

PARAMETRIC PERSPECTIVES

NEWSLETTER / ISSUE NO. 11 / FALL 2010

NEWSLETTER HIGHLIGHTS

Active Tax Management	01
Industry Update: ESG Investing	02
The Performance Hurdle for Active Managers is Going Up!	03

► Active Tax Management: Across the Decades and Through the Crisis

by David M. Stein



David Stein is Chief Investment Officer at Parametric.

It is October 2010, and if the US Financial crisis is not over, markets are certainly more stable and investors are more confident than they were two years ago. It is time to take a breather and, in the light of the crisis, to revisit (1) our long-term investment philosophy and (2) the strategy of Active Tax Management in equity portfolios, a topic we have been working on for almost twenty years.

Investing in Times of Stress

After all the claims over many years by market seers who promise to make us money and protect us from disasters, I am still largely skeptical. Markets are cleverer than you, or I, or any other thoughtful persons. We love to talk of risk and volatility as though we know what they are and can control them. The trouble is that volatility, as a measure of uncertainty, is a measure of our lack of knowledge. Particularly when volatility is high we need to recognize that we don't know much. This is hard for many of us. Randomness and volatility are not new. What is surprising, is that volatility was so low for so long, and that so many people came to expect stability. While it is true that the financial-services industry could do more to serve investors, investors too need to recognize that some of their goals are unreasonable; they should expect the unexpected.

The key investment issue, then, is not one of predicting returns but of addressing this question: What should you

do when you don't know? The answers are very simple, relatively boring, and don't change year-to-year:

- Focus on the long term
- Manage risks, costs, and fees very carefully
- Actively manage taxation

One can't easily outperform the markets by being clever, but there are some things that one can do. One example is to reduce volatility by rebalancing sensibly: mathematically, this increases the expected growth rate, the portfolio's compounded return, over the long haul. This idea is embodied in our Structured Emerging Market, Structured International and Structured Commodity strategies.

Active Tax Management

Another thing one can do is to actively manage taxes. Taxes are a first order expense. Theory tells us that one can add substantial value by doing this well. Also, equity portfolio structure is key: one should separate the goal of achieving beta from the search for alpha; one should also separate tax-management from the search for alpha.

What is active tax management? Here are a few examples:

- Customization at key strategic events. Portfolio construction requires an ongoing tradeoff between where you'd ideally like to be and the tax cost of getting there; and it is good to be positioned where only small changes will be required. There are times when one should be particularly

continued on p. 2

Active Tax Management continued...

cautious with respect to taxation—for example, when you transition assets from one money manager to another, when you raise cash, when you make gifts to beneficiaries or donate to charities.

- Balance the tax cost of the search for alpha against the value of this alpha. This cost is higher than most people realize, often costing 2% or more in taxes per year for equity managers, far more for hedge funds.
- Integration of taxes with estate planning or (in the case of corporations) corporate reporting.
- Arbitrage the differences among tax rates: i.e., between income and capital gains rates; short-term and long-term rates; and current and future rates.

While it is hard to anticipate the value of some of these, or even to precisely measure their value in retrospect, here is one activity that is easier to measure:

- Active Gain and Loss Realization. This activity derives its value from the exploitation of a tax-option that the IRS provides investors. Perhaps because it is measurable,

many investors and advisors focus too much on loss-harvesting alone.

What is active tax management worth? As researchers, we have projected this with theoretical models for some time; we can now study performance that investors have actually experienced over the past years. It turns out that the theoretical models have often been conservative, and that live portfolios have outperformed predictions. For many investors, loss-harvesting alone has provided an after-tax excess return (that is, above a passive ETF or Indexed mutual fund) of between 1.50% and 2% per year over a ten-year period.

After-tax performance evaluation, though necessary, is more complex than that of pre-tax performance evaluation. In particular, be careful when reviewing after-tax composite performance—the idiosyncratic nature of tax management and the way composites are constructed means an individual portfolio cannot have the same experience as the composite. Also, it is a good thing when a broadly diversified portfolio matures to a state where its cost basis is a low proportion of its market value.

For active tax management, past performance is a predictor of future performance.

