PARAMETRIC

July 2018

To Everything There Is a Season: The Four Stages of a Tax-Managed Custom Core™ Account

Paul Bouchey, CFA
Chief Investment Officer

For many investors and their advisors, portfolio tax management begins and ends with loss harvesting. And sure: It's a powerful tool to help offset gains elsewhere in the portfolio, and it's rightfully a large piece of the tax-management puzzle. But it's not the only piece. The fact is, if you're focused solely on loss harvesting, you may miss out on other key opportunities to plant the seeds that help further minimize tax liability. So, yes, loss harvesting is certainly a time to reap. But as we argue in this paper, there's also a time to sow.

Parametric takes tax management seriously, making it a critical component of our tax-managed Custom Core strategy. And in our experience, approaching tax from the vantage point of the portfolio's life stages helps us understand which tools may be most effective at managing tax along the way. With that in mind, let's look at the life stages of a portfolio and the tax-management strategies available at each.

Parametric
1918 Eighth Avenue
Suite 3100
Seattle, WA 98101
T 206 694 5575
F 206 694 5581
www.parametricportfolio.com

Stage 1: Account creation

When we create a new account, we carefully transition existing assets to avoid realizing capital gains taxes. At this stage of the account, the advisor works with the client and our analysis team to build a customized index solution—perhaps blending indexes, considering ESG screens, tilting toward particular factors, or just choosing our most popular index, the S&P 500®. Cash-funded accounts are fairly straightforward to initiate. Using a risk model and our proprietary optimization software, we construct a portfolio of 200 to 300 stocks that closely track the underlying customized benchmark. The initial market value is equal to the cost of the portfolio, its cost basis.

For an account funded with in-kind securities, the problem is more complex. Our investment team must find a good trade-off between the tax cost of transitioning to the new portfolio and the risk of underperforming the benchmark. The goal is to avoid realizing taxes at the time of inception by holding some of the existing securities but doing so in a risk-controlled way. Often we provide advisors and their clients with several transition scenarios to consider: some that tightly track the benchmark and pay more capital gains tax, and others that take more benchmark-relative risk by holding more of the existing portfolio and paying less tax. The average market value can be much higher than the average cost basis. In some cases this leads to fewer loss-harvesting opportunities and a higher tracking-error risk that must be managed over time.

Stage 2: The early years

This stage often includes risk-managed trading to realize tax losses. A key tactic here is tax-rate arbitrage—paying close attention to trading such that the investor pays only the (lower) long-term tax rate on capital gains. This involves avoiding short-term gains when possible and harvesting short-term losses to offset any unavoidable short-term gains.

At this stage of the account, the goal is to realize any capital losses that show up among the securities in the portfolio. These losses may be used to reduce current-year taxes. Or, in the case of a portfolio with legacy positions from the initial account transition, some of the losses can be used to offset gains resulting from tightening up risks.

The benefit of loss harvesting is easy to observe and quantify. The losses from the tax-managed portfolio can be used to offset any realized capital gains in this tax year, reducing the tax paid by the investor. Most advisors and investors focus on these immediate and concrete dollar savings—for example, by making opportunistic loss-harvesting trades during market corrections

Stage 3: Appreciation

If all has gone according to plan, the portfolio will eventually become highly appreciated. There will be more embedded unrealized gains and, as a result, fewer opportunities for loss harvesting.

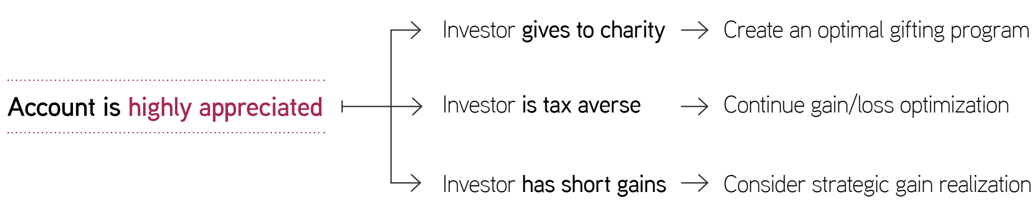
However, loss harvesting is just a tactic. There are other, potentially more impactful, sides to the tax-management story to consider. One of those is deferral. When an asset is at a capital gain and you sell it, you owe tax on the realized gain. If you choose not to sell it, the tax you would have paid continues to compound in the portfolio. Later, if you end up paying the tax, you still get to keep the compounded returns on that money, essentially deferring the realization of taxes into the future and earning market-like returns on the asset in the meantime. Another way to think about this is that the tax liability from a realized capital gain that was offset by realized losses isn't gone—it's merely stored in the equity account in the form of a lower cost basis and higher unrealized gains.

