RESEARCH BRIEF
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WITHOUT TAX MANAGEMENT, SMART BETA STRATEGIES MAY NOT BE SO SMART

Simple tax-management techniques may allow investors to keep more returns after taxes.

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Smart beta strategies are increasing in popularity among high-net-worth individuals. These smart beta strategies seek to add value through a variety of portfolio-construction techniques. However, the additional turnover that accompanies these strategies creates an extra tax impact, which can reduce the value add on an after-tax basis. That begs the question: are smart beta strategies still smart after taxes?

WHAT IS SMART BETA?

Before we address that question, it may be helpful to define what smart beta strategies are and what they seek to accomplish. Smart beta strategies are often used as a replacement to a passive capitalization-weighted portfolio, or as a complement to existing passive and/or active strategies. While the style has no formal definition, smart beta strategies generally rely on three basic tenets: no fundamental views are expressed at the security level; outperformance is based on the structure of a rules-based portfolio; and portfolios are constructed in a systematic fashion.

Most smart beta strategies are designed to make an active bet on some systematic return characteristic or another, and their performance will be largely determined by the success or failure of that characteristic. Examples of these systematic bets are a size bias, a preference for value, low volatility, leverage, or momentum, although there are a variety of others, and there is no doubt more will follow.

THE IMPACT OF HIGHER TAX RATES

The recent tax increases effective in 2013 will likely have a profound effect on investment portfolios going forward. The chart below highlights the differences in rates from the 2012 tax year to 2013.

Figure 1: Higher Taxes: From Risk to Reality

Maximum Federal Tax Rate	2012 Rate		2013 Rate	
Compensation (Wage) Income	35%	→	41.95%	(39.6% tax + 1.45% Medicare tax + 0.9% health care reform surtax)
Qualified Dividends	15%	→	23.8%	(20% tax + 3.8% health care reform surtax)
Long-Term Capital Gains	15%	→	23.8%	(20% tax + 3.8% health care reform surtax)
Taxable Bond Interest	35%	→	43.4%	(39.6% tax +3.8% health care reform surtax)
Non-Qualifying Dividends	35%	→	43.4%	(39.6% tax +3.8% health care reform surtax)
Short-Term Capital Gains	35%	→	43.4%	(39.6% tax +3.8% health care reform surtax)

Source: Tax Policy Center. This table is for illustrative purposes only and uses the highest current applicable federal tax rates plus the new 3.8% health care tax, where applicable.

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Most investment processes completely ignore taxes. While there may be good business reasons to do this, there are simple ways investors can organize their portfolio and their trading to potentially be more tax efficient. It may be tedious work that requires a lot of attention, but it is definitely achievable. We liken the process to watching grass grow; the work may be dull and boring but, like a lush lawn, the results are a worthy goal.

▸▸ CONSIDERING TAXES WITH A SMART BETA STRATEGY

In order to determine whether smart beta strategies are still smart after taxes, we applied the premise that there is a difference between smart beta strategies with and without active tax management. Active tax management seeks to reduce or eliminate capital gain distributions to separately managed account owners, as well as for mutual funds and exchange-traded funds (ETFs). In a separate account, additional loss harvesting would accrue to the taxpayer.

These strategies are often built working from low-volatility indexes, which attempt to reduce risk, or fundamentally weighted indexes, whose components are chosen based on fundamental criteria such as revenue, dividend rates, earnings and book value.

Ultimately, we find that when investment managers apply tax-management techniques to strategies with a large number of securities, which have a modest amount of turnover and which follow a rules-based portfolio-construction approach, high-net-worth investors may retain a significant portion of pre-tax alpha after-tax.

▸▸ STUDYING THE EFFECTS OF TAX MANAGEMENT

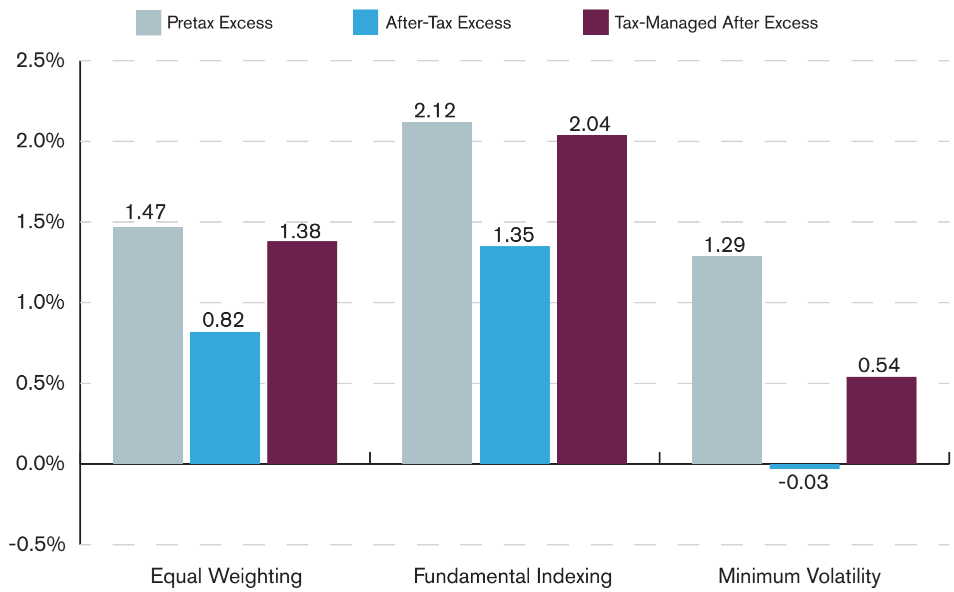
We measured after-tax returns for three smart beta strategies and tested the standard tax-management techniques in search of an answer. We looked at the return characteristics for these three smart beta strategies versus the cap-weighted index for U.S. stocks: equal weighting (EW), fundamental index (FI) and minimum volatility (MV).

