

# PARAMETRIC PERSPECTIVES

NEWSLETTER

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“The Bush tax cuts are something that we plainly can’t afford moving forward. Whether it expires or whether we repeal it a little bit early we’ll determine later, but it’s going to go.”

- David Axelrod  
Obama Senior Advisor

## ► Tax Rates Are Going Up - Boost Tax Alpha Now!



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With the sunset of historically low capital gains rates on the horizon and the potential of higher tax rates due to the approval of the health care reform bill (not to mention the sizeable increase in the Federal deficit) now is the time to consider enhanced tax management strategies for your clients.

### Exhibit 1: MAXIMUM FEDERAL TAX RATES

Maximum Federal Rate on:	Prior Tax Rate	2003 JGTRRA Tax Rate	2005 TRRERA Sunset Provision Expiration	2011 Tax Rates According to Current Budget Proposal*
Stock Dividends	38.6%	15%	December 31, 2010	20%
Long-Term Capital Gains	20.0%	15%	December 31, 2010	20%
Short-Term Capital Gains	38.6%	35%	December 31, 2010	39.6%
Ordinary Income (includes interest)	38.6%	35%	December 31, 2010	39.6%

\*These are our conservative estimates. If the Patient Protection and Affordable Care Act and the related Reconciliation agreement are all signed into law, beginning 2013 investors could expect an additional 3.8% increase in capital gains rates.

One strategy to reduce the sting of an impending tax rate increase is to pay taxes now before rates go up. Clients considering an allocation shift or liquidation may find that it is advantageous to expedite their plans and execute in the lower tax environment. Another strategy, specifically applicable to tax managed portfolios, is to realize long term gains today to improve loss harvesting opportunities in the future. Our research shows that due to the difference between long-term and short-term capital gains rates it is possible to increase the potential future tax alpha of a portfolio by realizing long-term gains and refreshing the portfolio's cost basis. However, there is a tradeoff between the initial tax cost and the expected future benefit. Parametric can provide you with a simulation analysis to help you decide whether or not this strategy is suitable for your clients.

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## How It Works

Through loss harvesting and tax management, the realization of gains in a typical tax managed portfolio is deferred. As unrealized gains accumulate in the portfolio, less of the portfolio is available for loss harvesting and tax alpha is reduced. One can increase the loss harvesting potential of the portfolio by realizing long-term gains and reinvesting the proceeds. Exhibit 2 shows a hypothetical portfolio tax alpha over five years with and without the initial realization of gains:

Exhibit 2:

	Current	Realize 10% LT
Market Value	8,900.0	8,900.0
Cost Basis	5,750.0	6,000.0
Cost/Market Ratio	0.65	0.67
Average Tax Alpha from Loss Harvesting (5Y)	0.95%	1.10%
Initial Market Value of Lots Sold		1,540.0
Initial Realized Net Gains		237.0
Cost/Market Lot Threshold		0.72
Immediate Tax Cost		(\$36)
FV Estimated Additional Tax Benefit 5Y		\$72
Annualized 5Y Add'l Tax Benefit Return		20%

In thousands, as of 04/12/2010. Tax benefit based on mid-range tax alpha, discount rate of 4%. Example of potential additional tax alpha generated by realizing 10% of the portfolio's long-term gains. Estimated results are produced through a Monte Carlo simulation. Assumes current LT/ST tax rates of 15/35, future tax rates of 20/39.6, market return of 8% and 35% stock volatility. Actual portfolio results will vary.

In Exhibit 2, notice how the tax alpha in the current scenario is .95%. By realizing 10% of the portfolio's long-term gains, we can potentially increase the tax alpha to 1.10%. Another way to evaluate this strategy is to consider the additional tax benefit compared to the initial tax cost. In this case the \$36K initial tax cost generated an estimated, additional \$72K tax benefit, which constitutes a 20% annual tax benefit return based on the initial tax cost.

## Important Considerations

The additional future tax alpha requires an initial upfront tax cost – in this case \$36K. The initial tax cost of \$36K or 40 bps is compensated by the 75 bps of additional tax alpha estimated over the next five years. The additional tax alpha is produced by realizing long-term gains today to increase the potential to generate short-term

losses that can be used to offset short-term gains in the future. If your client does not expect realized short-term gains in the future this strategy may not be effective in increasing tax alpha.

