

Tax-Managed Investing Strategies

Introduction

In this article we address the major issues that we face in trying to make smart recommendations to optimize after-tax returns for our clients, what is called “tax efficiency” in the investment world. We believe this represents a crucial way to add value over a static approach that simply follows an investment formula. Our clients are appreciative of the care and attention we give to maximizing after-tax returns and our level of sensitivity to tax issues. They generally seem to understand that the knowledge, diligence, and analytic and organizational ability that go into our recommendations far exceed not only their own capability, but that of cookie-cutter asset management advisers.

Before we address the factors that determine a manager’s or investment’s tax efficiency, there are several broad points to consider:

First, tax efficiency is not the be-all end-all of investing. After-tax return is. The best indicator of after-tax returns is pre-tax returns as established by recent studies. The name of the game is not to minimize taxes, but rather to make as much money as possible for the client, with an understanding that Uncle Sam has several ways to take that money away.

Second, some fund managers come from an institutional background where taxes are not factored in to the investment process. They may be talented stock-pickers, but ignorant or unaccustomed to strategies that can improve tax efficiency.

Finally, and most importantly, paying taxes is inevitable, and the issue is the time-value of money, not whether to pay tax or not to pay taxes (which unfortunately is not an option). For instance, a big distribution from a mutual fund requires that money that might otherwise continue to compound and grow will be used instead to pay taxes. However, that same distribution also reduces the net asset value (share price) of the investment by a commensurate amount, and upon the eventual sale, the gains on which the tax bill is calculated are reduced accordingly. It is only the return that would have been earned on the money that was paid to the government, not the *total* tax bill, that represents the difference in returns between a tax inefficient fund (one that pays out a lot of gains) versus a tax efficient fund. In fact, some early studies of tax efficiency were fatally flawed in that they compared after-tax returns against returns that were *never* taxed.

As a final note, in a strong-return environment, larger distributions are more likely, but even after-tax returns will be better on an absolute basis in such an environment.

What Influences a Mutual Fund's Tax Efficiency?

There are a number of factors that bear heavily on how tax efficient a fund is likely to be—or at least has the *potential* to be.

The Fund Manager's Tax Awareness

The manager's sensitivity to tax issues, and willingness to address them in making portfolio decisions, has a great deal of bearing on the tax efficiency of a mutual fund. The tools available to managers to minimize taxes are also many of the same ones available to advisors in making decisions for clients, and are discussed in more detail from that perspective further on in this article.

One of the tools available to managers looking to increase their tax efficiency is tax lot accounting—choosing the lot(s) of shares to sell that have the most favorable tax impact, considering cost basis and holding period. Tax lot accounting, simply defined, allows a manager to look at all the shares of a particular stock (or fund) that he owns, and specify the ones he wants to sell that have the lowest tax liability. In our view, this is something we believe all managers should do. We will discuss tax lot accounting in greater detail later.

Another way managers can reduce taxes is to harvest losses. Some managers do this year-round, some just at year-end, and some pay no attention to it at all. This could simply involve selling a security that is under water (and that they don't expect to move much in the near term) and reconsider whether to buy it back after “the wash sale rule” expires 31 days later (more details on the wash sale rule are below). Another strategy could involve selling a stock at a loss and redirecting the assets into a similar holding in the same industry, thereby maintaining the desired industry allocation. Harvesting losses is not a completely black and white issue—there are some risks and potential drawbacks—so some managers have consciously chosen not to use this tactic because they think the potential costs outweigh the benefits. The holding period is important as well, since short-term gains are taxed at much higher ordinary income rates. A manager may wish to sell a stock that will soon qualify for the more favorable long-term rates, and decide to hold the position a little longer. If the stock is deteriorating quickly, the need to sell might outweigh the tax consequences. In the tax swap example above, selling a position to harvest the loss can pose a new risk of having to wait a year before the new holding period qualifies for the more favorable long-term rates. If the manager feels it is necessary to sell soon, the higher short-term tax rates could more than offset the benefit of harvesting the loss. All of these factors must be weighed qualitatively in making decisions on a tax basis.

