

CHIEF INVESTMENT OFFICE

Educational Series

Tax-Loss Harvesting and Personal Indexing: An Effective Portfolio Strategy During Volatile Market Environments

March 2023

The investment backdrop for 2023 includes a strong economy as measured by nominal gross domestic product (GDP) growth resulting in persistent and high inflation levels, and tighter financial conditions and geopolitical uncertainty. Amid a tight labor market, and rising wages and stronger consumer balance sheets, Americans are releasing their pent-up demand into the services sector. Businesses, flush with cash, are addressing labor shortages with capital expenditures for efficiency gain. Central banks, led by the Federal Reserve (Fed), are gradually tightening policy to catch up with rising inflation. Geopolitical tensions are significantly elevated and will likely be accompanied by rising defense spending, concerns about energy security, and cyberattacks.

The wide range of outcomes for inflation, interest rates and the ongoing pandemic support higher market volatility in the near term. Economic indicators indicate a recession is likely but market prices have not. This disconnect could support higher market volatility in the near term. Reasonable valuations measured by price earnings ratios for Equities and relatively high yields for Fixed Income, however, mean medium- to long-term returns should be favorable, in our opinion.

PLANNING CONSIDERATIONS IN A VOLATILE MARKET

Leveraging volatility and market weakness to your advantage

Market volatility may be unpleasant, but there are some benefits.

- From a long-term investor's perspective, volatility, resulting in market drawdowns, have presented attractive investment entry points for deploying new cash or for rebalancing.
- For taxpayers considering estate planning, it can provide the opportunity to gift a greater number of shares to a family member or trusts while keeping the value of the gift constant.
- Volatility may provide opportunities for better income tax management, including realizing tax losses (capital losses), which may have an immediate tax benefit if those losses offset realized short- or long-term capital gains in the same calendar year.

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CIO VIEW

We believe the right portfolio positioning is to be diversified and invested. Investors have opportunities to take advantage of what a more volatile market environment brings— such as rebalancing, active tactical asset allocation decisions, sector positioning and/or active investment selection. But, volatility also brings opportunities for greater tax efficiency by harvesting tax losses which can help offset current gains or can be carried forward for use in future years.

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Please see last page for glossary and important disclosure information.

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Tax-loss harvesting

In times of market volatility, the question often arises as to whether to harvest or defer capital losses. The psychology of whether to accelerate or defer a loss is very different from dealing with gains. Accelerating a gain means paying a tax sooner, and that may mean incurring “pain” sooner. Investors often will defer “pain” even if it means more later, in the form of a higher capital gain. On the other hand, accelerating a loss means paying less tax sooner, and that could mean gratification is sooner.

Benefits of active and systematic tax-loss harvesting

Though psychologically unpleasant, volatility in the stock market may provide opportunities for loss harvesting and thus helps to enhance after-tax returns. Systematic tax-loss harvesting takes advantage of the market volatility throughout the year to realize accounting losses in the portfolio. During periods of heightened volatility, there is greater opportunity to systematically harvest losses. These losses may help offset taxable gains that the portfolio may have already incurred or may incur later in the year. Capital losses realized in excess of capital gains realized for the year may also offset a certain amount of investment or wage income earned during the year. Moreover, if realized losses are not used to offset gains or income in the same calendar year, they may be carried forward indefinitely for federal tax purposes (state rules could vary) and thus help mitigate taxes on future gains.

Selling some or all of the investment in stocks, funds or exchange-traded funds (ETFs) that have declined in value to harvest losses requires market-timing and could result in losing exposure to the market, at least for a period of time. By contrast, a systematic loss harvesting strategy, such as direct indexing, sometimes referred as personal/custom indexing, invests in a subset of underlying securities of a chosen index. This particular approach, which we detail further in the direct indexing section below, can systematically sell securities that have declined in value to harvest losses, taking into account tax rules, while maintain exposure to the market throughout.

What are the tax rules around using tax losses?

Separate and apart from the psychological motivation for recognizing losses, a number of tax rules apply to capital losses that do not apply to capital gains. First, the deduction for capital losses, if in excess of capital gains recognized in a year, is limited to a maximum of \$3,000 per year (with any excess losses carried forward indefinitely to later years). Second, losses are sometimes disallowed where a taxpayer sells a stock or other securities and repurchases it or substantially identical securities in a short time period (i.e., the so-called “Wash Sale” rule which is described in the next section). There are no correlative rules on the capital gains side. Simply put, when analyzing whether it makes sense to recognize a loss now or later, one must consider other factors to see if the loss can be taken in the current year.

