMA concept has been adopted by many large brokerage firms and banks to streamline the cost and complexity of running thousands of accounts. Our CPM strategy extends this capability by offering tax management and customization within the UMA structure for independent advisors and multi-family offices.

The CPM strategy extends the capabilities of the core manager—the ability to provide customized, tax-efficient individual portfolios—across the entire portfolio, increasing the opportunities for tax management. However, the satellite portion of the allocation is no longer completely autonomous. Managers provide their model portfolios to the centralized portfolio manager who reviews, optimizes, and delivers a customized, tax-efficient solution across the client's entire portfolio. By controlling the sale of specific tax lots, deferring gains, harvesting losses, and coordinating wash sales among several active managers, CPM can enable greater portfolio customization, risk management, and tax efficiency. In addition to the basic tax-management techniques, the centralized portfolio manager also can implement manager and asset allocation changes, and apply rebalancing policies to the overall portfolio, all in a tax-efficient manner.

What It's Worth

We use a concept we call “tax alpha” to measure the value of our active tax-management strategies. Tax alpha compares the after-tax performance of a portfolio against that of a benchmark, adjusted for any excess pre-tax return. This adjustment reflects our mandate to

track a target, either an index or an active manager, on a pre-tax basis and ensures that tax alpha is not influenced by unintended tracking error. Very few managers report their returns relative to an after-tax benchmark. To calculate the after-tax returns of the target, we simulate a passive, single-security investment in the appropriate target, tailored for client-specific characteristics. We calculate after-tax returns on a pre-liquidation basis, in a manner consistent with the prevailing industry methodology for after-tax performance calculations.

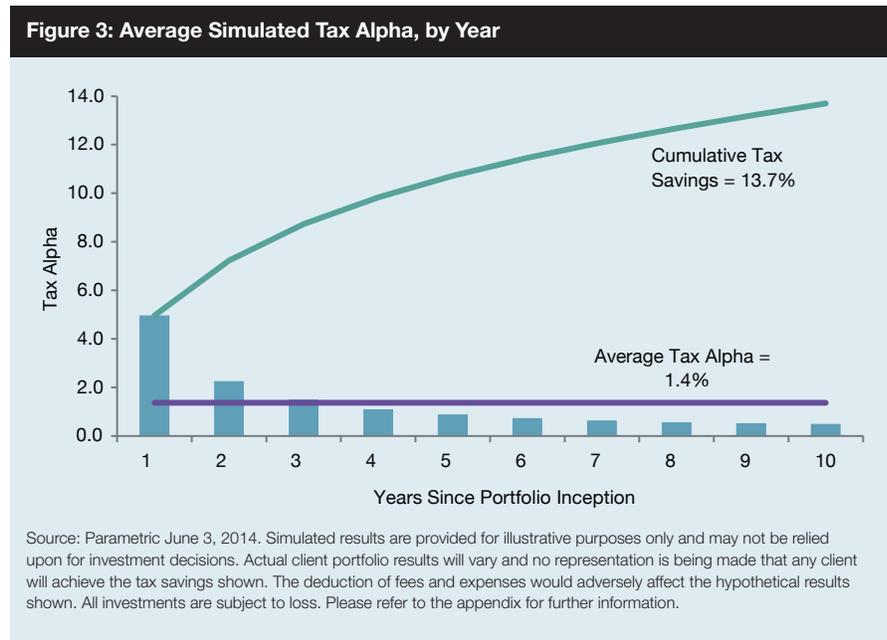
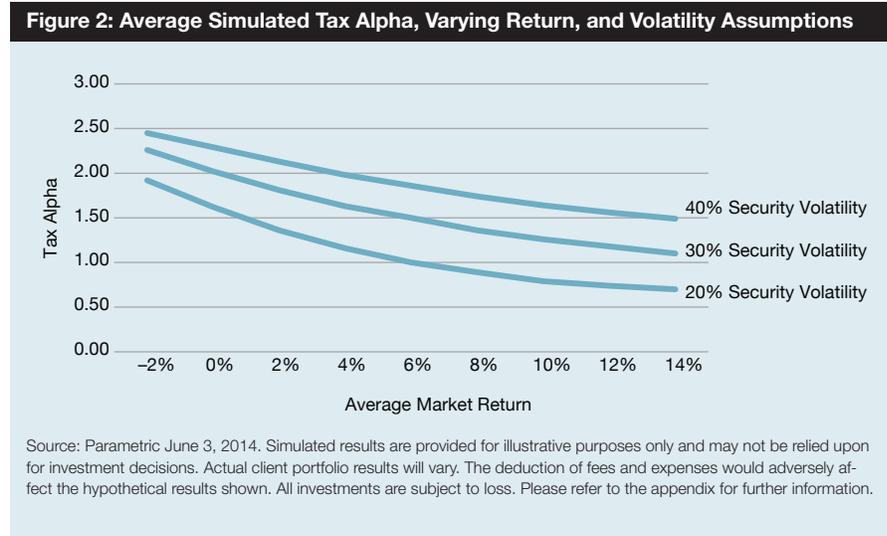
We look at tax alpha on both a simulated and a realized basis. Simulated results help us explore the impact of market conditions on tax alpha without the influence of client-specific factors. Realized results serve as an important source of feedback about the actual experience of our clients.

