INVESTOR CHALLENGE

Client Transitions from Underperforming Active Manager to Custom Core®, Maximizes Tax Efficiency

CHALLENGE

An advisor's client was unhappy with the performance of an active manager but leery of a transition that would trigger a large tax bill.

SOLUTION

Parametric ran a proprietary transition analysis that examined the tax and tracking-error trade-offs of moving to a passive portfolio.

RESULTS

The client now holds a more diversified, tax-efficient portfolio with reduced risk relative to the target index.

Challenge

An advisor brought on a new client who held a separately managed account (SMA) with an underperforming US large-cap value manager. Given the investor's unhappiness with this manager's inability to outperform, the advisor recommended a more passive and broader US large-cap index exposure. However, even though the manager underperformed its stated benchmark, the market's upward movement meant the SMA held a number of highly appreciated securities. Simply selling out of the client's existing SMA would trigger the realization of a large capital gain and, with it, a huge related tax cost.

So even though the client and the advisor both lost confidence in the active manager, the primary hurdle preventing them from acting was the tax ramifications of shifting the client's SMA toward a more index-like exposure.

Simply selling out of the client's existing SMA would trigger the realization of a large capital gain.

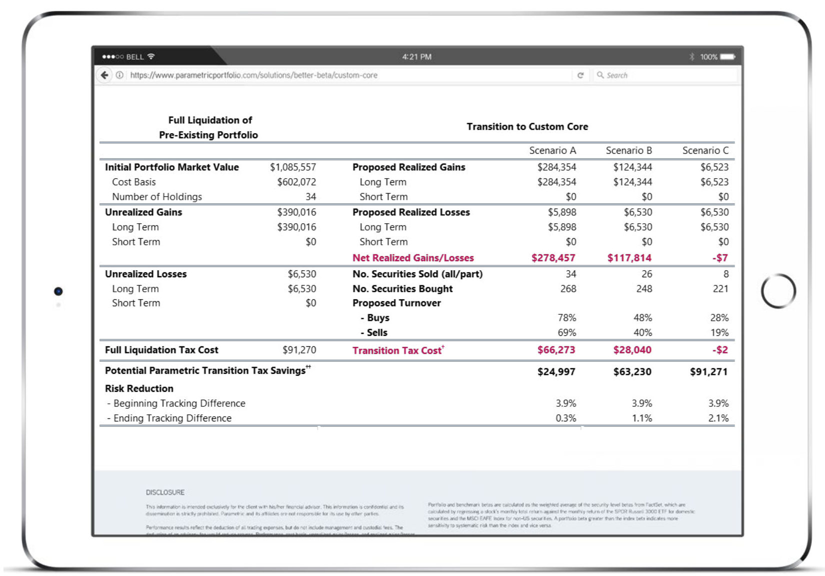
Parametric solution

Taxes often present a formidable hurdle for investors looking to transition from one portfolio to another. However, Parametric has designed a broad tool kit to help investors and their advisors balance the capital gains they're willing to realize against an acceptable percentage of tracking error to the desired benchmark exposure.

In this case the advisor wanted to remove the value tilt from the client's concentrated portfolio of large-cap value stocks and move the portfolio to a broad market exposure. Accordingly, the first step was to designate the target exposure as a US large-cap-weighted index, with no notable value tilt.

Once Parametric determined this target, we built a transition analysis to explore the tax implications of moving closer to the desired target exposure via a Parametric Custom Core® SMA. Because the current SMA had embedded gains, the client didn't want the transition to create a significant taxable event but was willing to incur some tax to move closer to the target benchmark.

Sample transition analysis



Full Liquidation of Pre-Existing Portfolio		Transition to Custom Core			
			Scenario A	Scenario B	Scenario C
Initial Portfolio Market Value	$1,085,557	**Proposed Realized Gains**	$284,354	$124,344	$6,523
Cost Basis	$602,072	Long Term	$284,354	$124,344	$6,523
Number of Holdings	34	Short Term	$0	$0	$0
Unrealized Gains	$390,016	**Proposed Realized Losses**	$5,898	$6,530	$6,530
Long Term	$390,016	Long Term	$5,898	$6,530	$6,530
Short Term	$0	Short Term	$0	$0	$0
		Net Realized Gains/Losses	**$278,457**	**$117,814**	**-$7**
Unrealized Losses	$6,530	**No. Securities Sold (all/part)**	34	26	8
Long Term	$6,530	**No. Securities Bought**	268	248	221
Short Term	$0	**Proposed Turnover**			
		- Buys	78%	48%	28%
		- Sells	69%	40%	19%
Full Liquidation Tax Cost	$91,270	**Transition Tax Cost†**	**$66,273**	**$28,040**	**-$2**
Potential Parametric Transition Tax Savings††			**$24,997**	**$63,230**	**$91,271**
Risk Reduction					
- Beginning Tracking Difference			3.9%	3.9%	3.9%
- Ending Tracking Difference			0.3%	1.1%	2.1%

DISCLOSURE

This information is intended exclusively for the client with his/her financial advisor. This information is confidential and its dissemination is strictly prohibited. Parametric and its affiliates are not responsible for its use by other parties.

Performance results reflect the deduction of all trading expenses, but do not include management and custodial fees. The

Portfolio and benchmark betas are calculated as the weighted average of the security level betas from FactSet, which are calculated by regressing a stock's monthly total return against the monthly return of the SPDR Russell 3000 ETF for domestic securities and the MSCI EAFE Index for non-US securities. A portfolio beta greater than the index beta indicates more sensitivity to systematic risk than the index and vice versa.

PARAMETRIC

INVESTOR CHALLENGE

To help understand the trade-offs of incurring taxes and reducing tracking error, Parametric created a set of custom transition analyses involving the SMA holdings and the target index. This report provided a number of scenarios, ranging from a full transition (moving the portfolio into complete alignment with the benchmark, regardless of taxes) to one with very high tracking error (and less realization of taxes). The advisor then walked through these scenarios with the client to investigate which scenario best aligned with the client's goals. The client chose a middle path that resulted in some taxable gains being realized while maintaining a moderate degree of tracking error with the selected target exposure. As part of this transition, the advisor also asked Parametric to seek to reduce the tracking error over time via the reinvestment of dividends and the proceeds of future loss-harvesting trades.

To help understand the trade-offs of incurring taxes and reducing tracking error, Parametric created a set of custom transition analyses.

Results

The client no longer holds a concentrated, highly appreciated portfolio that reflected the views of an active manager in whom the client no longer had confidence. Instead the client holds a more diversified, tax-efficient portfolio with reduced risk relative to the target index. Over the course of time, the deviation between the client's portfolio and the target index will be whittled down by Parametric's continuous management efforts, opportunistically using cash flows and loss-harvesting proceeds to remove the largest deviations between the index and the portfolio.

At Parametric, we manage more than $134 billion in assets in Custom Core accounts alone.* Paying close attention to tax management while maintaining adherence to the client's desired benchmark is a critical component of our comprehensive approach.

Now the client holds a more diversified, tax-efficient portfolio with reduced risk relative to the target index.

*As of 12/31/2020

Find more insights and research at parametricportfolio.com

30388 | 9.15.2021