Deferral is easy—you just hold the stocks and never sell, right? Unfortunately, it's not that easy. A proper tax-deferral strategy is one that manages the risks along the way. In Custom Core accounts, Parametric uses a process called gain-loss matching optimization, which seeks to avoid the realization of capital gains tax while carefully managing portfolio risk relative to the investor's custom benchmark. The same risk-management and optimization tools are used on the portfolio, but, with fewer losses available, the trade-offs between taxes, transaction costs, and risk become more difficult to manage. Indexes are constantly changing in the face of corporate actions and reconstitutions. If there are ESG or factor customizations, those must be updated and managed through time. Investors will occasionally need to change their benchmark to meet new objectives. In some cases a steady cadence of withdrawals makes deferring taxes even more challenging.

Stage 4: The end game

This brings us to a common question related to tax-managed Custom Core accounts—namely, what to do when the portfolio becomes appreciated and generates fewer realized tax losses? First, it's important to recognize that this is a good problem to have. A portfolio that's producing fewer realized losses has likely appreciated dramatically (increasing the market value) and provided significant amounts of realized losses (decreasing the cost basis).

And second, it's important to understand the investor's mind-set. If he or she is highly averse to realizing any taxes, consider continuing gain-deferral optimization and let the tax benefits compound over time. If there are withdrawals that are required from the portfolio to provide income, use a tax-efficient optimization process. Eventually the estate plan will be realized and the portfolio will receive a step-up in cost basis, effectively eliminating the tax liabilities when assets pass to heirs.



If the investor has charitable intent, in some cases he or she can also eliminate the tax liability altogether through charitable giving. Consider creating a donor-advised fund account, private foundation, or other charitable vehicle. Instead of giving cash each year, deposit cash into the tax-managed equity account and then contribute appreciated securities every year to charity. This has three benefits:

- The gift will be tax deductible
- The investor transfers tax liability out of the portfolio
- Fresh cash increases the average cost basis, making it easier to harvest tax losses in future years

If the investor has a consistent supply of short-term realized gains that need to be sheltered each year, consider strategically realizing long-term capital gains in the portfolio to reset the cost basis and reinvigorate short-term loss harvesting opportunities. For advisors interested in a tax-lot analysis, Parametric can provide a report that shows the distribution of tax lots in the portfolio with suggestions for how to manage the tax liability in the long run.

The stages occur in order, right?

Not necessarily. Human life may proceed in a linear fashion, but account life stages don't have to. Depending on market conditions or events in the investor's life, stages may be repeated. For example, many accounts in stage 3 became stage 2 accounts again during the global financial crisis of 2008–2009.

And in the end, investors can choose to realize tax at the long-term rate to start the process all over again, give away the liability by selecting the optimal tax lots for charitable giving, or continue to defer paying the tax until the assets can become part of the gift and estate planning process.