For each strategy, we included the largest 1,000 U.S. stocks in each fundamental index. To reduce turnover of holdings and the tax impact on investors, we rebalanced annually on the basis of market price data at the close of the market on the last trading day of each year. We examined the 20-year period from January 1993 through December 2012.

Using the highest marginal tax rates, we measured the pretax, after-tax and post-liquidation returns for each of the strategies. Our study assumed that net losses are carried forward and available to offset gains in future years and that in the final period, the portfolio is liquidated.

In the end, the smart beta strategies we studied outperformed the cap-weighted index on a risk-adjusted basis, as the chart below shows. Our findings show that smart beta strategies may potentially retain a significant portion of their excess returns after taxes for even the most heavily taxed high-net-worth investors.

Figure 2: Taxes Are a Drag on Performance, But Tax Management May Help



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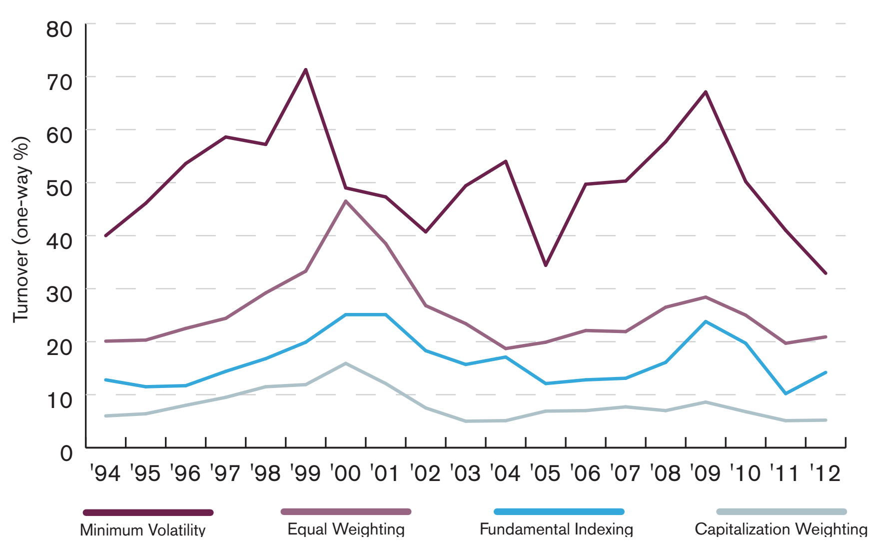
▸▸ CONFRONT THE TAX DRAG WHEN TAKING A SMART BETA APPROACH

Smart beta strategies seek consistent long-term outperformance. However, things can still go awry. While smart beta strategies tend to be lower turnover than traditional active strategies, they do have higher turnover than capitalization weighting, as the chart below shows. This increase in turnover has two effects: an increase in trading costs and, perhaps more importantly, an increase in taxes.

Figure 3: High Turnover of Smart Beta Strategies May Result In An Increase In Taxes



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Overall, taxes can represent a very large performance drag. Managers, advisors and investors often give too little attention to the tradeoff between seeking expected return and the tax consequence of doing so. The large breadth of the strategies and lack of stock specific alpha allows for potential value added from active tax management. Tax management may reduce tax drag for passive indexes, smart beta indexes, and even for active strategies.

As our research shows, despite higher turnover of smart beta strategies, there are simple tax-management techniques that may allow investors in smart beta strategies to keep more of those returns after taxes. These can include:

- **Defer the realization of gains.** For example, consider a zero interest loan from the government.
- **Manage the holding period.** Tax rates are reduced on capital gains when holding longer than 12 months.
- **Harvest losses.** Accelerating the realization of losses can dramatically reduce tax impact. Use tax-loss turnover in a disciplined fashion to harvest losses that can help offset gains taken elsewhere in the portfolio.
- **Pay attention to tax lots.** Use specific lot accounting to help minimize capital gains realizations. By selling shares with the highest basis first, investors may minimize capital gains.
- **Avoid wash sales.** Coordination across managers is difficult unless you use an overlay manager.