TAX-EFFICIENT EQUITY INVESTING

A Primer from Parametric
ACTIVE TAX-MANAGEMENT TECHNIQUES
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KEY TAKEAWAYS

> There are six basic tax-management techniques that managers of taxable assets should employ.

> Tax-management context (i.e. choice of investment vehicle) matters.

> Portfolio structure for taxable investors has evolved from tax-inefficient style-box investing to a tax-friendly core-satellite approach with centralized tax management.

> Thoughtful tax management can boost gross after-tax returns by an estimated 1% to 2% per year—results borne out by actual client experience over the past 20 years.

Active tax-management involves more than just letting gains run and cutting losses at the end of the year. It requires year-round attention to the trade-offs among risk, return, and taxes whenever an investment decision is made. Decisions that have a taxable component include selling an investment, changing benchmarks, changing managers, making contributions and withdrawals, giving to charity, and rebalancing the asset allocation.

Investment managers have six basic ‘tools’ at their disposal to help build a comprehensive tax-management strategy:

- **Defer the Realization of Gains.** A manager has to choose to sell an asset with an imbedded gain in order to incur a tax obligation. If instead the manager chooses to hold the security, the tax is deferred. This deferral is mathematically identical to receiving a zero-interest loan from the government in an amount equal to the liability. For investors who anticipate being subject to a lower tax bracket in the future (i.e., soon-to-be retirees), the value of this loan can be significant. In some cases, the payment of that liability can be deferred indefinitely. For example, capital gains are never realized when securities are gifted to charity or if their cost basis is stepped up upon the taxpayer’s death.
• **Manage the Holding Period.** Capital gains from the sale of a security are taxed as ordinary income unless the investment is held for over 12 months. Long-term capital gains qualify for a tax rate lower than the ordinary rate. Whenever possible, managers should avoid incurring short-term gains.

• **Harvest Losses.** Selling lots of an asset whose market price has fallen below its purchase price results in a realized capital loss. These losses are advantageous to taxpayers because they can be used to offset realized capital gains: painful short-term gains are offset first, then losses can be applied to friendlier long-term gains. If no gains are available to offset in a given tax year, the loss can be carried forward indefinitely. While many investors only harvest losses in December, this strategy is far more valuable if it is done opportunistically throughout the year, as part of ongoing, routine portfolio management.

• **Consider the Yield.** Dividends are also taxed as ordinary income, but most can qualify for a lower tax rate as long as the security is held for longer than 61 days. Tilting away from dividend-paying stocks toward capital appreciation can also increase tax deferral and reduce the tax bill. But be wary of the allure of low yields; low payout ratios are no assurance of faster earnings growth.

• **Pay Attention to Tax Lots.** Tax-aware managers will generally use “highest in, first out” (HIFO) tax-lot accounting in order to reduce the tax impact of the sale of a security. However, in some cases, HIFO may not be the desired method. An investor with a tax-loss carry-forward, for example, may find it more beneficial to accelerate gains (i.e. select the tax lots with the lowest cost basis). A manager who is able to thoughtfully identify the ideal tax lots to trade under differing circumstances can create benefits for the investor, particularly those who need to generate cash flow from their investments or have charitable giving plans.

• **Avoid Wash Sales.** When a security is repurchased within 30 days of its sale, any loss realized cannot be used to shelter capital gains. Tracking wash sales is particularly challenging when an investor uses multiple managers. For example, the tax loss generated by manager “A” will be voided if manager “B” buys the same security within 30 days.
TAX-EFFICIENCY OF VARIOUS INVESTMENT VEHICLES

To be effective, tax-management techniques must be applied in context. The vehicle selected to implement an investment strategy has important ramifications for a taxable investor. Common investment vehicle choices include hedge funds, commingled structures such as mutual funds and exchange-traded funds (ETFs), and separate accounts.

Hedge funds typically use a partnership structure in which the investment manager is the general partner and the investors are limited partners. Gains and losses incurred within the portfolio flow through to the limited partners, however, typical hedge funds are tax-inefficient though, due to their tendency to generate high turnover.