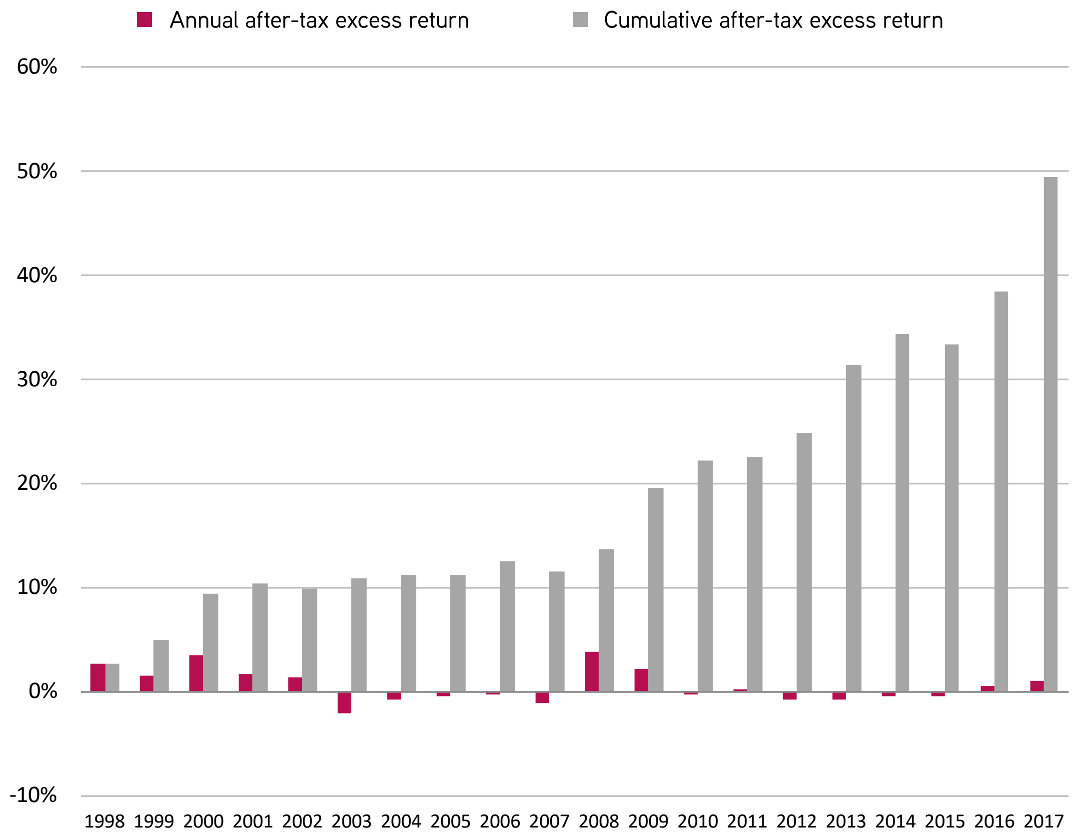
Over a long horizon most of the value added from the strategy will likely come from tax deferral. Figure 1 shows returns for the Parametric US Large Cap 1998 Vintage Composite, which consists of taxable accounts indexed to the S&P 500 that were incepted in 1998. Figure 2 shows the annual after-tax excess returns (the immediate benefits of loss harvesting) and the cumulative after-tax excess return (which includes the benefits of loss harvesting and deferral). In the early years and in 2008–2009, loss harvesting is abundant and the annual after-tax excess returns are strongly positive. For later years, the cumulative after-tax excess returns grow due to the continuing benefit of deferring the tax liabilities that were stored in the portfolio during the earlier loss-harvesting years.

Figure 1: Returns, Parametric Custom Core US Large Cap 1998 Vintage Composite

	1-Year Annualized	5-Year Annualized	10-Year Annualized	Annualized Since Inception	Cumulative Since Inception
Gross of Fees & Tax					
Composite Return (Gross)	22.7%	16.0%	8.9%	6.7%	259.8%
S&P 500	21.8%	15.8%	8.5%	6.6%	248.6%
Excess Return	0.9%	0.2%	0.4%	0.2%	11.2%
Pre-Tax					
Composite Return (Net)	22.3%	15.5%	8.5%	6.3%	229.8%
S&P 500	21.8%	15.8%	8.5%	6.6%	248.6%
Excess Return	0.5%	-0.3%	0.0%	-0.3%	-18.8%
After-Tax					
Portfolio Return (Net)	21.6%	14.7%	8.6%	6.9%	269.9%
Benchmark Return (Simulated)	20.6%	14.7%	7.8%	6.1%	220.5%
Excess Return	1.0%	0.0%	0.7%	0.8%	49.5%

Sources: Parametric, FactSet. For illustrative purposes only. Composite performance is presented gross and net of advisory fees. Composite performance reflects the deduction of brokerage commissions and reinvestment of dividends and other earnings. Past performance is not indicative of future results. It is not possible to invest directly in an index. Indexes are unmanaged and do not reflect the deduction of fees or expenses. Benchmark after-tax performance is hypothetical. Please review the Disclosures for additional information. All investments are subject to the risk of loss.

Figure 2: After-tax excess returns, Parametric Custom Core US Large Cap 1998 Vintage Composite



Source: Parametric. For illustrative purposes only. Past performance is not indicative of future results. After-tax excess returns are derived from composite performance and simulated benchmark after-tax performance. Composite performance is net of fees and brokerage commissions and reflects the reinvestment of dividends. Benchmark after-tax performance is hypothetical and does not reflect advisory fees or brokerage commissions. It is not possible to invest directly in an index. 1998 consists of 8 months of performance, since composite was incepted on May 1, 1998. See Disclosures for additional information.

The bottom line

As we've shown, tax management involves much more than just loss harvesting. And it's important no matter which stage the account is in. At an active tax manager's disposal is a suite of tools that extend beyond identifying losses and avoiding wash sales. These include transition management, gain-loss matching optimization, tax-efficient withdrawals, and optimal gifting programs.

Further, a Custom Core account is about much more than just tax management. It's the freedom to design a unique portfolio and the ability to make changes to that portfolio over time. This will be true no matter the environment and no matter the life stage of the account.

Disclosure

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment adviser with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity; alternative and options strategies; and 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 investment centers in Seattle, Minneapolis, and Westport, Connecticut.