## Is Long Term Gain Realization Right For Your Clients?

Every portfolio is different, and it is important to consider the costs and potential benefits before realizing long-term gains in your client's portfolio. Parametric can assist in this decision by providing an analysis outlining the potential tax alpha and estimated tax costs. For a more detailed explanation/description of this strategy see David Stein's paper: "Enhanced Tax Rate Management: Expanding Loss Harvesting to Offset Short-Term Capital Gains." You can request a copy of this paper and an analysis of your client's portfolio from your Parametric representative.

## ► Black Swans in Emerging Markets

By Joe Wawrzaszek

Research by Javier Estrada in the Journal of Investing (Summer 2009) on daily stock returns over the last 20 years reveals that extreme events—loosely defined as rare occurrences with outsized impacts (think Black Monday)—occur with greater frequency and magnitude in emerging markets than in their developed counterparts.

The increased frequency and impact of extreme events in emerging markets underscores the importance of Parametric's diversified approach. An examination of daily returns data for 16 emerging market countries over the past 20 years found that missing the 10 best days "resulted in market portfolios 69.3% less valuable than a passive investment." Worse, missing the top 20 and 100 days reduced portfolio values by 84.8% and 99.4%, respectively.

Extreme events, however, are difficult to predict, making market timing an even more difficult challenge. Indeed, 10 days accounted for less than one-fifth of one percent of the average number of trading days examined in the study.

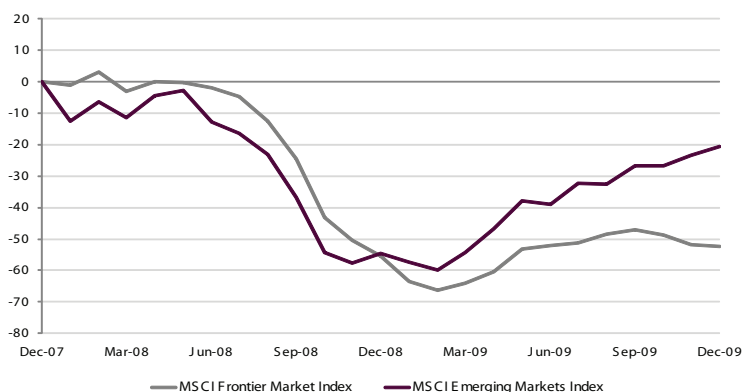
While successful market timing in emerging markets can yield supernormal returns, "active" investors are more likely to assume disproportionate risks in the process, both in terms of missed opportunities and potentially magnified losses. Because of this, Parametric reiterates that diversification should play a central role in the investment decision-making process, especially in the current market environment.

## ► The Tale of Two Markets: Crisis and Recovery in the Emerging Markets By Brian Dillon

It was the best of times, it was the worst of times...or was it the other way around? In 2008, the MSCI Emerging Markets Index<sup>®</sup> posted the largest single-year drop in its 20+ year track record, wrapping up 2008 with a -53.33% return. During much of that year Parametric's Structured Emerging Market strategy outperformed the index. As markets began to reel during the second part of the year, the emerging markets experienced heightened levels of volatility. It was during the highest points of volatility that the strategy outperformed significantly. Our structural underweights to the largest countries and overweights to the smaller countries provided a benefit to relative performance, since capital outflows were concentrated in the largest emerging market countries.

The main driver of relative performance in 2009 was the structural exposure to the frontier markets. While the frontier markets posted positive returns for the year, their outstanding performance did not keep pace with the explosion of the more developed emerging markets (up 78%). The very same structural underweights to the largest countries and overweights to the smaller countries, which provided outstanding downside protection in 2008, dampened performance during this tremendous updraft. Further examination of how differently the MSCI Frontier Markets Index<sup>®</sup> behaved as compared to the MSCI Emerging Markets Index<sup>®</sup> reveals much about the nature of these returns during 2008 and 2009. Throughout the course of 2008, the frontier markets handily outperformed the emerging markets on a relative basis until the final few trading days of the calendar year. Once that inflection point occurred, the emerging markets advanced well above the frontier markets throughout the course of 2009. In the first part of 2010, this trend has reversed with the frontier markets again outperforming emerging markets.

RETURNS OF MSCI FRONTIER MARKET INDEX VS. MSCI EM INDEX



Source: Bloomberg

It is our position that a structured investment philosophy provides effective long-term diversified exposure to the emerging markets asset class. Especially during times of uncertainty, a consistent rules-based approach mitigates negative investor behaviors. With this long-term, risk-adjusted focus, Parametric endeavors to invest in a consistent fashion despite record-setting levels of volatility. It is through thoughtful, disciplined implementation that Parametric strives to effectively manage volatility in even the most challenging markets.

