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Tax-Management Strategies for Appreciated Portfolios

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Tax management can be an effective way to boost an equity portfolio's after-tax returns. For example, by deferring the realization of capital gains, investors control the timing of the payment of taxes, effectively lessening the brunt the longer they delay. Similarly, tax-loss harvesting can offset capital gains, mitigating and in some cases eliminating the tax bill.

As time marches on, however, the natural consequence of these tax-management techniques is a reduction in the portfolio's cost basis. When you have positions with large embedded gains and few if any positions that are candidates for loss harvesting, tax-management techniques can appear to no longer offer material. benefit. But that isn't game over. We look at four options to help investors navigate their tax situation.

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Option 1: Do nothing

Depending on your portfolio's cost basis, it may be prudent to simply wait for a market correction. In fact, those with relatively shallow gains (say, 10–20%) may not have to wait long to see a particular lot fall into a loss position. The table in Figure 1 demonstrates that double-digit drawdowns are relatively common in the US equity markets, even in the presence of relatively strong overall market returns. US markets have ended on a positive note in 17 of the past 21 years; however, even in these market conditions, investors saw intraday drawdowns ranging from -3% to -27%. Add to that the natural level of dispersion in the marketplace at both the sector and security level, and it's not uncommon for portfolios with low tax basis to have some or all of their holdings become eligible for tax-loss harvesting during a market correction.

Figure 1: S&P 500® Index maximum daily drawdown, January 1, 1997–December 31, 2017

Calendar year	Maximum drawdown (daily)	S&P 500 Index return
1997	-10.80%	33.40%
1998	-19.20%	28.60%
1999	-11.80%	21.00%
2000	-16.60%	9.10%
2001	-29.10%	11.90%
2002	-33.00%	22.10%
2003	-13.80%	28.70%
2004	-7.40%	10.90%
2005	-7.00%	1.90%
2006	-7.50%	15.80%
2007	-9.90%	5.50%
2008	-47.70%	37.00%
2009	-27.20%	26.50%
2010	-15.60%	15.10%
2011	-18.60%	2.10%
2012	-9.60%	16.00%
2013	-5.60%	32.40%
2014	-7.30%	13.70%
2015	-12.00%	1.40%
2016	-10.30%	12.00%
2017	-2.60%	21.80%

Sources: FactSet, S&P

A prime example of this phenomenon occurred during the events of 2008. As markets fell, many client portfolios moved from a highly appreciated state to one where the tools of tax management could rapidly add value to their portfolios—allowing investors to realize losses for future tax mitigation while maintaining market exposure for future market recovery.

It's also important to bear in mind that tax loss harvesting opportunities decrease but don't necessarily go to zero over time. Our research suggests that even a highly appreciated portfolio can still expect to see some positive tax alpha in many environments. Figure 2 shows the hypothetical tax alpha under various 10-year market conditions (0%, 4%, and 8% total return scenarios) and levels of portfolio appreciation, using Monte Carlo analysis and assuming 35% stock volatility.

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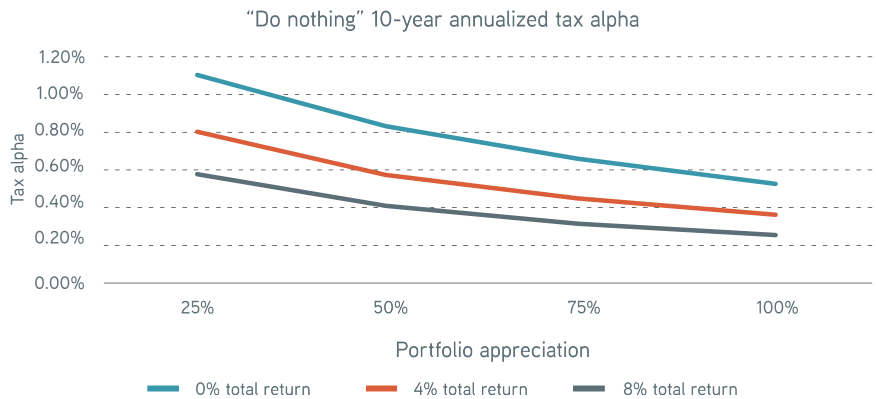
Figure 2: Hypothetical annualized tax alpha in appreciated portfolios



Source: Parametric. Tax alpha is net of fees and transaction costs. The projections or other information generated by the Monte Carlo simulation tool regarding the likelihood of various investment outcomes are hypothetical in nature; are based on assumptions the user provides, which could prove to be inaccurate over time; do not reflect actual investment results; and are not guarantees of future results. Results may vary with each use and over time.

