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Building Better Beta

Our Tax-Managed Core (TMC) equity strategy strives to provide “better Beta”. To us this means working to deliver predictable index-targeted pretax returns, improved after-tax returns, and customization benefits of many types. The combination of active tax management and flexible per-client customization is, for many affluent or high-net-worth investors, an extremely compelling alternative to mutual funds or ETFs.

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Working with our clients to create customized solutions is often the genesis of a new strategy. This was the case with our first TMC portfolio in 1992, when a family office inquired about actively managing the taxes incurred by custom growth and value, index-based portfolios. Twenty years, and thousands of portfolios later, we are still collaborating with our clients — including that first TMC investor.

Of all the dimensions around which Parametric can customize a TMC portfolio, the most common can be generalized into three categories: customizing tax management, customizing the investment target, and incorporating the client's outside investment constraints.

Customizing Tax Management

Account Inception – Custom Analysis & Gain Budgeting

Building an index-based separate account from cash is a straightforward task. However, for investors funding with pre-existing positions, understanding current gain/loss and ST/LT holding periods is essential. Unlike comingled vehicles, which force investors to raise cash to invest, a TMC portfolio can selectively utilize existing securities and raise cash tax-efficiently to reduce the impact of taxes at portfolio inception. A Parametric custom transition analysis can illustrate potential savings and trade-offs. Transition analyses can be performed and evaluated before any contract is signed, relationship is formed, or fees are incurred.

TMC investors sometimes react to a transition analysis with a desire to limit the initial tax bill. In these cases, we can set a gain budget (maximum gain realized per period) plan for diversification. A multi-period approach has the potential benefit of allowing loss harvesting to occur to offset some or all of subsequent gain realization. We have many clients who have fully transitioned fairly concentrated, low-basis portfolios with this type of approach.

Ongoing Tax Management – Tax Loss Harvesting

Our loss-harvesting process attempts to realize capital losses in order to obtain an after-tax benefit for the investor. We are focused on this subject throughout the year. Our loss-harvesting process sells a basket of securities and replaces it with another basket so that the resulting portfolio reflects its risk targets. During loss-harvesting we seek to keep risk exposures in line and carefully balance the tax benefit against any increase in tracking error. We attempt to realize only those losses that are not negated by wash sales rules. Accordingly, we do not harvest losses on a security lot if a separate lot was purchased within the past 31 days.

Ongoing Tax Management – Strategic Gain Realization

While we typically avoid gain realization, we have, upon request, strategically realized long-term gains for our clients. With a significant spread between long and short-term capital gains rates, our research has shown a potential benefit to refreshing the cost basis of a portfolio to increase possible short-term loss realization opportunities in the future. When rising tax rates are on the horizon, it may make sense to accelerate the realization of select long-term gains to take advantage of current tax rates, reset the basis and holding period of a portfolio and create greater potential for future short-term losses. Parametric can help describe and analyze the key variables; future tax rates, ST/LT rate differences, time horizon and gain/loss realization outside the portfolio are among the most important.

Customizing the Investment Target

SRI/ESG

Incorporating client values and related preferences has been part of the TMC process since the first portfolio. Parametric offers a number of ways to achieve this goal beyond the base case of targeting a SRI or ESG index. We frequently work with advisors and their clients to apply custom social screens, or focus on best-in-class companies.

Custom Fundamental Exposures

Sometimes advisors have strategic views they would like to incorporate into clients' core portfolios: tilts to value, growth, large, mid, small-cap, low volatility, etc. In the current environment, increasing portfolio yield is a frequent Parametric project.

Custom Target Benchmarks

Sometimes there isn't a publicly available index target with desired characteristics. As a result, Parametric offers a variety of custom benchmarks:

Custom Combination Benchmarks

Parametric's proprietary portfolio management systems allow us to combine different indexes to create unique combinations. Often this means blending U.S. and non-U.S. target indexes to create desired global beta exposure, or blending style target indexes to emphasize growth, value, or a capitalization segment.

Custom Exclusionary Benchmarks

Parametric frequently responds to requests to exclude securities or industries from a target index. Often, the goal is to increase diversification relative to other holdings, or express a performance or valuation view. When exclusions are a large portion of the target index, Parametric can provide information on the diversification and tracking-error trade-offs. Performance measurement can be customized as well to measure target performance with and without exclusions.

Custom Constructed Indexes

The advisors we work with are among the sharpest and most creative in the industry. It is exciting for us to be involved in creating portfolios aimed in new directions. For example, we created a Master Limited Partnership (MLP) target index and a portfolio with limited K1 issuance.

Customizing for Outside Constraints?

Estate Planning Vehicles and AMT

When clients' tax situations change from year to year, we work with advisors and adapt accordingly. Estate planning vehicles have unique tax treatments from one year to the next; clients sometimes move into and out of AMT status. Wherever practical, we coordinate with advisors to integrate new or anticipated rates and any unique, trust-related, taxable items.

Incorporating Option Writing

Through our registered investment adviser subsidiary, Parametric Risk Advisors, we can alter, and potentially enhance, risk control and return patterns through option writing strategies. Our Index DeltaShift covered call or buy-write strategies can be managed in conjunction with a TMC portfolio to seek yield enhancement, increased total return, and reduced portfolio volatility.

Better Beta for Clients

In one form or another, Parametric customizes every TMC portfolio we manage. Since investors can create standard equity index exposure inexpensively and conveniently via mutual funds and ETFs, our value proposition is centered on customization. In the base case, we build a portfolio from cash, target a standard benchmark, and customize the construction as well as gain/loss recognition for each client. However, for the majority of our TMC portfolios, we extend our activities to one or more custom analyses or implementations. Whatever your unique needs, we would love to hear from you.