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Making Taxes Less Taxing: Reexamining Portfolio Design

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Perhaps the only thing less appealing than the thought of higher taxes is having to actually pay them. Like parents who try to disguise vegetables at dinnertime, our government has devised increasingly creative ways to hike taxes while leaving ordinary rates (and negative media headlines) unchanged. As a result, individuals in the highest tax bracket can face additional taxes in excess of their marginal rate. Some of these incremental taxes are incurred through earned wages while others are triggered by investment gain realization, creating effective tax rates that can approach or exceed 50%. Similar to soggy broccoli, it seems improbable to hope that these taxes will simply disappear on their own accord.

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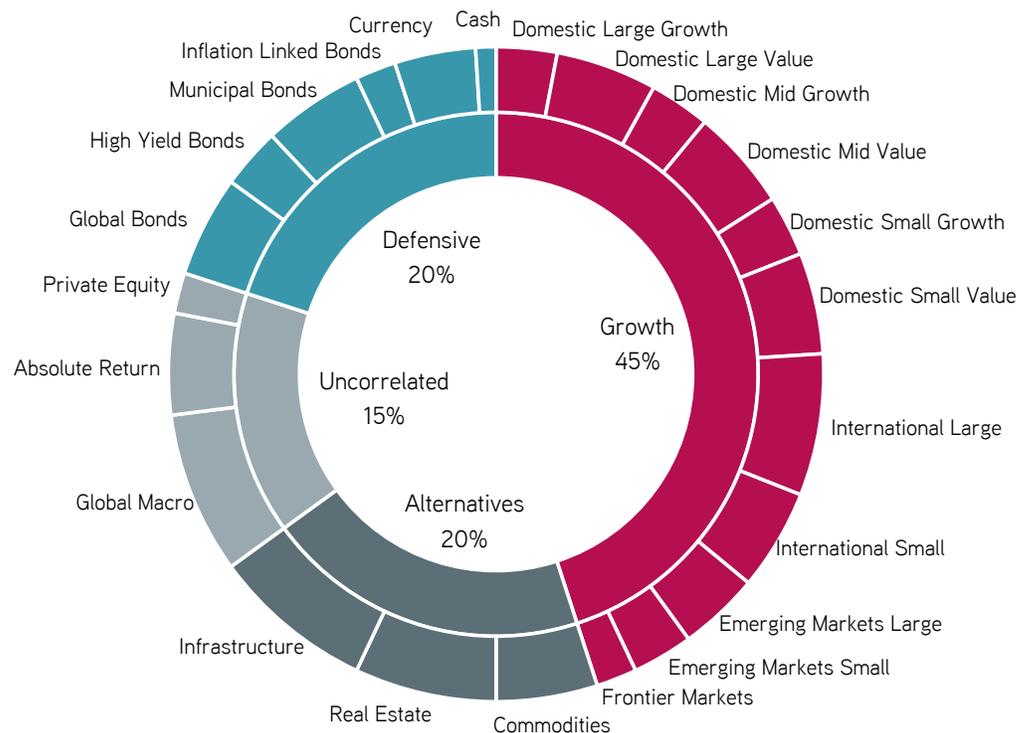
Not easily fooled, many individuals are well aware of these ‘hidden’ taxes and go to great lengths in order to avoid them. Common practices include income deferral, gifting to heirs, and charitable donations. Many also recognize the key role portfolio management plays and seek to hire financial advisors with tax-management expertise. Such advisors typically recommend strategies such as capital gain deferral, loss realization, and gifting low-basis stock.

As tax-savvy as these advisors are, however, many unfortunately ignore a critical component of tax-efficient portfolio management: construction. The problem with glossing over taxes during the initial design phase is that the resulting portfolio often lends itself to tax inefficiency, forcing even the most well-intentioned advisor to feel torn between their objective to maximize pre-tax returns, and their client’s desire to maximize after-tax returns. In this paper we discuss this seeming “lose-lose” situation and recommend a simple remedy for relief.

Building to Win

In theory, an advisor’s mandate is straightforward: to build a portfolio that seeks a target return objective with a specified degree of risk control. To achieve this, many advisors derive the appropriate portfolio asset allocation by applying concepts around asset class risk, return, and correlations. The next step in their process is manager selection, which typically becomes the most time-consuming component. Advisors often painstakingly sift through the investment manager universe, identify candidates for inclusion, and perform fairly extensive due diligence before hiring the desired managers. Then, once the portfolio is established, the advisor periodically reviews the managers for opportunities to either rebalance, or in some cases, replace with another manager. Basically, what may begin with an ostensibly simple objective often evolves into a complex structure (see as an example, Figure 1).

Figure 1: Sample Tax Un-Aware Portfolio



Source: Parametric, 2016.

