

**Equity Portfolio Structure and Design**  
*When the Whole is less than the Sum of its Parts*

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Large cap. Mid cap. Small cap. Growth. Value. Momentum. Sectors. Active. Passive. Tactical timing. These style buckets, and others, help professional advisors select portfolio specialists with beat-their-benchmark track records. Risk is minimized. What's wrong with that?

What's wrong is that a complex portfolio structure hurts investors by generating excessive capital gains taxes. The alarm is rarely sounded unless the advisor goes back and reviews aggregate performance and discovers that it was, after taxes and after all, not all that terrific.

The tax costs of equity portfolio structure -- and a remedy -- are discussed in a research brief entitled "*Equity Portfolio Structure and Design in the Presence of Taxes*," available to financial advisors from Parametric Portfolio Associates at (206) 694-5575 or [www.parametricportfolio.com](http://www.parametricportfolio.com).

**Equity Portfolio Structure**

Standard approaches to equity portfolio structure that are accepted by much of the investment advisory and consultative world have typically evolved for tax-exempt institutions.

**FIGURE 1: TYPICAL TAX-EXEMPT EQUITY STRUCTURE**

Large 80%	Large Growth 40%	Large Value 40%
Small 20%	Small Growth 10%	Small Value 10%
	Growth 50%	Value 50%

Figure 1 shows the spirit in which many equity portfolios are partitioned. In partitioning a portfolio into Large Growth, Large Value and Small-Cap segments, the advisor expresses a number of implicit ideas. First, he believes that style and size are major dimensions of risk. Second, he believes that investment management skill requires specialization or that specialist managers have the ability to outperform generalists. Third, he believes he is able to control the risks cleanly by selecting managers who remain true to their style and by evaluating their performance and rebalancing them regularly. If the portfolio is passive in some sectors and active in others, he expresses a belief that some sectors of the market are more efficient than others, and/or that he has more skill in selecting managers in these sectors.

This approach has been found to be very useful for tax-exempt institutions, and the beliefs seem often to be true in practice. Advisors will classify managers, for example, by their investment philosophy (active or passive), discipline (quantitative or fundamental), specialization (style or size), skill (stock selection, sector rotation, hedging, technical analysis, or trading), risk control (diversified or concentrated), sensitivity to taxes, or other attributes.

Typically, advisors will then select a set of managers and monitor their performance, replacing them as necessary, rebalancing the assets of each, and ensuring that the aggregated risks are aligned to their requirements. They may then observe that some sector of the market is lacking (many managers underweight utilities, for example) and install a completion portfolio, or they may note that the structure inhibits a manager from rotating between Growth and Value, and compensate with a tactical style rotator.

While a complex equity structure has its benefits, the intricacy can lead to difficulties. For example, complexity can drive high implementation, advisory and rebalancing costs. And, it can lead to a focus on the wrong issues: for example, issues of pre-tax performance evaluation, issues surrounding a search for a better manager (rather than a better structure), and overpriced entertainment. All said, the investor pays high fees for active investing but gets mediocre performance before taxes and inferior performance after taxes.

### **Issues for Taxable Investors**

There are differences between institutional tax-exempt investing and private investing: private investors have a more limited lifespan, have higher borrowing costs, and need to pay advisory costs that are a greater proportion of their assets. In addition, they pay taxes, and this, especially, changes the investment management landscape.

The advisor who practices tax-efficient portfolio management will think in terms of a buy-and-hold portfolio which delays the realization of capital gains, will comprehend the value of active tax management, and will choose the right investment vehicle. However, even this is not enough. The tax-efficient advisor also must understand the hidden taxes that equity structure exacts.

The following are flavors of capital gain taxation:

1. *The portfolio manager's alpha tax.* In his search for *alpha*, or added value, the portfolio manager sells appreciated stocks and incurs, for the investor, capital gains taxes. But new securities rarely appreciate enough to compensate for the taxes generated by the sale of the old ones. Indeed, the active manager typically needs the replacements to outperform the original by 2-4 percent per year, before taxes, to justify his realization of capital gains.
2. *The re-balancing tax.* Over time, style buckets lose alignment. When Growth increases more than Value, for example, it requires the sale and purchase of

securities to restore proper weight to each style bucket. If the advisor is trying to tactically time between the styles, the rebalancing cost can be high. This balancing act generates more sales and, alas, more tax pain for the investor.

3. *Manager selection tax.* Just as the active manager continually seeks more attractive securities, so the advisor seeks more attractive managers. When the advisor hires a new manager, that manager will reconfigure his sub-portfolio to suit his own trading philosophy and preferences. Again, capital gains are taxed.

Even more pain is inflicted here by the *multi-manager tax*. This tax occurs every time a manager is hired or fired, when a manager buys a security that another manager is selling, or when a manager sells a security the investor also holds at a higher basis. The need to improve after-tax performance has prompted some to employ a tax-quarterback who is aware of what the managers are doing, identifies the best tax lots, and prevents wash sales.

4. *Benchmark reconstitution tax.* When the specialist benchmarks are re-defined, some securities switch buckets. For example, Value stocks migrate to Growth, or Small cap securities grow to Large. Managers reconstitute their portfolios when this happens so as to be aligned to their benchmarks and, voila, more taxes. This tax is typically in the range of 80 and 100 basis points a year.