Tax-managed Custom Core™ strategies are offered by Parametric Custom Tax-Managed & Centralized Portfolio Management, a segment of Parametric.

This information is intended solely to report on investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. Past performance is not indicative of future results. The views and strategies described may not be suitable for all investors. Investing entails risks, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Parametric does not provide legal, tax, or accounting advice or services. Clients should consult with their own tax or legal adviser prior to entering into any transaction or strategy described herein.

Charts, graphs, and other visual presentations and text information were derived from internal, proprietary, or service-vendor technology sources and may have been extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet, and other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

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 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. The Custom Core US Large Cap 1998 Vintage Composite was incepted on March 1, 1998, and consists of accounts incepted between March 1, 1998, and November 30, 1998. 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 US dollars using a time-weighted, daily linked total return methodology. Dividend and interest income is accounted for on an accrual basis. Starting Q4 2016, composite net returns reflect the deduction of a 0.35% annual management fee—the highest paid by any client in this composite. Prior to Q4 2016, composite net returns reflect the deduction of a 0.45% annual management fee.

When calculating after-tax returns, Parametric applies the client's individual tax rate (which may include federal and state income taxes) if provided by the client. If the individual tax rate is not provided by the client, Parametric applies the highest US federal tax rates. For short-term gains, the highest US federal marginal income tax rate is 37% plus the 3.8% net investment income tax, for a combined rate of 40.8%. For long-term gains, the highest US capital gains tax rate is 20% plus the 3.8% net investment income tax, for a combined rate of 23.8%. These assumed tax rates are applied to both net realized gains and losses in the portfolio. Applying the highest rate may cause the after-tax performance shown to be different from an investor's actual experience. Investors' actual tax rates, the presence of current or future capital loss carryforwards, and other investor tax circumstances will cause an investor's actual after-tax performance to be over or under Parametric's estimates presented here. 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. Actual client after-tax returns will vary. As with all after-tax performance, 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 this portfolio to fully offset any net capital losses realized, and any resulting tax benefit has been included in Parametric's computation of after-tax performance.

Performance, cost basis, unrealized gains or losses, and realized gains or losses calculated and reported by Parametric may vary from official custodial statements based on different accounting procedures, reporting dates, or valuation methodologies for certain securities. Client performance summaries and any related data produced by Parametric are not audited. Clients are encouraged to carefully review and compare the official custodial records with the various data and performance statistics reported by Parametric.

Benchmark after-tax returns are simulated for each client portfolio using client-specific after-tax benchmark portfolios. Performance of the after-tax benchmark is simulated using the same inception date, cash flows, cost basis, and tax rates as the client portfolio. The after-tax benchmark's capital gain realization rate is based on the average turnover rate of the pre-tax benchmark and ending gain or loss of the after-tax benchmark for each period. The dividend income is estimated using the pre-tax benchmark index's dividend return during the period. After-tax benchmark returns reflect the deduction of taxes but do not include any other fees or expenses. After-tax benchmark returns are hypothetical, do not reflect actual trading, and may not be relied on for investment decisions.

Benchmark and index information is provided for illustrative purposes only. Indexes are unmanaged and cannot be invested in directly. Please refer to the specific service provider's website for complete details on all indexes.

The S&P index(es) ("Index") is a product of S&P Dow Jones Indices LLC and/or its affiliates and has been licensed for use by Parametric. Copyright © 2018 by S&P Dow Jones Indices LLC, a subsidiary of the McGraw-Hill Companies Inc. and/or its affiliates. All rights reserved. Redistribution, reproduction, and/or photocopying in whole or in part are prohibited without written permission of S&P Dow Jones Indices LLC. For more information on any of S&P Dow Jones Indices LLC's indexes, please visit www.spdji.com. S&P® is a registered trademark of Standard & Poor's Financial Services LLC, and Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC. Neither S&P Dow Jones Indices LLC, Dow Jones Trademark Holdings LLC, their affiliates, nor their third-party licensors make any representation or warranty, express or implied, as to the ability of any index to accurately represent the asset class or market sector that it purports to represent, and neither S&P Dow Jones Indices LLC, Dow Jones Trademark Holdings LLC, their affiliates, nor their third-party licensors shall have any liability for any errors, omissions, or interruptions of any index or the data included therein.

Parametric is located at 1918 8th Avenue, Suite 3100, Seattle, WA 98101. For more information regarding Parametric and its investment strategies or the firm's list of composite descriptions or to request a copy of Parametric's Form ADV, please contact us at 206.694.5575 or visit www.parametricportfolio.com.