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Parametric's Approach to Tax Management

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Parametric's tax-managed Custom Core® accounts are designed for investors who want flexible, tax-efficient equity index exposure. Additionally, they can provide a focused potential source of tax-loss harvesting that can be used to offset realized capital gains elsewhere in their portfolio. This brief is intended to help investors understand how Parametric's tax management works and the conditions under which it can produce improvements in after-tax performance across a diverse set of investor objectives.

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What is tax management?

Tax management entails applying knowledge about the tax code in a comprehensive and disciplined manner to seek to minimize the effect of taxes on returns. Historically, excess-return conversations have been focused on pretax returns. However, for the taxable investor, it's after-tax returns that really matter. What drives the difference between the two is the amount paid out in taxes on realized gains or received dividends.[1] Although these are both critical components of total returns, any opportunity to moderate taxes on them can improve the after-tax experience. The primary methods for this are holding securities long enough to qualify for the lower long-term tax rate, selecting loss-maximizing or gain-minimizing tax lots for trades, and avoiding repurchases that would disallow the loss (in other words, the IRS's wash-sale rule).

While these methods are available to any investor with knowledge of the tax code, they've become secondary concerns for active managers in the pursuit of excess pretax returns. For many clients, however, tax management is a primary concern. Most managers are active in their stock selection but passive in regard to taxes. Parametric, on the other hand, is active in tax management but passive in stock selection, seeking to track rather than beat the benchmark but outperform on an after-tax basis.

As a general rule, tax-managed Custom Core portfolios seek to generate capital losses in excess of capital gains when possible rather than simply offsetting them, since the separate account structure allows these to be used by the account holder. Thus, the value of this activity is even more valuable when there are excess capital gains elsewhere in the investor's overall portfolio. Commonly, these are found within the investor's equity allocation, due to either an allocation to less tax-efficient passive solutions or active managers. However, they could also be found in fixed income or property holdings as well. This means that even investors with a highly tax-efficient equity allocation may find tax management beneficial from a total portfolio perspective. This powerful tax-mitigation feature is unavailable through traditional, commingled, and passive vehicles such as exchange-traded or mutual funds.

How it works: account inception

The first step for a new investor is to specify a target equity benchmark. The target benchmark is typically an existing index, or it can be customized. Existing indexes range from traditional market-weighted choices (such as the S&P® 500, Russell 3000®, or MSCI EAFE) to alternative-weighted variants (such as EDHEC Smart Beta or FTSE® RAFI) to a host of specialty indexes such as socially responsible, dividend focused, REIT, or master limited partnership. These benchmarks may offer different opportunities for tax management. Many market-cap-weighted indexes tend to be naturally tax efficient, whereas some of the alternative indexes are less so. Of course, Parametric strives to maximize the value of active tax management no matter which target benchmark is chosen.

In certain cases the client may desire a customized target. Tax-managed Custom Core accounts are especially well suited for this, given the flexible nature of the separate account structure and Parametric's years of experience building client-tailored solutions. Specialization could involve blending existing indexes, tilting an index toward specific fundamental factors, or applying screens to avoid certain industries, achieve social and environmental goals, or restrict particular securities.

[1] *After-Tax Return = Pretax Return − (Net Capital Gains Taxes + Dividend Taxes)/Weighted Market Value.* If there are no asset flows during the period, weighted market value is just the start-of-period market value. If there are asset flows, we modify the start-of-period market value to add the day-weighted flows in the period.

Whether customized or not, the target benchmark can be changed later if necessary, and the portfolio manager will strive to accomplish the transition in a tax-efficient manner.

To enable active tax management, the portfolio manager will deviate somewhat from the index with regard to security weights. This deviation is called tracking error and measures the variation between the client portfolio and the target benchmark returns over time.[2] Allowing a higher tracking error may increase the manager's opportunity for tax management, but it also increases the risk that the portfolio will under- or outperform its target in any particular period, which would conflict with the tracking objective. Typically, Parametric prefers to manage accounts within a tracking error of 1%. However, for accounts incepted in kind, tracking error may be allowed to run higher for some time to transition the portfolios toward the target benchmark in a tax-sensitive manner.

Once the target benchmark and appropriate degree of tracking error have been identified, the portfolio manager purchases a subset of stocks in the target benchmark to build a portfolio that offers sufficiently similar return and risk characteristics, based on a third-party multifactor risk model. If the account is large enough, the manager may buy all the stocks in the index, but for smaller accounts this could be cost prohibitive. Accounts may be incepted with cash or securities.

How it works: monitoring and loss harvesting

Once the portfolio is fully invested and aligned to its target, the tax-management process can begin. This entails monitoring the holdings regularly for losses as well as undesirable changes in risk exposures or predicted tracking error, relative to the target. The frequency of loss harvesting will fluctuate depending on the market environment. A trade is made only if the tax benefit offsets the transaction costs and is done so in a way that keeps the predicted tracking error within the desired bounds.

Due to the complexity of this decision and to ensure consistency, Parametric's portfolio managers use proprietary software to seek the optimal solution. However, this isn't a completely automated process. Every trade is chosen based on the specific characteristics of the portfolio, and each trade is approved individually by the portfolio manager, who is responsible for ensuring the portfolio works to meet both its dual pretax return tracking and after-tax excess return objectives.

A critical ingredient to providing superior after-tax performance, relative to a tax-oblivious strategy, is the ability to specify transactions at the individual tax-lot level. This enables the manager to maximize realized losses and minimize realized gains by identifying the highest-basis lots and avoiding selling the lowest-basis lots. This contrasts with a system that selects tax lots on a first-in, first-out basis or to a collective vehicle holding, such as an ETF, that can be harvested for a loss only if the entire instrument declines in value, regardless of the performance of the underlying constituents. Given that any holding may contain multiple tax lots and that even in strong up markets there still tends to be a pool of securities with declining prices, this level of specification is a potent tool for extracting tax benefits across market environments. Additionally, through regular monitoring, a Custom Core account is better positioned to take advantage of tax-management opportunities, which can come and go throughout the course of the year.

[2] For more on this subject, see Rey Santodomingo, "A Simple Guide to Tracking Error," Parametric (March 2018), https://www.parametricportfolio.com/insights-and-research/a-simple-guide-to-tracking-error.

Lastly, unless directed otherwise by the client, the manager generally seeks to produce excess capital losses. Since capital losses can be applied against capital gains elsewhere in the client's total portfolio and indefinitely into the future, this ensures that tax-management opportunities are fully captured and banked as they become available rather than risking that they dissipate before they're actually needed. These excess capital losses are reflected in the after-tax returns during the period they're taken.

Conclusion

A tax-managed Custom Core portfolio can help investors with diverse objectives improve their after-tax experience by providing a focused source of loss harvesting that can be used to offset realized capital gains elsewhere—all while tracking any benchmark of their choosing. Through a disciplined, customer-centric process using sophisticated technological systems, Parametric's goal is to maximize after-tax returns in a variety of market environments.

About

Parametric Portfolio Associates LLC (Parametric), headquartered in Seattle, is a leading global asset management firm, providing investment strategies and customized exposure management to institutions and individual investors around the world. Parametric offers a variety of rules-based, risk-controlled investment strategies, including alpha-seeking equity, alternative, and options strategies, as well as implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is a majority-owned subsidiary of Eaton Vance Corp. and offers these capabilities through locations in Seattle, Minneapolis, Boston, and Westport, Connecticut.

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