The Wash Sale Rule

Although the Wash Sale Rule can be triggered at any time and is not limited to year-end tax loss harvesting, it often comes into play when an investor “harvests” a loss, which often occurs at year-end. The rationale behind the Wash Sale Rule is to disallow a current tax loss if an investor has not changed their economic position due to a quick sale and repurchase. If an investor sells stocks (or other securities) at a loss and reacquires “substantially identical securities” within 30 days before or after the loss is realized (total of 61 days), that is a “wash sale,” and the result is the:

- loss is disallowed currently.
- disallowed loss is added to the basis of the reacquired securities, in effect deferring the loss until the investor sells those reacquired securities.
- holding period of the “old” securities carries over to the holding period of the reacquired securities.

The result is approximately the same as if the investor had not sold/reacquired the shares. The Internal Revenue Service (IRS) states that the Wash Sale Rule is also triggered if the reacquisition is by the investor's spouse or their controlled corporation.

With multiple investment managers and separate investment accounts, the Wash Sale Rule could be inadvertently triggered. There is no requirement that it be triggered intentionally. For example, assume fund manager "A" of your separately managed account (SMA) sells shares of "ABC" stock to harvest a loss, while fund manager "B" buys ABC stock within 30 days. That is a wash sale. The Wash Sale Rule can also apply partially. For example, if an investor sells 100 shares at a loss but reacquires only 60 shares of the same stock, the Wash Sale Rule would apply to those 60 shares. For the other 40 shares that were sold at a loss, the loss would be allowed.

Form 1099-Bs for securities provide tax reporting information, but they do not provide taxpayers everything they need for tax reporting if the taxpayer has multiple trading accounts or trades equities and equity options. Wash sales are determined based on identical positions (same CUSIP numbers) in the same account. However, Wash Sale Rules require taxpayers to calculate wash sales based on substantially identical positions (between Equities and Equity options and Equity options at different exercise dates) across all their individual accounts including Individual Retirement Accounts (IRA)—even Roth IRAs. Therefore, it is suggested for clients to work with their tax advisors to evaluate wash sale situations across all their accounts and report them under the tax advisors' guidance.

What should investors consider?

We believe it is a good time to review your investment goals and the effect volatility has had on your investments and to develop an intentional plan to rebalance investments (if necessary) and take advantage of opportunities that have arisen to put money to work or to help manage estate, gift and income tax rules. The overall tax burden of changes to an investment plan can be minimized through harvesting of capital losses. Furthermore, loss harvesting may be more efficiently executed through personal/custom/direct indexing.

What is direct indexing?

The objective of direct indexing is to closely track investor-selected benchmarks, while at the same time offering a variety of customization options including tax loss harvesting, environmental, social and governance screening, factor tilts and thematic investing. To track an investor-selected index, the fund manager chooses a sample of stocks that provide the similar risk and return profile of those of the index.

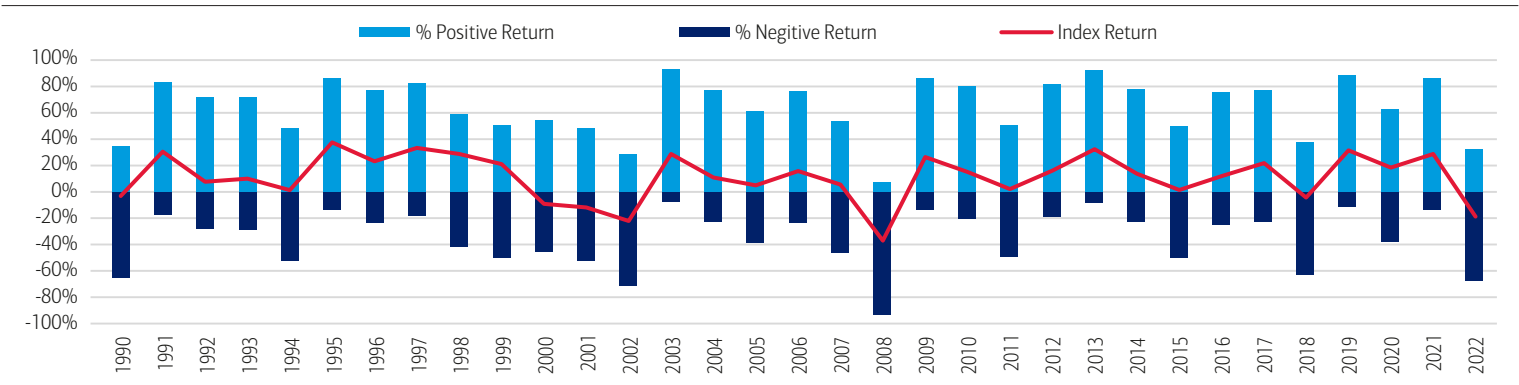
One of the most popular customization options implemented through direct indexing solutions focuses on tax savings or improvement of after-tax portfolio returns. The strategy invests in a subset of the underlying securities of an index, such as the S&P 500, then systematically sells the stocks that have declined in value to harvest losses while maintaining the risk characteristics of the portfolio similar to those of the index. As such, the portfolio seeks to track the performance of the chosen index while harvesting losses. At tax time, the losses help offset capital gains, and allow investors to keep more of their returns. By contrast, if an investor owns the S&P 500 through ETFs, the investor benefits from gains if the index rises, but receives no harvestable losses unless the entire position drops in value.