There is an additional step for those who manage taxable assets. Many advisors recognize the necessity to tax-manage, especially for those clients within the highest tax brackets. Typically this includes deferring capital gains, harvesting losses, and selectively trading tax lots with the highest cost basis. In most cases, the advisor leaves these tax management decisions up to the underlying investment managers. For many advisors this is the toughest step in which to measure success, as after-tax performance reporting remains a rarity in practice.

A Rock and a Hard Place

Alas, the honorable goals of the advisor – to generate alpha, control risk, and select the top performing investment managers – are at painful odds with their tax consequences. As promised, we describe some common dilemmas that plague even the most well-meaning advisors. In each scenario the advisor is continually caught between two equally unpalatable choices: meet the pre-tax mandate, or work to dodge a tax liability?

As mentioned, manager selection is usually the most arduous piece of portfolio construction and management. That said, let's take a situation where an insightful advisor hires a very talented investment manager. Accordingly, the manager delivers on the promise to identify a winning stock. The manager, exercising good discipline, then sells the name, and locks-in an outstanding pre-tax return. The advisor, however, is not quick to celebrate; the sale of the stock results in the realization of a significant capital gain. In the best of circumstances, the sale is long term and taxed at long-term capital gain rates; in the worst scenario, the gain is short term and subject to ordinary rates. Either way, this Pyrrhic victory is not lost upon the advisor: the bigger the triumph for pre-tax returns means the larger the impact on after-tax performance.

Consider now the opposite occurs, and assume the advisor did not initially pick a talented manager. After diligent and thorough monitoring against the peer universe, the advisor determines that the manager is in fact, an underperformer. When a more attractive manager emerges, the advisor will rightfully want to turn over control of the assets to the new manager. The new manager understandably desires to promptly reconfigure the inherited assets to reflect a new, unique investment philosophy and approach. Sadly, all the time and effort spent on replacing the old manager with a new one may very well be in vain after the full tax consequences of transitioning are taken into account. The advisor faces a difficult crossroad: replacing the inferior manager may trigger consequential capital gains, however, leaving the manager in place risks further underperformance and in some cases potential loss of the client's continued business.

While the prior two examples have focused on generating returns, controlling risk is just as critical a piece of portfolio management for advisors. Most clients have an upper limit to their ability and/or willingness to take financial risk. Rebalancing is a fairly straight-forward risk-mitigating strategy employed by many advisors. By very definition, though, this tactic demands that an advisor sell some of what has relatively appreciated in value in order to buy more of what has relatively depreciated. In most circumstances, this will trigger a taxable event. Our well-intentioned advisor faces a thorny impasse: reign in risk, or choose instead to forego rebalancing in order to avoid incurring a tax liability? Without the benefit of foresight the choice is murky at best.

Certainly loss harvesting is an effective technique that can help offset the capital gains realized through alpha recognition, manager transitions, and rebalancing. Recently, however, advisors have more widely embraced commingled vehicles (e.g. mutual funds and exchange traded

funds or ETFs) as an efficient way to invest on behalf of their clients. While these investments inarguably facilitate ease of use, one drawback is that they do not pass through capital losses to investors. The advisor's only hope is to harvest losses when the client's cost basis of the entire fund exceeds market price. The choice to sell the whole fund means that the advisor cannot buy it back for a period of time or lose the tax benefit, per wash sale rules. Of course, this further compounds the advisor's inner conflict: lock in the loss now, but then potentially have to settle, at least temporarily, for inferior investment exposure.

Another shortcoming of commingled vehicles is that they 'share the pain,' i.e., tax liabilities are passed pro-rata along to all investors, regardless of length of investment. For some advisors, a tax-management technique is to dodge the fund's capital gain by selling out just before the distribution date. Here again, though, the advisor is trapped; to avoid the capital gain, the choice is to either accept being out of the market entirely or, as is more likely, hold a less ideal investment product over the wash sale period. To add insult to injury, the advisor who chooses the latter risks an increase in value in the new investment over the short term. This forces yet another tax-related predicament – whether to recognize a short-term gain in order to transition back to a favorable vehicle.

Sadly, the tax pain does not yet end here for the advisor. By delegating tax management to the active investment managers (even if they are "tax-aware" managers), the advisor exposes the portfolio to further tax hazards. For example, an underlying manager may be buying a security that another is selling in order to lock in a loss, effectively creating a wash sale. No less painful is the scenario where a manager sells a security with a large embedded gain that the investor holds elsewhere with a much more tax-friendly, higher cost basis. In short, even portfolio tax-management itself can be a tax drag! What a complicated mess it can become.