Conclusions

How have our ideas changed? Our own convictions remained stable, and have now been validated by extremes of market behavior. If tax rates increase, the value of active tax management will increase too. Over the years, however, we have become more sensitive to the role of volatility, and have extended our exploitation of volatility from tax management to other rebalancing approaches.

Despite media sensationalism, not that much is really new (and, much of what is new is not good!). Good investment strategies often are boring. We have seen many active ideas come and go. There is currently willingness by some to embrace tactical decision-making in an attempt to avoid the next bubble, or market decline. Those investors ignore that this endeavor incurs large costs and adds risk; there is no reason to think that tactical decisions have become any easier to make.

A final thought: the romantic poet Keats spoke about a key characteristic of a man of achievement that he called Negative Capability: “[Such a man] is capable of being in uncertainties, mysteries, doubts, without any irritable reaching after fact and reason.” That is, he is comfortable with his lack of knowledge and can live with volatility.

► Industry Update: Environmental, Social, Governance (ESG) Investing

by Joe Wawrzaszek, CFA

MSCI's transition on September 1, 2010 of the FTSE KLD Indices to a new series of environmental, social and governance (ESG) indices confirms a growing appetite for ESG products by introducing a broader platform for these indices and related products going forward. More than just a name change, the rollout of the MSCI ESG Indices introduces both refined methodologies for scoring and monitoring companies against ESG criteria, and a new strategy for establishing benchmark targets for eligible securities. The emphasis signals an evolution from more

traditional screening techniques that have primarily advocated a restrictive approach to investing.

A precursor to ESG investing, socially responsible investing (SRI) paved the way for socially-concerned institutional and private investors to achieve a desired exposure—say the S&P 500—by excluding companies associated with activities deemed inconsistent with the investor's values. Common examples of these exclusions include companies with significant involvement in alcohol, firearms, gambling, and tobacco. Beneficent desires

continued on p. 4

► The Performance Hurdle for Active Managers is Going Up!

by Rey G. Santodomingo, CFA, and Timothy W. Atwill, CFA, PhD

The decision between a passive and an active investment strategy is typically framed as a choice between costs and performance. Passive strategies are widely recognized to have lower costs (e.g. lower management fees, more tax efficient), but in exchange the investor gives up the expectation of excess returns. In contrast, the costs associated with active management are higher than comparable indexing strategies, with the expectation that active management will result in positive excess returns (an expectation which is not always met). In order for an active strategy to make economic sense, the expected outperformance, or alpha, must be larger than the added costs incurred by active management. As such, this difference is often referred to as the “performance hurdle”.

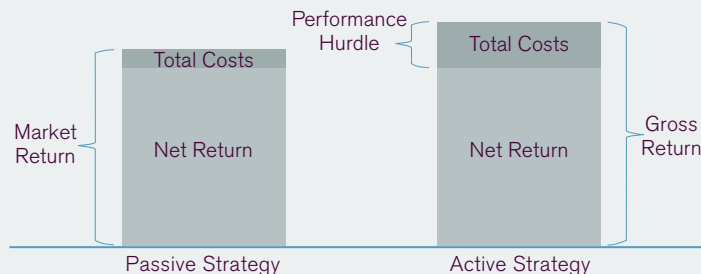
It is well known that the high turnover common with active strategies can lead to tax costs. The average turnover for mutual funds in Morningstar’s database is 70 percent. *With higher tax rates on the horizon, the cost of turnover is set to rise.* The increase in an active strategy’s tax costs (and hence its performance hurdle) is sensitive to the portfolio’s rate of turnover and the market return. More turnover and higher market returns lead to more realized gains and higher tax costs.

Exhibit 2, below, shows estimated performance hurdles for an active strategy corresponding to various combinations of turnover and market return assumptions.

We first calculate the after-tax liquidation value after 20 years of investment in a passive strategy with 5% turnover and a 25 basis point fee. We assume a 1.5% dividend yield, and that tax rates revert to 20% for long-term gains and dividends and 39.6% for short-term gains.

We then perform the same calculation for an active strategy with higher turnover and a 75 basis point fee. If we assume the same total return for both strategies, then clearly the higher turnover and higher fee strategy will have a lower ending value. So, we ask the question, how much would the total return of the active strategy have to

EXHIBIT 1: ACTIVE MANAGER PERFORMANCE HURDLE



increase to end the 20 years with the same amount of money as the passive approach? This is the performance hurdle.

