

The Dangers of Heavy-Handed Year-End Tax Management

Parametric Portfolio Associates Commentary

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Is year-end tax management worthwhile, or is this letting the tax tail wag the investment dog? Despite the 2003 tax law changes, year-end tax management remains worthwhile and investors should pay close heed to tax ramifications. But tax management needs to be done with care.

2004 is likely to be the second year in a row with positive returns and for many investors this means another year of realized capital gains. If these gains are short term, they come at a heftier tax price relative to their long term cousins. Even though both rates were reduced last year, short term tax rates are very high compared to long term tax rates. This affects investors whose strategies produce strong short term gains (e.g. hedge funds and managers with high turnover).

Tax management requires thinking ahead. Investors who have long-term gains may want to take some gains now at the current low rate of 15% in order to re-position their portfolio for 2005. This is a good time for investors with large concentrated holdings to seriously diversify.

Keep in mind that you want your dividends to qualify for the lower dividend tax rate -- those who pay taxes at the higher non-qualified rate should re-think their strategy for 2005.

Done correctly, tax management can be very powerful. Done incorrectly, in a heavy-handed manner, investors may expose themselves unnecessarily.

Investor beware: taxes are not the tail on a cute little puppy dog. They are the tail on an investment alligator and are a large part of the beast. If you don't know what you are doing, you become lunch.

Here are six year-end tax tips that investors need to watch.

1. Don't wait until the end of the tax year to plan

Tax planning needs to occur throughout the life of a portfolio. While there may be reasons to wait until the end of the year to sell in order to realize capital losses, this is not always a good idea. Many others are doing it at the same time, and you may be trading into weakness. Instead: think of this subject throughout the year; and any losses that you can realize earlier during the year serve the same tax purpose.

2. Don't be too aggressive realizing losses and miss out on stock appreciation

When you realize losses, keep in mind the wash-sale rule, which restricts re-purchasing the stock for 31 days. During this time, you miss a potential bounce-back in stocks. Look at what happened in December 2000/January 2001: in the month of January 2001, the Nasdaq 100 Index re-bounded 10% after being down 34% for the fourth quarter of 2000. Large stocks experienced whiplash; Xerox, which was down 33% in December, rebounded 77% in January; Microsoft, down 24% in December, rebounded 41%; and even staid IBM, down 9% in December, rebounded 32%.

3. Don't focus only on individual securities

If you realize losses on individual securities, you affect the risk characteristics of your portfolio and leave yourself exposed to major underperformance. Rather: think of the risk (diversification) of the portfolio as a whole, and make certain that you do not undo desirable bets that you wish to maintain. For example, make sure you do not sit with a large portion of your portfolio in cash during this period, and avoid being underexposed to a sector you like. You are particularly susceptible to risks of momentum or volatility. Always balance the risks incurred against the tax benefits.

4. Don't force your money manager to do things reluctantly

Some investors see a high impending tax bill and instruct their investment manager to realize losses. If your investment manager has seriously studied the securities and wants to maintain his positions, let him do this. If you interfere, his responsibility for portfolio performance becomes unclear, and why then are you paying him?. If you trust your manager to manage your portfolio in the presence of taxes, let him at this. If not, fire him, and find an expert.

5. Don't become enamored with mutual funds that have imbedded losses

Some investors see a mutual fund that has high-imbedded losses as attractive. While these mutual funds may not need to distribute gains for a while, their tax status may be a result of: (a) very poor tax management in the past; and (b) a high rate of withdrawals. A high-imbedded loss may ironically be evidence of an undesirable fund.

6. Consider the long view

In 2003, the S&P 500 reported returns of 28.67%. In 2004, returns are likely to be positive but more modest. Smart tax strategies can be more beneficial in lower return environments -- the value of actively managing your taxes is higher when markets are weaker. But, do not lose your long-term focus. While there may be year-end opportunities for short-term tax management, you must keep your eye on your long-term objectives and not become distracted by day-to-day market movements.

About the Author

David Stein, PhD, is Managing Director and Chief Investment Officer of Parametric Portfolio Associates, a leader in tax-managed investing. He heads Parametric's Investment, Research and Technology activities, maintains a focus on Parametric's intellectual capital, and is dedicated to advancing the art and science of investment management in the presence of taxes. He holds a number of patents, a Ph.D. from Harvard University in Applied Mathematics, and a M.Sc. degree from the University of Witwatersrand, South Africa.