CAPTRUST

Do Tax-Loss Harvesting Solutions Deserve a Place in Your Portfolio?

By Bruce Paulson, CPA, JD, CFP®
June 1, 2018

Investors who prefer lower expenses for their equity exposure often favor low-cost exchange-traded funds (ETFs) and mutual funds, passing on or not considering higher-fee separate account equity index (SAEI) solutions. Which indexation path works best for a client is fact dependent. SAEI solutions, compared to index ETFs or mutual funds, offer two advantages: higher tax efficiency at the account level and, the focus of this discussion, a separate tax saving that comes from lot-level tax-loss harvesting. As a solution, an SAEI can help solve tax-related investment problems.

General Q & A

What are separate account equity index (SAEI) products?

A separate account is an individual account where the investor directly owns the portfolio securities, rather than a fractional share of securities held by a mutual fund, ETF, or other commingled vehicle. This means each share (or lot) provides its own tax basis. It also means there is no chance of buying into a portfolio with unrealized capital gains or being impacted by the actions of other investors.

Do you need only cash to fund an SAEI product?

No. An SAEI product can be funded with existing shares without triggering deferred income tax gains.

How are SAEI products different from mutual funds or ETFs?

ETFs and mutual funds are prohibited by law from distributing excess realized losses (e.g., losses that exceed capital gains occurring within the funds) to investors. The same is not true with separate accounts owned directly or through a limited liability corporation, which permit the creation of so-called *tax alpha*.

What is tax-loss harvesting?

Tax-loss harvesting is the process of selling securities at a loss and using those losses to offset otherwise taxable capital gains. Losses at the lot or security level of a portfolio occur because of the natural price volatility in stocks. This kind of tax-loss harvesting is assiduous and is normally done throughout the course of an investment year, not randomly at year end as often occurs within actively managed equity portfolios.

What is tax alpha?

Tax alpha is the measure of improvement in net after-tax return caused mainly by tax-loss harvesting. The number is usually expressed in annualized basis points and discussed either before or after liquidation (e.g., based upon market value or cash value of the account).

Does the market need to be going down for tax losses to be harvested?

No. While the return from tax-loss harvesting is higher in a bear market accompanied by high volatility than a bull market where volatility is low, individual securities within the portfolio fall in price even if the portfolio as a whole is showing positive returns.

How long can tax-loss harvesting within an SAEI solution go on?

If the portfolio is long only, most of the tax-loss harvesting occurs in the first few years of the portfolio, declining dramatically after year five. This is because as losses are realized, tax basis in the portfolio declines and, as equity prices rise, SAEI portfolios accumulate large unrealized gains, leaving no more losses to harvest absent a new infusion of cash.

What, over time, is tax-loss harvesting worth?

Different views exist on this. The answer depends upon cost differences, the direction (up or down) and volatility of equity prices, and personal income and estate tax factors. The most important tax factors are when the tax losses are used, the tax rate applied to these losses, the period over which tax savings and deferral of tax is measured, and whether tax savings from harvesting losses is temporary (e.g., the account is liquidated and capital gain tax paid) or permanent (e.g., appreciated shares are given to charity or pass through an estate, receiving full basis step-up).

Based upon published articles and 10-year back tests from different firms, the extra tax-loss savings opportunity from SAEI net of fees compared to a low-cost ETF with similar pre-tax returns is as follows:

- **After tax (pre-liquidation):** This means, using fair inputs, taxes are considered each year, but the ending unrealized capital gain that builds up is not taxed. The annual tax-loss savings from lot-level tax-loss harvesting appears to be around 1.5 percent—higher if state taxes are considered.

- **After tax (after liquidation):** The same inputs and process as above, but tax is paid on the ending unrealized capital gain. The annual tax-loss savings from lot level tax-loss harvesting drop to around 0.80 to 1 percent—higher if state taxes are considered.

Does the tax savings from tax-loss harvesting mean more when equity returns are low than when they are high?

We think so. Think about it this way: The savings from tax-loss harvests are money in, the opposite of fees, which are money out. Both are after-tax numbers. If equity returns are 10 percent, then a 1 percent fee consumes 10 percent of gross return. If returns are 5 percent, the same 1 percent consumes 20 percent. Likewise, if the saving from tax-loss harvesting is 1 percent, its contribution to total return is higher when gross returns are low than when they are high.