Exhibit 1 illustrates the percentage of leaders and laggards in the S&P 500 over the past 30 years. No matter what the index annual returns are, there are stocks that end the year with a negative return each year. Additionally, a direct index strategy may capitalize on security price movements throughout the year.

DIRECT INDEXING OBJECTIVE

To closely track investor-selected benchmarks, while at the same time offering a variety of customization options including tax loss harvesting, environmental, social and governance screening, factor tilts and thematic investing.

Exhibit 1: Leaders and Laggards in the S&P 500, 1990–2022.



Source: Parametric as of 2022. **Past performance is no guarantee of future results. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Please see index definitions at the end of this report.**

What could be the expected after-tax performance?

For direct indexes focusing on delivering favorable after-tax performance while minimizing tracking error, we generally expect after-tax alpha to be between 1% and 2% annualized gross of fees. We define tax alpha as the portfolio excess after-tax return relative to a benchmark, adjusted by any excess pretax returns. This strategy is expected to shine during pronounced down periods and deliver more muted after-tax excess performance during strong up markets. After-tax alpha and minimizing tracking error are competing objectives, so the fund manager needs to make the decision about how to balance them in their portfolios. Investors also should have a clear understanding of this relationship and have a higher tracking-error tolerance if they want to emphasize after-tax performance more in their portfolio.

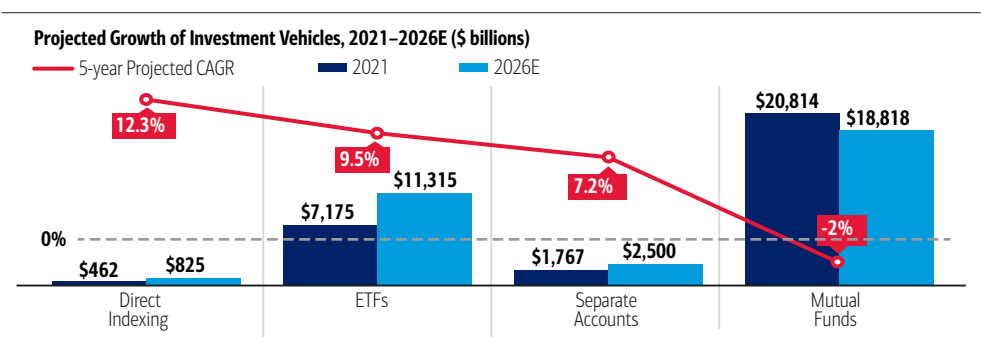
How could direct indexing be used in portfolios?

We are seeing direct indexing strategies continue to grow in assets and popularity as the need for tax-loss harvesting and gain deferral persists. Investors seeking losses to offset gains from active managers or other taxable events may use these strategies as a primary investment allocation to provide both market-like exposures while adding tax efficiency to the overall investment portfolio. Customization capabilities of these strategies also appeal to investors who are seeking custom social values alignment or factor tilting. Direct indexing portfolios can also be tailored to manage concentrated or legacy holdings.

What are projected growth trends in the space?

The direct index, manager-traded SMA market stood at approximately \$462 billion in 2021 according to Cerulli Associates. Cerulli anticipates that the demand and interest in direct indexing will lead to a surge in assets in the space, with direct indexing assets growing at a five-year compound annual growth rate (CAGR) of 12.3%, and closing 2026 with \$825 billion in total assets. This growth is expected to exceed that of ETFs, mutual funds, and the overall separate account market.

Exhibit 2: Projected 5-Year Growth Rates by Product.