The Investment Approach of the Fund

Certain types of funds may be more or less likely to be tax efficient as a function of their investment approach. Interestingly, we have been unable to make a strong conclusion about the tax impact of the fund's style and market-cap emphasis. For example, some small-cap growth funds “churn and burn,” trading frenetically as the manager adjusts to the changing industry and company dynamics

that are common in that universe; this can lead to substantial realization of short-term capital gains. Also, some of those small, high-growth companies quickly become mid or large caps and must be sold, triggering gains. However, some small growth managers have a discipline that forces them to sell stocks that decline past a certain threshold, on the basis that the company may be suffering from deteriorating fundamentals. This can lead to substantial realization of losses, which may actually make the fund fairly tax efficient. On the other hand, a buy-and-hold small-cap growth manager may incur low capital gains on a year-to-year basis, but may have a large build-up of unrealized gains. That manager, who is making an effort to remain tax efficient on a year-to-year basis, may eventually be forced into realizing substantial gains when he finally sells out of the low-basis stocks. This is one of the reasons why the tax “overhang” of unrealized gains isn’t necessarily a good predictor of future tax inefficiency; the capital gains time bomb of low-basis positions can be offset for years by the manager’s tax sensitivity or long-term approach that lead to the build up in the first place. The bottom line is that the weight of the manager’s process is so much greater than the type of stock typically owned in the portfolio that it is not possible to make a meaningful generalization about tax efficiency based on the manager’s category—the investment approach is far more influential.

Turnover and Cash Flows

Portfolio turnover by itself is also not a reliable predictor of tax efficiency. It would seem on the surface that high turnover would mean high taxable gains, but there are several situations where this is not so. Turnover can result from cycling out of holdings, but in some cases this could be driven by tax trading to minimize gains, while in others it could simply reflect return-oriented trading that is done without regard to tax consequences. High turnover can also result from positions being added to the portfolio due to new investment dollars flowing into the fund. This final point—net inflows—can be a significant positive from a tax standpoint, since the new dollars are taking on a share of the existing tax liability. These new shareholders will pay for gains they weren’t even there to receive.

The flip side of the cash flow coin is the negative tax consequences that can result from redemptions. The worst-case scenario involves a kind of “death spiral,” wherein a fund experiences poor performance, which in turn leads investors to bail out and redeem shares, which forces the manager to sell securities and potentially realize gains. In the case of Warburg Pincus Japan Small Company Fund, investors who stayed with the fund in 2000 saw not only a loss of greater than 70%, but also were handed a taxable *gain* of more than 55% of net asset value. While that fund had a great year in 1999, gaining 329%, an investor who chased it and bought in at the beginning of 2000 received none of the gain from 1999, all of the 72% loss in 2000, and while on the ground, was kicked with a massive tax bill on gains he never saw.

Common Misconceptions

In searching for better tax efficiency, many investors overstate the significance of the options at their disposal. We point some of these out because they can siphon research resources in unproductive directions, or contribute to false expectations about the degree of benefit that can be gained from certain tax strategies.

One misconception is that index funds are zero-tax investments (in terms of ongoing taxable distributions). They are generally very low, but they do pay ordinary income dividends, and when stocks move out of the index they can trigger gains when they are sold. This is a significant issue with small-cap indexes, which can see their component companies grow in market cap and graduate up and out of the index. Small-cap index funds are generally far less tax efficient than large-cap index funds. Separate account management is another avenue that is widely perceived as adding tax efficiency, since the stocks are owned directly and timing and frequency of sales can be controlled, and other tax strategies can be employed to improve after-tax returns. But in many cases, little attention is given to these issues on separate accounts. Often a very junior manager may be running the accounts, and works from a model portfolio controlled by a “bigger name” or more senior manager. Trades are commonly implemented across all accounts without regard to tax consequences. Tax-sensitive clients can have blocks on their account to prevent realizing any short-term gains, but this would run the risk of preventing trades whose timeliness makes sense on an after-tax basis.

Tax Management Techniques

There are a number of strategies and tactics we use for our clients. Some are very basic, while others require more thought and time. We will start with the basics.