Simulated Tax Alpha

For the TMC strategy, our simulated results indicate the potential for an annualized tax alpha in the range of 0.7–2.5 percent, depending on market conditions (see figure 2).¹ We find that tax alpha is usually higher during periods with lower market return and higher security volatility levels. However, within the range of market conditions we studied, the tax alpha in our simulated scenarios was always positive and was meaningful even in periods of strong market performance and moderate volatility, particularly in the presence of high tax rates.

A notable aspect of tax alpha is that it tends to be largest in the early years when market values of holdings are close to cost basis.² However, cumulative tax alpha tends to continue to rise over time. Figure 3 illustrates this for a 10-year simulation assuming an 8-percent average market return and a 30-percent security volatility. On average the tax alpha over this period was 1.4 percent, with higher tax alpha in the earlier years. The cumulative effect was a tax savings of 13.7 percent.

It is important to note that the tax alpha calculation assumes that losses realized in the core can be fully utilized by the taxpayer in a given year. Fortunately, even if this is not the case, unused losses can be carried forward to



future years. In addition, the tax liability embedded in the portfolio tends to grow over time if the market value of the investments rises and the manager avoids realizing gains. Some investors eventually will liquidate, realize the gains, and pay the taxes, thus reducing their tax alpha. Other investors will never realize the gains either by gifting them to charity or passing them on to heirs, who receive a step up in basis.

For our CPM strategy, Stein and McIntire (2003) predict annual tax alpha of 0.60 percent. In reality, this appears to be a somewhat conservative estimate.

Actual Tax Alpha

In practice, the tax alpha experienced across thousands of TMC client accounts over the past 16 years has been 2 percent on average, confirming the range indicated by our simulations. For CPM accounts, the average tax alpha for the past 11 years has been ~1 percent.

Figure 4 shows the tax alpha and pre-tax excess returns for our composite of tax-managed accounts benchmarked to the S&P 500 Index. The composite is based on accounts that were funded in cash and had no restrictions. Composites for accounts based on other indexes show similar tax

alpha patterns, although the level in any given year may be slightly different. Of course, the actual tax alpha for any client will vary depending on a number of factors including, but not limited to, inception date, account restrictions, cash flows, and market conditions.

It is clear that bear markets enhance tax alpha potential: 2000–2002 and 2008 all had negative market returns and large tax alphas. These are also periods distinguished by high volatility. In contrast, the years 2010–2013 had low volatility with less opportunity for realizing losses, particularly after the market bounced back strongly in 2009. Another important influencing factor on realized tax alpha was the year of inception. If we group the accounts by year of inception and examine the tax alpha, we see a similar pattern but somewhat different level. The average tax alpha of accounts inceptioned in 1998 over the past 15 years was around 1 percent.

Figure 5 shows the tax alpha and pre-tax excess returns for our composite of CPM accounts benchmarked to each account’s respective target. The composite is based on accounts that were funded in cash and had no restrictions. Similar to TMC accounts, tax alpha fluctuates depending on market conditions; however, the date of inception is less impactful. Tax alpha remains more consistent over time and does not tend to decline as the years since inception increase.