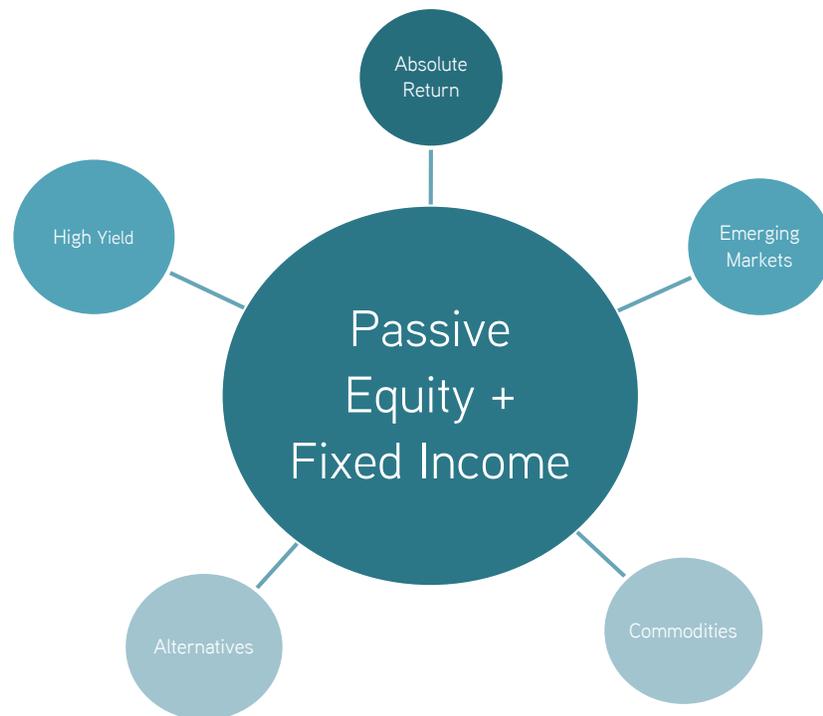
A Fresh Start

Fortunately there is no need for the advisor, or client, to suffer this taxable torture. The solution is a simple one: consider a different portfolio design. While the suggestions that follow are neither new nor radical, we find they are so often forgotten or discarded in practice that they bear repeating. The following are recommendations to improve portfolio tax efficiency and simultaneously avoid the predicaments inherent in many traditional (non-tax aware) portfolio structures:

Dedicate a significant portion of the portfolio to a passive, buy and hold, core exposure.

By reconfiguring away from a portfolio built around many specialists to one with a broad, passive anchor, the advisor helps to potentially minimize taxes brought about from capital gain realization, manager transitions, and rebalancing. With increased low-turnover investments, one would expect less realization of significant capital gains and perhaps more opportunities to harvest losses. Rebalancing taxes are also reduced because with a lower number of managers, fewer trades are required to realign the portfolio. Similarly, there are fewer securities to transition when a manager change must be made.

Figure 2: Sample Core-Satellite Portfolio



Source: Parametric, 2016.

Reduce the number of managers to just a few high-conviction specialists. With a broadly diversified core, there's no reason to pay specialist managers for risk control. The advisor's focus can shift instead to a small number of highly specialized, very concentrated satellite managers. Note that even with high-conviction managers, the advisor should still seek to minimize unnecessary turnover and short-term gain realization. An ideal solution is one where the advisor has the ability to further shelter tax-inefficient satellite managers in tax-deferred or tax-exempt accounts.

Consider tax-efficient definitions of thematic bets. Note that our use of "passive" core in Figure 2 does not necessarily imply that these investments must track a market cap weighted index. It is popular today for advisors to desire to add a "smart-beta factor" (e.g. value, quality, momentum), a responsible tilt, or other style tilt to their portfolio. Often such biases can be implemented by simply over- or under-weighting names in a low-turnover fashion, thus avoiding the higher tax implications (not to mention management fees) of active specialists.

Separate accounts ease the negative tax consequences of fund investments. Within a separate account, the advisor is able to tailor turnover by setting client-specific boundaries around when to rebalance and recognize capital gains. As an example of the latter point, the advisor may decide to delay the sale of a legacy manager's security in a newly hired manager's strategy, a decision made impossible within a fund. Another key benefit of a separate account is the ability to pass through losses. Further, the many advantages of a separate account are made even more powerful when there is someone in charge of looking across the investment managers for tax opportunities; he or she is in the best position to help avoid wash sale violations and advise on strategic gain realization.

End the Agony

As we've discussed, there are a number of common circumstances where an advisor is left (understandably) unsure as to whether it's better to satisfy pre- or post-tax objectives. Frustratingly, it seems as though no good deed goes unpunished when it comes to the taxes incurred through the pursuit of excess returns, manager selection, and portfolio risk control. The truth of the matter is that too many advisors still focus on tax management after the portfolio is designed, and as a result, can only hope to lessen the inevitable consequences of such a tax-unaware structure.

While the tension between seeking alpha and avoiding taxes will never be completely eliminated, it can be mitigated through thoughtful, up-front portfolio construction. In this paper, we offer up a simple but effective solution: a tax-friendly core-satellite approach. By reducing the number of active managers, advisors will find there is less need to agonize over the choice to defer capital gain realization or keep portfolio risk in check. As a result, the advisor can spend more time focused on identifying and hiring the best managers for the job. And in our opinion, that is a rare win-win scenario that advisors can't afford to miss.

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