The Basics: Things We Watch Out For

- **Basic Rule #1:** *Pay attention to the holding period* and be aware when a holding graduates from short- to long-term gain status. If you are thinking about selling a holding, consider whether it’s really necessary to take the short-term gain. Can you hold off until it hits its one-year anniversary? Sometimes you may feel there is a bona fide reason for selling and taking a short-term gain, but if you’ve already held it for ten or 11 months, you should think about this very carefully.
- **Basic Rule #2:** *Defer gains* to the following calendar year if you are confident you can do so without adverse consequences. This is good because of the time value of money; you don’t have to pay those taxes for an extra year and will get to use that money in the meanwhile.
- **Basic Rule #3:** *Watch for restarting the clock.* Whenever you make a new purchase, you are starting a new holding period. Consider this example: suppose you have a tactical position (what we’d term a “fat pitch”) that you’ve held for five months, and it’s at a small loss. Ordinarily, you might want to take the loss and swap into another fund in the same asset class, thereby realizing the loss, but still maintaining your asset class exposure. However, suppose the fat pitch takes off in the subsequent eight months, and you decide you want to unwind your tactical positions. If you’d held the original fund, it would be a long-term gain. However, because of the swap, you are now faced with the choice between holding a position you’d prefer to sell, or taking a sizable short-term gain that erodes some of the benefit of your correct call. A related point to think about is that with the difference in tax rates, a long-term loss has less economic value than a short-term loss, and as such you should be particularly careful when thinking about strategies that involve harvesting long-

term losses as part of a strategy that could ultimately force you to realize a higher liability *short-term* gain somewhere down the road.

- **Basic Rule #4:** *Be careful of wash sales.* Simply put, if you take a loss in a particular asset, and you purchased that same asset (or one that is substantially identical) within 30 days of the sale (it doesn't matter if the purchases were before or after the sale), you cannot claim the loss. Thus, if you do a tax swap, be sure to wait 31 days before reversing it. It sounds simple, but in practice it can get tricky if you are adding money to the account. We feel it's a good idea to make a quick check of sales during the past 31 days before making a purchase.
- **Basic Rule #5:** *Don't buy a fund right before a scheduled distribution.* No one wants to be (in effect) handed back a portion of their own money as a taxable gain.

Allocating Between Tax-Deferred and Taxable Accounts

Investors with both taxable and tax-deferred accounts can improve their tax situation by considering which investments to allocate to which accounts. There are some easy rules of thumb, defined on the broad basis that—all things being equal—the worst tax offenders should go in the tax-exempt account(s).

- Less efficient funds—taxable income-oriented funds or inefficient equity funds belong in tax-deferred accounts.
- If we have to own bonds in a taxable account, tax-exempt bonds are a better option for all but very low-bracket investors or clients subject to the alternative minimum tax.
- Tactical (fat pitch) allocations are better suited to tax-deferred accounts, since if we are right and the move plays out quickly, we could be faced with a short-term gain that diminishes the value of the correct tactical move.

Trading Strategies

Trading Strategy #1: *Tax lot accounting* can add a lot of value without doing anything that is highly tricky or complex. Tax lot accounting is a method of keeping track of the date and cost basis (or number of shares) for each time you purchased a particular investment. By utilizing this technique, when it comes time to sell a portion of the investment, you can indicate which shares to sell based on which lot is the most advantageous from a tax standpoint. For example, let's say you purchased Fund ABC on two different occasions: 1000 shares at \$10 a share in January, and another 1000 shares at \$12 in September. So, you now own 2000 shares of Fund ABC. Several months go by, and for whatever reason you decide you want to reduce your position in Fund ABC—which is now selling for \$11—by half. When we place the trade, we can indicate that you want to sell the shares you purchased in September, allowing you to realize a \$1000 loss. If we didn't do this, you could wind up

with the average cost (\$11 a share), and no realized loss. Worse yet, if our systems were set up to use FIFO accounting (first-in, first-out), you would have sold the January shares and incurred a \$1000 gain. Here are some guidelines on ways to use tax lot accounting to our advantage:

- Generally, it is better to sell high-cost-basis lots first, and take the sure deferral of what would have been a bigger tax bill.
- Long-term gains are better than short-term.
- There could be cases, however, where selling a short-term, but high-basis lot generates less tax than selling a long-term, low-basis lot. One must do the math. For example, let's say you need to sell \$10,000 worth of Fund ABC, and you can choose between two specific tax lots: one with a 10% *short-term* gain and one with 30% *long-term* gain. If you were in the 33% tax bracket, you would pay roughly \$460 in taxes for selling the long-term lots, versus approximately \$300 for selling the short-term lots. In this situation, you actually generate a smaller tax liability by taking a short-term gain. These kinds of decisions should also be viewed with an eye towards the future. If longer-term trading plans are already known, then these should be factored in as well. For example, in the above situation, you might still take the 30% long-term gain if you knew you were going to be liquidating the entire position over the next several years anyway.
- When considering a sale, and this is especially true when rebalancing, it often makes sense to sell only the lots that generate small tax hits. For example, suppose we've used the ABC Fund in a taxable account over many years, and due to a big run-up, it is currently a \$100,000 position and our target allocation for that fund is only \$80,000. In looking at the specific tax lots, you see that we have one lot of \$9000 with a modest long-term capital gain. All the other lots have very large gains. Rather than selling the whole \$20,000 in order to rebalance precisely and having to sell \$11,000 worth of the low-basis lots, it is worth considering selling only the \$9000, and perhaps looking for another fund to trim in the same asset class. The rebalancing wouldn't be as accurate as we might like, but it is progress, and it may be the best compromise in striving to manage risk and maximize after-tax returns.