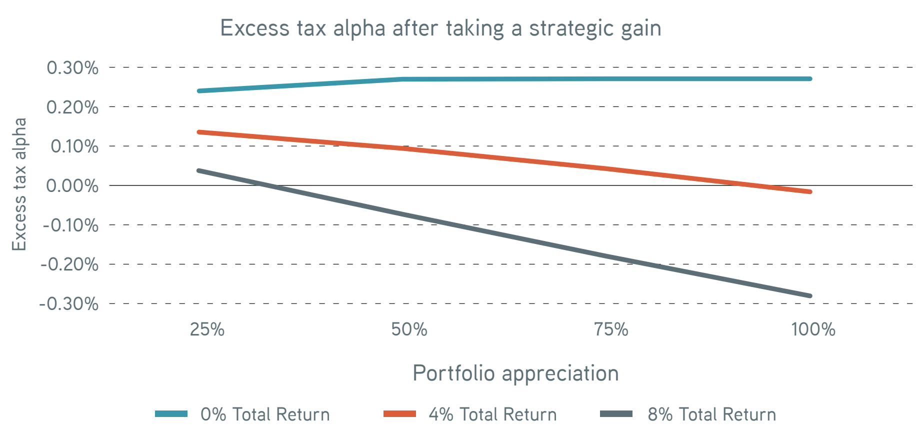
However, the "just wait" strategy may not be advantageous for the investor in immediate need of a short-term loss. In this case there's a different course of action to consider.

Option 2: Consider a long-term strategic gain

In some cases it can make sense to take a strategic gain—that is, to realize an embedded long-term capital gain with the aim of resetting the position's cost basis. Because the new cost basis resets to par, this increases the odds that this new lot may fall into a loss position. If this happens in the year after the gain is realized, the investor can harvest a short-term loss. Given the large differential between the long-term gain rate paid and the investor's ordinary rate, there are scenarios where the math works in the investor's favor.

Our research, as summarized in Figure 3, suggests that in flat to moderately rising markets, this strategy can add between 10 and 25 basis points (bps) of additional tax alpha after fees (on average), depending on the starting level of portfolio appreciation. Again, we apply a Monte Carlo analysis, with an assumed 35% stock volatility.

Figure 3: Hypothetical excess annualized tax alpha after taking a strategic gain



Source: Parametric. Tax alpha is net of fees and transaction costs. The projections or other information generated by the Monte Carlo simulation tool regarding the likelihood of various investment outcomes are hypothetical in nature; are based on assumptions the user provides, which could prove to be inaccurate over time; do not reflect actual investment results; and are not guarantees of future results. Results may vary with each use and over time.

[1] Tax alpha is hypothetical and is defined as the simulated net after-tax excess return minus any gross pre-tax excess return.

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We'd be remiss not to heed caution to this approach in bull markets; when markets are generally trending upward, the investor is likely better off deferring the gain, as illustrated in the 8% market environment above. Because taking a strategic gain is a risk, investors should carefully weigh this decision. An urgent need for short-term losses or a strong belief that the market is likely to fall in the short term are some good reasons to consider taking a strategic gain.

Option 3: Make cash contributions to the portfolio

The addition of cash naturally raises the portfolio's basis, increasing its ability to generate losses going forward. But how much and how frequently are ideal? Using a cash portfolio as our starting point, we looked at the effect on tax alpha of 5% annual cash contributions over a period of 10 years. In all market environments considered, the additional cash resulted in higher tax alpha. The relative pickup in tax alpha is intuitive; tax alpha is higher as 10-year returns decrease and as stock volatility increases. As shown in Figure 4, the 5% annual cash contributions added around 20–30 bps of excess tax alpha on average versus an identical appreciated portfolio that had no additional cash infusions.

Figure 4: Hypothetical excess tax alpha from 5% annual cash contributions

	Total return			
Stock volatility	-4%	0%	4%	8%
25%	0.2%	0.2%	0.2%	0.1%
35%	0.3%	0.3%	0.3%	0.2%
45%	0.4%	0.4%	0.4%	0.4%

Source: Parametric. Tax alpha is net of fees and transaction costs.

Option 4: Gift appreciated holdings to charity or heirs

While we won't go into all the details here, there are additional benefits available for the charitably minded as well as those looking to tax-efficiently pass on their wealth to younger generations. In either situation one can select highly appreciated stocks from a tax-managed separately managed portfolio and gift them to a tax-exempt charitable organization, a donor-advised fund, or family members in lower tax brackets.

In all cases the investor is effectively raising the cost basis of the portfolio and in some cases even receiving an immediate tax benefit. If the investor can further replenish the gifted value with a cash contribution or higher-basis stock, this could lift future tax alpha even higher.

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Conclusion: An appreciated portfolio isn't "game over"

A high degree of appreciation isn't necessarily the end of the line for a tax-managed portfolio. Three of the techniques described above, for example, can help create loss-harvesting opportunities. But which one is optimal for your situation can vary.

To aid in decision making, it helps to first assess your situation: Do you need to shelter gains for the current tax year (in other words, immediately), or can you be more patient? Next, assess the overall market: Do you have strong reasons to believe it may fall in the near term?

With these questions in mind, our advice for highly appreciated portfolios boils down to:

- Taking a strategic gain is an economic risk. The less urgent your need to shelter gains immediately, the less you need to risk taking a strategic gain. Taking a long-term gain is best reserved for when you're confident the market is about to decline or there's an urgent need for short-term losses.
- Charitable gifting and cash infusions are helpful but perhaps not always practical. They can help in any market environment; however, we recognize they aren't always available to investors.
- Don't just do something. Wait. If there's not an immediate need for losses, and you're unsure about the future direction of the market, waiting to see what happens is a perfectly acceptable approach.

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