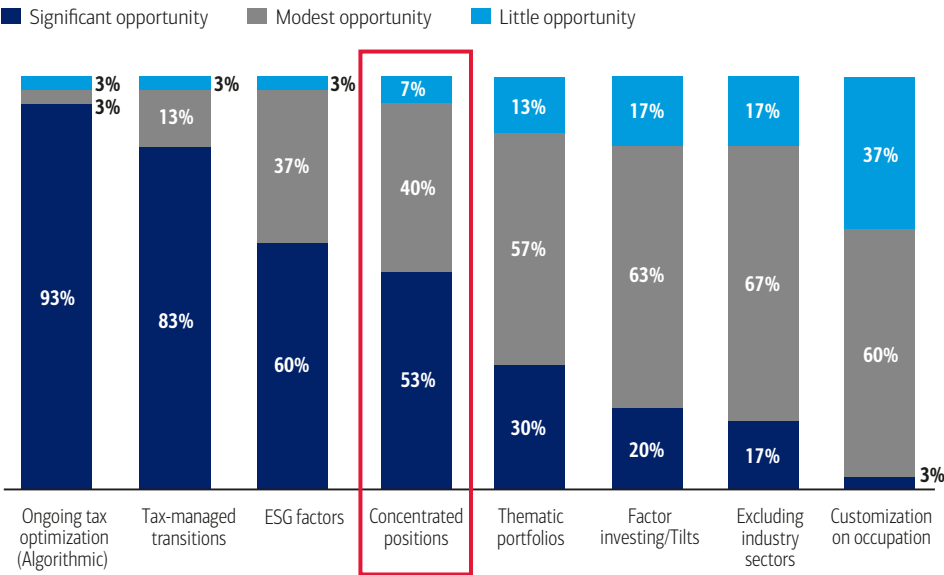
Source: Cerulli Associates, JP Morgan, Morningstar Direct as of December 1, 2021. Growth projections are based on growth in assets. **Please important disclosures at the end of this report.**

What are some of the pros and cons of direct indexing?

Customization capabilities and tax efficiency are the key differentiating features of the direct indexing strategies. The most common benefit of direct indexing is in tax planning, where using a taxable account may create the potential for different options including tax-loss harvesting, gain deferral, application of gain budgets, transferring in/out specific tax lots and transitioning portfolios. A second benefit is portfolio customization, which allows restrictions/or and screens applied to securities, sectors, industries, countries, or a host of environmental, social and governance, religious factors. Some restrictions may help reduce overlapping risk exposure, while others may be incorporated based on values or beliefs.

Exhibit 3: Assessment of the Opportunities for Direct Index Customization.

Managed Account Sponsors: Opportunity for Direct Indexing, 2022



Analyst Note: Sponsors were asked to rate the opportunity for each type of direct indexing. Source: Cerulli Associates, "The Case for Direct Indexing: Differentiation in a Competitive Marketplace", December 1, 2022.

The various functions of direct indexing may help an investor who is seeking to diversify a concentrated position or transition from another asset manager. The investor may donate appreciated shares to fund charitable means, or work with their direct indexing provider to create a plan to slowly exit a highly appreciated or concentrated equity position.

For a while, one of the disadvantages of direct indexing was the high investment minimum (\$100K+), especially compared to ETFs. However, with the adoption of fractional share trading, some providers are bringing down their investment minimums. Another downside to direct indexing is that the strategy tailored for loss harvesting tends to keep appreciated stocks and sell losing positions. Therefore, the stocks that remain in the portfolio, including those that were bought as replacements, tend to have a lower cost basis. As a result, liquidating these positions or switching to a non-direct index strategy might be expensive from a tax perspective. To overcome this, a direct indexing strategy may incorporate charitable gifting of appreciated positions or inheritance planning to take advantage of the step-up in basis at death. At the same time, investors can add cash to refresh the portfolio.

Glossary

Active management seeks to outperform benchmarks through active investment decisions such as asset allocation and investment selection.

Alpha is a measure of the active return on an investment.

CUSIP is a nine-digit numeric or nine-character alphanumeric code that identifies a North American financial security for the purposes of facilitating clearing and settlement of trades.

Tracking error is the divergence between the price behavior of a position or a portfolio and the price behavior of a benchmark.

Fractional share trading is a portion of an equity stock that is less than one full share.

Index Definitions

Securities indexes assume reinvestment of all distributions and interest payments. Indexes are unmanaged and do not take into account fees or expenses. It is not possible to invest directly in an index. Indexes are all based in U.S. dollars.

S&P 500 Index includes a representative sample of 500 leading companies in leading industries of the U.S. economy. Although the index focuses on the large-cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market.

Important Disclosures

Investing involves risk, including the possible loss of principal. Past performance is no guarantee of future results.

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Asset allocation, diversification and rebalancing do not ensure a profit or protect against loss in declining markets.

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