Trading Strategy #2: *Harvest losses* by selling out of funds where we can maintain our desired overall exposure through other investments. Here is an example of one kind of a swap: suppose you own \$50,000 each of two relatively similar funds, Fund A and Fund B. Let's further suppose that your cost basis in each is \$60,000, but that due to a big drop in the market, you now own both funds at a loss. You could sell Fund A (realizing the loss now) and invest the proceeds in Fund B. This will temporarily give you more exposure to Fund B than you might ordinarily like, but because the funds are relatively similar, you aren't taking too much asset-class risk. You now have two "lots" of Fund B: the original position at \$50k (which is at a loss), and the new \$50k position you just purchased. Thirty-one days later, you can sell the original Fund B position (which will in all likelihood still be at a loss) and use the proceeds to invest back into Fund A. This is not totally without risk: if there's a big run-up in Fund B while you're overweighted, you may be faced with a situation where you have to actually take a gain (although it may be a small one) to rebalance back into Fund A. To a certain degree, this could negate the value of the loss you initially realized. But once again, one move

involves certainty (harvesting the loss) while the other is too short term to be predicted with much confidence, and even under it's worst case would do little more than negate the value of the first move.

Trading Strategy #3: *Focus on after-tax returns* when we're dealing with a taxable account. We've mentioned this before, but it cannot be emphasized enough. Decision-making is easy when you own two similar funds, and the less desirable of those funds is at a loss. Just sell it and reinvest the proceeds into the fund you prefer. The question becomes more difficult when the less-desired fund is at a gain. You are now required to assess the relative performance differential (we simply assess it in terms of our relative confidence in a manager over a full market cycle) against the tax consequences. A good way to get a feel for these types of judgment calls is to do scenario analysis. This lets us determine the return required by a new position to justify paying the gain on the sale of an existing position. Sometimes the performance premium required is very high, suggesting that it will be very difficult for the new fund to outperform the old fund by enough to make the trade worth it. But you might be surprised by how low that margin can sometimes be, and it may only require a couple of years of modest outperformance. You take the tax hit to sell out of the fund you're less enthusiastic about, but at the end of the day you'll be ahead of the game because the new fund outperformed the original fund by an amount that exceeded the tax liability. In other words, incurring a tax liability is sometimes the smarter move.

While some of these strategies may seem highly qualitative (subjective), we point out that the goal is to compare that which can be known with certainty (the tax consequences of a move) versus that which is at best just a guess (the relative return of investment A versus investment B.) The test is how confident are you that the value added by making a desired investment move will outweigh the value added (or detracted) by its tax consequences.

Conclusion

In many cases, a tax edge can be gained simply from owning well-researched, long-term positions that are stable and pose little problem in the way of tax issues. But investment climates change, sometimes bringing mistakes and sometimes bringing compelling new opportunities to light, and our client situations change as well. Tax awareness is essential.

Making investment decisions in the light of their tax consequences is as much art as science. While many of the techniques are small, collectively they can add up to real value. Some of the decisions are straightforward and clear, while some require difficult judgment calls. But both the no-brainers and the judgment calls require a thorough understanding of the science: how to quantify the tax benefits and understand the strategies available to harness them. The critical point is in staying on top of every trade and using our knowledge to tip the tax odds in a client's favor when it makes sense to do so. Tipping the odds involves common sense, since at the end of the day what matters is how much money a client has as a result of our investment recommendations, not how much or how little they paid to Uncle Sam. It is better to make \$100 and pay \$20 in gains than to make \$60 and pay no gains.

There is always pressure to focus on pre-tax returns. After all, it's the pre-tax number that shows up on the reports where we evaluate our performance relative to a pre-tax benchmark. And yet the real reward from our efforts to maximize *after-tax* returns for our clients comes with their understanding of the skill, work and knowledge, combined with our investment expertise, that we bring to the table.

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