Is there a simple way to decide if the extra cost of an SAEI solution and tax-loss harvesting is worth paying?

Yes, you would compare the extra cost an SAEI solution incurs versus mutual funds or ETFs to the reasonable annual net cash savings that come from systematic tax-loss harvesting at the lot level of an account.

Can losses be harvested on a short book?

Yes. Short positions allow investors to benefit from the underperformance of securities. They can also provide additional opportunities for realizing capital losses in up markets when capital losses from long positions are scarce.

Is the tax-loss harvesting savings potentially more when a short book is present?

Yes. As mentioned, short positions can provide additional opportunities for realizing capital losses in up markets, when capital losses from long positions are scarce. Based upon rigorous back tests and live performance, the evidence suggests an annual net (of fees) tax alpha of 4 percent from a short book (as part of a market neutral portfolio). That number, though, is after-tax and pre-liquidation. And certain partnership tax rules limit deduction of losses to tax basis, which is beyond the scope of this article.

When do SAEI solutions for passive equity make the most sense?

Separate accounts for passive equity make the most sense where these facts are present:

a. Comfort with average (market-like) equity returns, up or down;
b. Intention and ability to remain invested for 10 years or more;
c. An ability to use tax losses as they occur;
d. Intention to donate appreciated shares to charity or carry same into an estate; or
e. A tax-related problem that SAEI can help solve.

Where facts opposite of b, c, and d exist, lower-cost index mutual funds or ETFs may be a better means of capturing index equity exposure.

Compared to Traditional Active Management

Some investors favor and are willing to pay higher fees for active managers. Other investors favor lower-cost passive equity solutions. In general, active manager fees and tax costs caused by trading will be higher than SAEI products. Based upon experience and published work, the extra net after-tax return needed to beat SAEI will likely fall in the 2 percent to 2.5 percent range.

What Problems Can SAEI Solutions Help Solve?

Too often, SAEI is seen as a passive product, where value comes only from paying the lowest price. That is unfortunate because, in the right hands, it can be used to solve several tax-related problems.

Replace less tax-efficient passive mutual funds or ETFs. Families who desire low-cost, passive equity exposure often invest in mutual funds or ETFs, not knowing about the tax-loss harvesting benefits of SAEI solutions. In some cases, it can make sense to sell appreciated index mutual funds or ETF shares and reinvest the money into a tax-loss generating SAEI product.

Tax-managed transition of high-cost active managers into a low-cost SAEI solution. Not infrequently, investors are displeased or neutral on active equity managers. Areas of displeasure include performance, fees, annual tax costs, or organizational changes that cast doubt upon future returns. SAEI products, used creatively, can reduce or, in some cases, eliminate the income tax that often accompanies change in manager, fund, or strategy.

Reduce tax cost of decreasing exposure to one (or several) low-basis, concentrated equities. Wealth creators or inheritors often see one or several marketable securities comprise a dominant

share of their net worth. Use of SAEI products in advance of or during the sale of low-basis stock provides tax losses that can be used or carried over to reduce the tax cost of rebalancing a portfolio to a desired level or risk.

Reduce income tax costs of owning tax-generating hedge funds. Hedge funds can be prolific, perennial generators of short- and long-term capital gains, causing significant federal and state income tax costs. Where hedge funds (compared to other lower-cost, more tax-efficient diversification options) play a useful volatility-dampening role in a portfolio, marrying hedge funds with SAEI can be an attractive net after-tax combination.

Reduce tax costs that come from holding wealth in certain trusts. Trusts such as charitable remainder trusts (CRTs), charitable lead trusts (CLATs), or grantor trusts (e.g., a trust where the grantor or founder pays the trust's income taxes) have special tax rules that can provide a fertile field for the tax-loss harvesting benefits of SAEI solutions.

Reduce upcoming tax cost from sale of a capital asset. Business owners, real estate owners, or owners of other long-term capital assets often face significant long-term capital gains taxes when they sell. Whether a long-term capital gain is certain or likely, the owner might consider investing the equity portion of his or her liquid investment portfolio in an SAEI portfolio to generate tax losses that, if not used currently, will be used to offset a future long-term capital gain.