



THE TAX ADVISOR: The Case for Loss Harvesting

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Tax loss harvesting is still underutilized by separate account managers

The presence of taxes should affect the way an investment portfolio is managed, but most portfolio managers are not sensitive to tax issues. Indeed, investment performance traditionally has been measured on a pre-tax basis only. This should not come as a surprise given the origins of money management. First, the bulk of professionally managed assets were for tax-exempt investors such as pension plans, endowments, and personal retirement accounts. Second, active managers are typically unwilling to compromise security selection for tax considerations. Fortunately, the tax management technique known as tax-loss harvesting is increasing in popularity. According to a recent survey conducted by The Money Management Institute, more than 70% of money management firms have seen an increase in loss harvesting during the last three years. This is significant because taxable separate accounts traditionally have not been managed with an eye toward taxes, even though this is a key benefit to having a separate account. A 2002 Cerulli Associates report concluded that less than one third of taxable separate accounts benefit from special tax treatment.

The MMI study also showed that the increase in loss harvesting is a result of client requests instead of coming from advisors, programs, or proactive money management strategies. Among accounts using loss harvesting strategies, clients were responsible for 77% of the requests. The survey also found that loss harvesting is used often in both bear and bull markets, with 43% of MMI respondents reporting no significant difference in their use of loss harvesting in positive months versus negative months.

Taxable investors should cheer this study. If clients are asking for loss harvesting, the managers and separate account platforms will eventually offer it as a standard and systematic feature. In fact, wrap programs are pointing to tax management as a key feature in the new, rapidly growing category in managed accounts—multistyle portfolios or unified managed accounts (UMA) with tax overlay management.

Not every manager who claims to be tax sensitive achieves it the same way or at the same level, however. It is critical to evaluate the manager's tax management skills based on a keen understanding of the manager's process, just as an investor would evaluate the stock picking acumen of an active manager. To understand what loss harvesting offers, it is important to know how market conditions set the expectation of the potential benefits delivered.

Simply defined, loss harvesting is a process that realizes capital losses within the portfolio. When pursued properly, whether by active stock pickers or passive managers, it will allow for similar pre-tax performance (versus non-tax managed accounts) while delivering a significantly better after-tax result. Loss harvesting enhances after-tax returns by creating losses in order to mitigate gains. To the extent there are excess realized losses from one portfolio, those losses can be used to offset any other capital gains that the investor may incur that year. Under current law, unused losses can be carried forward indefinitely.

Some loss harvesting approaches can add from 0.50% to 1.50% of after-tax performance (average annualized over 10 years) versus their benchmarks.

In practice, loss harvesting is a relatively straightforward technique as long as the portfolio manager takes into account several key considerations with respect to portfolio structure and trading. For example, risk management considerations have the potential to reduce loss

harvesting because of constraints such as sector and industry alignment that may be applied in order to maintain a portfolio that tracks its respective benchmark. Transaction costs must also be considered when evaluating the benefit of the losses versus the cost of the trade. Harvesting too frequently may not enhance after-tax returns significantly, but could lead instead to higher levels of turnover and transaction costs.

Source of the Value

Much of loss harvesting's benefit is derived from the optionality of realizing gains. A thoughtful investor has the option to pay a capital gains tax either at the present time or at some point in the future. Although the tax has to be paid eventually, the value of deferral can be significant, especially when compounding over a long horizon. Loss harvesting is also valuable in lower return environments since the tax rates apply regardless of gross returns. One does not need to be an expert in financial analysis to understand that paying taxes on a 6% return is more painful than taking the hit on a 20% return.

Deferring the gain is not the only benefit. There is significant benefit to what is, in effect, a tax rate swap. Imagine realizing short-term losses to offset short-term gains and avoiding the 35% Federal tax rate for such gains in the current year. When realizing the loss, the basis of the portfolio is reduced. Later, when some or all of the holdings are sold, the investor triggers the gain that had been deferred. If the securities were held for longer than one year, the gain is long-term in nature and taxed at the favorable 15% rate. The rate spread provides a permanent difference, effectively reducing the tax rate by nearly 60%.

Some sophisticated managers employ strategies that involve the early realization of long-term capital gains at the favorable 15% tax rate. In doing so, they reset a portion of the portfolio's basis and replenish the portfolio with short-term holdings. This is done to take advantage of the opportunity to harvest valuable short-term losses in order to shelter the higher-rate short-term gains (35%) that many investors are receiving from alternative investments such as hedge funds. Much of the performance from hedge funds comes from realized gains, an estimated 60% or more of which may be characterized as short-term gain. This can be an effective approach for investors with significant allocations to alternate investments where the investor expects a continuing stream of short-term gains.

When evaluating managers for tax management or loss harvesting prowess, financial planners should look for managers who have made it a central part of their process. These managers realize that the tax and performance balancing act needs to occur throughout the year. By calibrating the tax impact of all buys and sells, not just those at year end, they provide the greatest chance of maximizing after-tax returns. The CFA Institute has provided after-tax performance standards to the industry for a number of years, and a strong indicator of a manager's focus on these issues is whether he furnishes after-tax performance reports. After all, the bottom line for the taxable investor is the after-tax performance that he can spend!

Not Just Loss Harvest Engines

Whether active or passive as to security selection, a manager who employs loss harvesting is not buying securities in hopes that they will go down. He is merely dealing with the reality that there may be losses at any given time in the portfolio. It is essential to evaluate whether the loss harvesting process will help meet the portfolio's performance objective and reduce the tax bite.

Generally, the benefit of loss harvesting increases with the level of volatility in the market. Markets combine varying levels of direction, strength, and volatility, so clients will have different experiences depending on when they fund their account. For example, investors funding in 1998 enjoyed strong equity returns, but because of high volatility they had ample loss harvesting opportunities. In 2005, we have seen relatively low volatility providing few windows for loss harvesting. That said, the talented tax manager can still add more value than a tax-oblivious competitor even in low loss harvesting environments. These managers have ways to capture tax savings from this more episodic volatility, thus providing benefit to justify the cost of the trade. Managers who look to take losses only in the fourth quarter will typically capture a fraction of the losses available.

For many active managers, loss harvesting is a distraction to their core focus on securities selection. These managers should be selected for the right reasons since loss harvesting may materially compromise their performance. For the right passive managers, tax loss harvesting should come more easily as they are tracking a benchmark instead of trying to beat it, and they should find it easy to identify suitable replacement securities for their loss harvest trades. It is critical to remember that the primary objective for these managers is capturing the return of a benchmark. Asking them to deviate from that benchmark to garner tax savings will compromise the pre-tax objective without guaranteeing successful tax loss harvesting.

Since after-tax returns are the only returns that really matter to an investor, and because taxes are the single highest investor cost, loss harvesting is a technique that investors cannot afford to ignore. Yet despite its advantages, it traditionally has not received the attention it deserves. Today, however, taxable investors and their advisors have a renewed appreciation for the role that loss harvesting can play, which is resulting in an increase in its popularity. In addition, the growth of personal assets, increased investment education, and heightened investor participation are contributing to the awareness of loss harvesting. Importantly, managers and program sponsors are stepping up their efforts through improved processes and technology to make tax management available as a regular feature. Investors can find the right fit for them by finding managers or separate account programs that have tax management embedded in their approach, applied systematically throughout the year, and by regularly monitoring the pretax versus after-tax tradeoff.

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