As the name implies, mutual fund investors must share the taxable consequences of actions taken by others within a commingled vehicle. Mutual fund managers can actively harvest losses, but those losses may only be used to offset gains generated within the fund, they cannot be passed through to individual mutual fund holders.

Like mutual funds, ETF managers can match gains with losses within the fund. Unlike mutual funds, the fund manager can leverage the ETF redemption/creation process for further tax-efficiency (e.g. the manager may identify high cost basis tax lots to sell). Thus, in practice, ETFs are generally a more tax-efficient choice versus mutual funds.

When the vehicle is a separate account, realized losses on the sales of individual securities can be used to offset gains in the investor’s equity portfolio, or outside of it (e.g. from the sale of property). If the taxpayer has other goals or priorities, such as the desire to match gains and losses, accelerate the realization of gains, transition assets or to gift specific tax lots to charity, he or she can do so without structural limitation in a separate account. In these ways, the separate account offers investors the most opportunities for tax-efficiency.
THE EVOLUTION OF THE TAX-EFFICIENT PORTFOLIO

Over the years, portfolio design has evolved to become more tax-efficient (see Figure 7). In the beginning, style box investing was intended to help investors access specialist managers, however, this turned out to be a very poor strategy for taxable investors given the tax consequences of transitioning assets between styles. Taxable investors next embraced the core-and-satellite framework for its improved tax efficiency, better risk control and lower cost structure. In a core-satellite portfolio, a passive broadly diversified portfolio (the core) is augmented by active, high-risk managers (satellites).

The next phase in the evolution involves managing the core portfolio within a separate account so that gains realized by active satellite managers can be offset by losses realized from the passive core. Our research suggests that most if not all of the performance drag from taxes can be mitigated by allocating 60% to 80% of a portfolio to a tax-managed core implemented within a separate account.

Centralized portfolio management (CPM) is the latest phase. This strategy brings the satellite managers into the tax-management fold. Beyond the tax-management techniques described earlier, CPM can also coordinate buys and sells across multiple active managers, implement manager and asset allocation changes and apply rebalancing policies to the overall portfolio—all in a tax-efficient manner.
QUANTIFYING THE BENEFIT OF TAX MANAGEMENT

A number of studies examine the benefits of actively harvesting losses in a portfolio and suggest that the cumulative benefit of active tax management continues to rise over time. While the amount harvested is largest in the early years when market values are close to cost basis, the benefits continue to accrue due to compound growth of the tax savings. Figure 8 depicts the range of net tax alpha outcomes generated from 10,000 simulations. For this figure, we assume a 10-year horizon, 8% security return, 35% security volatility, quarterly rebalancing, 5% annual turnover, 0.1% transaction costs, and 35 bp annual fees, and short and long-term capital gain rates of 43.4% and 23.8%, respectively. The results of our simulations suggest that on average, net tax alpha should be expected to be between 0.8% and 1.6% per year.

Fig 8: TAX ALPHA SIMULATION

Source: Parametric. Monte Carlo simulation of tax managed portfolio. Hypothetical performance is provided for illustrative purposes only. It does not represent the experience of any investor.

2 See Stein and Narasimhan (1999); Arnott, Berkin and Ye (2001); Berkin and Ye (2003); Horvitz and Wilcox (2003); Rogers (2006); and Stein, Vadlamudi, and Bouchey (2008).
Resources and Additional Reading


Timothy Atwill, Ph.D., CFA  
*Head of Investment Strategy*

Mr. Atwill leads the Investment Strategy team at Parametric, which is responsible for articulating and evolving Parametric’s current investment strategies. In addition, he holds investment responsibilities for Parametric’s emerging market and international equity strategies, as well as shared responsibility for the firm’s commodity strategy. Prior to his current role, Timothy worked at Russell Investments in their manager research unit, and in their trading group, implementing derivative strategies for institutional clients. Prior to his time at Russell, he worked as a non-life actuary and derivatives portfolio manager at Safeco Insurance Company. Tim holds a Ph.D. in Mathematics from Dartmouth College, as well as a B.A. in Mathematics from Reed College, and has been a CFA® Charterholder since 2003.