For example, in an 8% market return environment, an active manager generating 70% turnover must consistently beat the market by 2.3% in order to achieve the same net annualized return as expected for a passive strategy over 20 years.

Given the above, when evaluating an active strategy, it is important to consider the manager’s ability to deliver excess return above their fees, expenses and incremental tax costs. As tax rates go up the performance hurdle for active managers will go up as well. The table below should be referred to when considering an active manager or reviewing current managers’ active strategies. Given a manager’s annual turnover, one can better judge if the manager is still likely to consistently generate sufficient alpha to overcome its performance hurdle. If not, a passive strategy—especially a tax-managed passive strategy—would be the better choice.

Rey G. Santodomingo, CFA, and Timothy W. Atwill, CFA, PhD, are Senior Research Analysts at Parametric.
rsantodomingo@paraport.com
tatwill@paraport.com

EXHIBIT 2: THE ACTIVE MANAGER PERFORMANCE HURDLE IN A HIGHER TAX RATE ENVIRONMENT

TOTAL RETURN (%)	TURNOVER (%)											
	5%	10%	20%	30%	40%	50%	60%	70%	80%	90%	100%	
6%	0.5	0.6	0.8	1.0	1.1	1.3	1.5	1.7	1.8	2.1	2.3	
8%	0.5	0.7	1.0	1.2	1.5	1.7	2.0	2.3	2.6	2.9	3.3	
10%	0.5	0.7	1.1	1.5	1.9	2.2	2.6	3.0	3.4	3.8	4.3	
12%	0.5	0.8	1.3	1.8	2.3	2.7	3.2	3.7	4.2	4.8	5.4	

Assumptions: index turnover rate 5%; index fee 0.25%; active management fee 0.75%; gains realization rate equal to turnover; dividend rate 1.5%; dividend tax rate 20%; short-term capital gains tax rate 39.6%; long-term capital gains tax rate 20%; time horizon 20 Years.



Parametric™

Leaders in Structured Portfolio Management

1151 Fairview Avenue N.
Seattle, WA 98109
T 206 694 5500
F 206 694 5581
www.ParametricPortfolio.com

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:

\$ 35 Billion*

*This figure represents the combined AUM of Parametric and its affiliate Parametric Risk Advisors as of 9/30/2010.

Established:

1987

Industry Update

continued from p. 2

notwithstanding, some investors have shied away from SRI over concerns of performance.¹ These investors may be most intrigued by the new ESG investment options.

While ESG investing resembles in spirit some of the fundamental objectives of SRI, the terms are incorrectly used interchangeably. An ESG approach follows a different path to supporting socially-minded causes. Indeed, ESG-related offerings are increasingly focused on delivering alpha through an investment selection process geared to identify companies that may outperform those with lower ESG scores. Whereas SRI seeks an investable subset of companies that remains after employing a host of screens (sometimes eliminating entire industries in the process), ESG investing endeavors to construct an investable universe of companies whose practices best promote, or otherwise embody, such issues as community, environment and sustainability.

Other investments that pair social welfare considerations with opportunities for alpha include a burgeoning set of 'Green' initiatives designed to capture the performance of companies associated with certain environmental movements, including: reducing carbon emissions, energy usage, water consumption, hazardous waste and promoting employee safety, workplace diversity and community involvement.

A leader in customized, index-based portfolios, Parametric currently manages approximately \$1 billion in client assets in accordance with SRI and ESG mandates and is well-positioned to balance specific investment objectives against tax considerations and transaction costs. For more information, or to request an analysis of your client's portfolio as well as more information about SRI, ESG and Green Index capabilities and products, please contact your Parametric representative.

¹ It is worth pointing out that some SRI measures, including the FTSE KLD 400 Social Index (now known as the MSCI KLD 400 Social Index), have outperformed non-SRI indices (like the S&P 500) during the past five years. Past performance does not predict future results.

Joe Wawrzaszek is an Assistant
Portfolio Manager at Parametric.
jwawrzaszek@paraport.com

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.