Conclusion

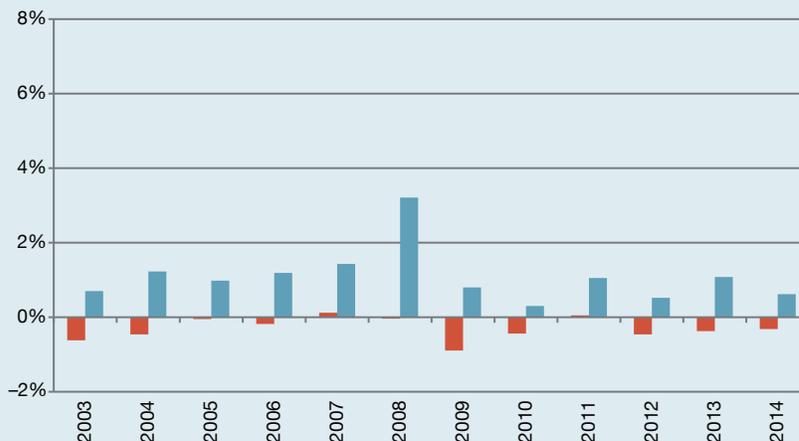
An effective tax-management strategy is one that employs a variety of the tactics that are best-suited for achieving the investor’s objectives over a long horizon. These tactics include gain deferral, holding-period management, loss harvesting, tax-lot identification, and the avoidance of wash sales. The value of these techniques may ebb and flow over time and in response to client-specific factors, but our simulations and decades of management experience indicate that a comprehensive active tax-management strategy can improve after-tax returns by 1–2 percent compared to a passive, tax-oblivious investment. ●

Figure 4: Actual Tax Alpha and Excess Pre-Tax Return (net of fees) for Tax-Managed Core S&P 500 Composite



Source: Parametric and FactSet as of December 31, 2013. Parametric composite returns include the reinvestment of dividend and interest income and are net of management fees and transaction costs. Past performance is not indicative of future returns. Please refer to the appendix for further information.

Figure 5: Actual Tax Alpha and Excess Pre-Tax Return (net of fees) for Centralized Portfolio Management Composite



Source: Parametric as of June 30, 2014. Parametric composite returns include the reinvestment of dividend and interest income, and are net of management fees and transaction costs. Past performance is not indicative of future returns. Please refer to the appendix for further information.

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Appendix: Composite and After-Tax Performance Methodology

All reported composites include only accounts funded with cash and free from client-directed investment restrictions. Because Parametric manages each account to reflect client-specific characteristics, accounts funded with securities and/or subject to restrictions will experience varying performance. All accounts included in each composite are fully discretionary. There is no minimum balance requirement for an account to be included in a composite. Accounts are included in their respective composites in their first full month of management. Accounts are excluded from their respective composites after their last full month of management. Terminated accounts are included in their respective composites for all full periods prior to termination. Account performance is calculated in U.S. dollars using a time-weighted, daily-linked total return methodology. Dividend and interest income is accounted for on an accrual basis. Tax Managed Core Performance labeled “Net of Fees” reflects

the deduction of a 0.45-percent annual management fee—the highest fee paid by any account in the composite. Centralized Portfolio Management “Net of Fees” reflects the deduction of a 0.25-percent annual management fee—the highest fee paid by any account in the composite.

When calculating after-tax returns, we apply the highest U.S. federal tax rates. For short-term gains, the highest U.S. federal marginal income tax rate is 39.6 percent plus the 3.8-percent net investment income tax, for a combined rate of 43.4 percent. For long-term gains, the highest U.S. capital gains tax rate is 20 percent plus the 3.8-percent net investment income tax, for a combined rate of 23.8 percent. These assumed tax rates are applied to both net realized gains and losses in the portfolio. In periods when net realized losses exceed net realized gains, applying the highest tax rates to our calculations illustrates the highest after-tax return that could be expected of the portfolio, and assumes the maximum potential tax benefit was derived. As with all after-tax perfor-

mance, the after-tax performance reported here is an estimate. In particular, it has been assumed that the investor has, or will have sufficient capital gains from sources outside of this portfolio to fully offset any net capital losses realized, and any resulting tax benefit has been included in our computation of after-tax performance.

Endnotes

1. This is based on the current highest marginal federal tax rates of 23.8 percent for qualified dividends and long-term gains and 43.4 percent for short-term gains. Given state-level taxes, many investors actually face considerably higher marginal rates, which will increase tax alpha.
2. Assuming the portfolio is incepted with cash. Portfolios incepted in-kind may show less pronounced first-year tax alpha.

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