Paul Bouchey, CFA  
*CIO Seattle Investment Center*

Mr. Bouchey leads Parametric’s investment, research and strategy activities. He is responsible for setting the overall research agenda and new product development. Prior to joining Parametric in 2006, Paul was a senior researcher at Russell Investment Group, where he focused on simulation, optimization, and quantitative decision models for institutional and private clients. He holds a patent on cross-sectional volatility indexing and has authored more than 10 academic and practitioner articles in journals such as The Journal of Portfolio Management, The Journal of Wealth Management, and The Journal of Index Investing. Paul earned a B.A. in mathematics and physics from Whitman College and an M.S. in Computational Finance and Risk Management from the University of Washington. He is a CFA® charterholder.
Rey Santodomingo, CFA
Managing Director of Investment Strategy - Tax Managed Equities

Mr. Santodomingo is focused on the continued evolution of Parametric’s tax-managed equity strategies and communicating these strategies to external audiences. As one of the primary strategists for Custom Core™, he works closely with taxable clients and advisors to design, develop and implement custom portfolio solutions. Prior to joining the Investment Management team at Parametric in 2008, Rey was a Vice President in Product Management at MSCI Barra. He earned an M.A. in Financial Engineering from the University of California Berkeley and a B.S. in Chemical Engineering from the University of California Santa Barbara. He is a CFA charterholder, a Board Member of the CFA Society of Seattle, and has served as an adjunct instructor at Seattle University’s Albers School of Business and Economics.

Jennifer Sireklove, CFA
Director – Investment Strategy

Ms. Sireklove is focused on the continued evolution of Parametric’s responsible investing strategies, and communicating these strategies to external audiences. As the primary strategist for Customized Responsible Investing, Jennifer works closely with advisors and their clients to design, develop and implement portfolio solutions that incorporate their values. Prior to joining Parametric in 2013, her career was in equity research, covering the energy, utility and industrial sectors. She earned an MBA in Finance from the University of Chicago and a B.A. in Economics from Reed College.

Martha Strebinger, CFA
Investment Strategist

Ms. Strebinger is responsible for assisting in the continued evolution of Parametric’s responsible investing and Custom Core™ strategies. Prior to joining Parametric in 2016, Martha worked at Truepoint Wealth Counsel in Cincinnati, Ohio as an Investment Specialist. Before Truepoint, she worked in Boston at Wellington Management Company and Grantham, Mayo, and Van Otterloo (GMO). She earned a B.S. in Human Biology, Health & Society from Cornell University. She is a CFA® charterholder.
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When calculating after-tax returns, Parametric applies the highest U.S. federal tax rates. For short-term gains, Parametric applies the highest U.S. federal marginal income tax rate of 39.6% plus the 3.8% net investment income tax, for a combined rate of 43.4%. For long-term gains, Parametric applies the highest U.S. capital gains tax rate of 20% plus the 3.8% net investment income tax, for a combined rate of 23.8%. These assumed tax rates are applied to both net realized gains and losses in the portfolio. Applying the highest rate may cause the after-tax performance shown to be different than an investor’s actual experience. Investors’ actual tax rates, the presence of current or future capital loss carry forwards, and other investor tax circumstances will cause an investor’s actual after-tax performance to be over or under Parametric’s estimates presented here. In periods when net realized losses exceed net realized gains, applying the highest tax rates to our calculations illustrates the highest after-tax return that could be expected of the portfolio, and assumes the maximum potential tax benefit was derived.

Actual client after-tax returns will vary. As with all after-tax performance, the after-tax performance reported here is an estimate. In particular, it has been assumed that the investor has, or will have sufficient capital gains from sources outside of this portfolio to fully offset any net capital losses realized, and any resulting tax benefit has been included in Parametric’s computation of after-tax performance.

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Parametric is located at 1918 8th Avenue, Suite 3100, Seattle, WA 98101. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric’s Form ADV, please contact us at 206.694.5575 or visit our website, www.parametricportfolio.com.