In thinking about tax costs in these ways, the investor does not typically pay all of the four taxes independently. In the extreme case -- with active, high-turnover managers -- all appreciation is taxed at the short-term rate each year. The advisor can dodge the alpha tax by selecting tax-sensitive managers, but unless the advisor focuses on the structural taxes, the investor will be assessed the other forms of taxation. Investors in certain mutual funds who change their minds or rebalance frequently pay dearly.

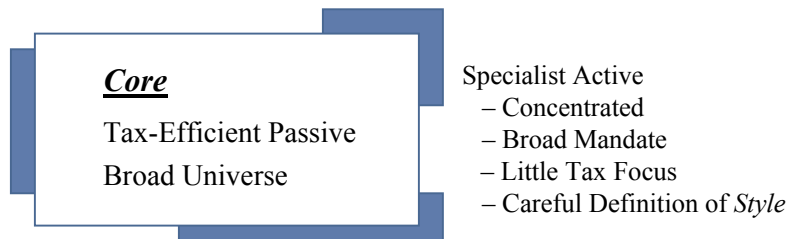
## Equity Portfolio Structure: Recommendations

It is easy to be tax inefficient; to be tax-efficient requires a focus on the issues at all times. So, how should the advisor counsel his taxable investors? Here are some recommendations:

### 1. *Simplify portfolio structure by seeking a centralized broad core exposure.*

Instead of the standard partitioned equity structure of Figure 1, the advisor should simplify portfolio structure with a buy-and-hold core, a broad cap-weighted universe of stocks index, such as RU3000 or Wilshire 5000, as illustrated in Figure 2. The management should be centralized in a single portfolio. This structure eliminates the benchmark reconstitution tax and the rebalancing tax.

FIGURE 2: RECOMMENDED EQUITY STRUCTURE FOR TAXABLE INVESTORS



### 2. *Focus on tax management by implementing a passive, tax-managed core.*

A passively managed core, with a single core manager, provides inexpensive diversification and avoids the alpha tax. It requires very low realization of capital gains. If actively tax-managed, it provides additional after-tax benefits through loss management and careful cash flow transitions. The passive core avoids costs associated with manager selection and de-selection and the multi-manager tax.

### 3. *Choose a small number of satellite active and focused managers.*

Paying active fees for risk control is expensive and unnecessary if the core portfolio provides suitable diversification. If the advisor wishes to make active bets, he can employ satellite managers around the central core.

Active approaches that are diversified, that make numerous small bets with small expectation of alpha, are more suited to tax-exempt portfolios. However, if the taxable investor desires pizzazz and entertainment, high-risk active managers can provide this. With concentrated high-risk managers, the advisor can manage risks by limiting the size of these portfolios.

With the central core controlling risks and taxes, the advisor's satellite managers can concentrate on what they do best. The advisor should set the managers' mandates broadly – skill requires scope – and let them take aggressive bets. Hedged or market-neutral, long-short approaches are suitable; long-short portfolios can enhance the manager's alpha by allowing him to underweight smaller stocks he dislikes. These approaches are also likely to realize capital gains, which should be offset by loss-management in the core portfolio.

Nevertheless, the advisor needs to measure manager performance on an after-tax basis so that the advisor – and the managers – know what they are actually achieving. Specifically, all should be very sensitive to the problem of realizing short-term gains. If the investor has both a taxable and a tax-deferred investment account, the tax-deferred account is the ideal place for satellite active managers.

How many active managers does the advisor need? How aggressive should they be? How large should their portfolios be? The answers will depend on the advisor's confidence in their skills. With greater confidence in them, the advisor will increase the size of their portfolios and allow them to take larger bets. Remember, though, that too many managers make it more difficult to oversee the total enterprise, inviting the possibility of over-diversification.

**4. *If you want a style or size tilt, do it with a tax-efficient definition of the sector.***

Note that by *passive* in Figure 2 we mean *buy-and-hold*. Passive is not necessarily *indexed*. Many investors prefer a long-term sector or theme tilt to their portfolio. Many times sectors or themes can be over- or under-weighted in a low-turnover, passive fashion that does not depend on short-term signals or price movements.

##### **5. *Keep the portfolio in place over the long haul.***

Each time the advisor changes his mind, the portfolio is exposed to taxation. Broad diversification is suitable for an extended horizon, and the core will still be diversified in a generation's time. A good tax-efficient core manager will maintain this diversification and will buy into evolving technology companies, for example, at lowest tax cost.

### **Conclusions**

For efficient tax management, the advisor needs to focus on more than the selection of a tax-efficient manager, he must design the equity structure well. This requires forethought and attention to detail. A poor design requires expensive maintenance and undermines other attempts at tax-efficiency.

We have identified four types of capital gain taxation lurking to trap the unwary: the portfolio manager's alpha tax; the rebalancing tax; the manager selection tax, and the benchmark reconstitution tax.

To avoid these taxes, we in the industry need to reject the conventional wisdom and embrace a new portfolio structure model. This model features a broad core equity investment that is passive and tax managed, and allows for concentrated active managers with relatively small portfolios who are unconstrained with respect to risk and are not too focused on taxes.

This simpler approach makes regular review, decision-making and rebalancing much easier. By keeping this structure in place for a generation or longer, the taxable investor can achieve returns superior to that of the traditionally partitioned portfolio structure.

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