### What's New at Parametric:

**Structured International:** Parametric has launched a new Structured International strategy for institutional and individual investors. We have managed seed capital in the strategy since January 2009 and are 2.18% above the MSCI EAFE Index since inception as of 3/31/2010. Current assets under management in the strategy, as of 3/31/2010, are \$28.5 million. The strategy follows a similar investment philosophy to our Structured Emerging Markets strategy: avoid concentration, reduce portfolio volatility, and rebalance systematically.

**TMC White Paper:** Parametric has published a new white paper, "Tax-Efficient Investing in Theory and Practice" by Paul Bouche, our Director of Research. The goal of the paper is to relate tax-management theory to a set of practical solutions for investors. Please visit our website to view the paper.

**Global ADR Portfolios:** Parametric is excited to announce an advanced capability that allows us to significantly lower the minimum investment size for several Global ADR portfolios. Portfolios managed to many global indices will now be available at minimums of \$250,000. This move will enable tremendous flexibility for many of our advisors who have adopted a core/satellite portfolio structure and view the core equity allocation from a global perspective. Benchmarks include:

- MSCI World<sup>®</sup>
- FTSE RAFI Developed 1000<sup>®</sup>
- KLD Global Sustainability<sup>®</sup>
- Dow Jones Islamic Developed Market<sup>®</sup>



## ► Fundamental Indexing Performs Well Through the Crash

By Paul Bouchey



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### About Parametric

Parametric is an industry-leading provider of structured portfolio management, headquartered in Seattle, Washington. Parametric and its affiliate, Parametric Risk Advisors, offer a variety of structured portfolio solutions, including customized core equity portfolios (U.S., Non-U.S., global), options strategies, and overlay portfolio management.

### Total AUM:

\$36 Billion\*

\*This figure represents the combined AUM of Parametric and its affiliate Parametric Risk Advisors. As of 3/31/2010.

### Established:

1987

Investors have become more flexible in their definition of “beta”. Many have looked to fundamental indexes that are not capitalization weighted, like the RAFI® indexes, for their core exposure. Parametric manages more than \$4 billion dollars in RAFI strategies for both individual and institutional investors.

One of the appealing aspects of the fundamental indexing approach is that it is structured. There are clear rules for constructing the index and this leads to a disciplined investment process. For example, during the March 2009 reconstitution, the FTSE RAFI 1000® index rebalanced back into Financials which had become underweighted from a fundamental point of view. Thinking back to those dark days of the first quarter of 2009, most investors

would have found it difficult to rebalance into financial stocks. In hindsight, it was absolutely the right move. The index earned double digit excess returns because it was a structured process, not driven by fear or greed. It was fortuitous that the reconstitution date fell right at the bottom of the market, but nevertheless it is a strong demonstration of the value of structured investing. The total returns for the S&P 500 and Russell 1000 for ten years ending 2/28/2010 are essentially flat, -0.31% and -0.09% annualized respectively. The RAFI 1000 index earned 6.05% annualized over the same period. These results are stronger than what was predicted by research and are likely due to the fact that markets whipsawed more significantly in 2008 and 2009 than in the last 60 years.

### Disclosures

Parametric is a majority owned subsidiary of Eaton Vance Corporation. Returns reported herein are preliminary and may be subject to change at anytime. This information is intended solely to report on investment strategies and opportunities identified by Parametric Portfolio Associates. 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. References to specific securities and their issuers are for illustrative purposes only and are not intended to be, and should not be interpreted as, recommendations to purchase or sell such securities. Please note that investments in foreign securities and markets pose different and possibly greater risk than those customarily associated with domestic securities, including currency fluctuations, foreign taxes and political and economic instability. Past performance is no guarantee of future results. Performance presented gross of investment advisory fees represents the investment performance record for a size-weighted composite of similarly managed, unconstrained discretionary accounts. The deduction of an advisory fee reduces an investor's return. Actual account performance will vary depending on the size of a portfolio and applicable fee schedule. Fee information described in Part II of Parametric's Form ADV is available upon request. The views and strategies described may not be suitable for all investors. This material has been prepared for informational purposes only. Parametric does not provide legal, tax and/or accounting advice. You should consult your tax or legal advisor regarding such matters. Please contact your account manager for further information.