BANK OF AMERICA

CHIEF INVESTMENT OFFICE

Educational Series

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

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The investment backdrop for 2022 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. Above-average valuations measured by price earnings ratios for Equities and low current yields for Fixed Income may moderate future returns for Equity and Fixed Income indexes.

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.

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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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 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 to personal/custom indexing, invests in a subset of underlying securities of a chosen index. This particular strategy, which we detail in the direct indexing section further below, can systematically sell securities that have declined in value to harvest losses, taking into account tax rules, while maintaining 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 (where any excess losses can be 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). 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 first instance 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 harvesting, it often comes into play when an investor "harvests" a loss, which often occurs at year's 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/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 (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.

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 better 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. Loss harvesting may be more efficiently produced through personal/custom/direct indexing.

There are a variety of ways that direct/personal/custom indexing can be formulated, managed and serviced. Direct index providers create an investment solution and construct a portfolio tailored to an investor's tax situations, management of concentrated or legacy holdings, alignment with specific goals and objectives, and charitable aspirations. As advisors tend to have good visibility into a household's entire financial picture and potential tax implications in real time, they may leverage direct index strategies to help deliver solutions that address changing personal tax situations. Many advisors have been using the tax-optimization and customization features of direct indexing as a way of differentiating their practice and helping to improve investment outcomes.

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 provides the similar risk and return profile of the index.

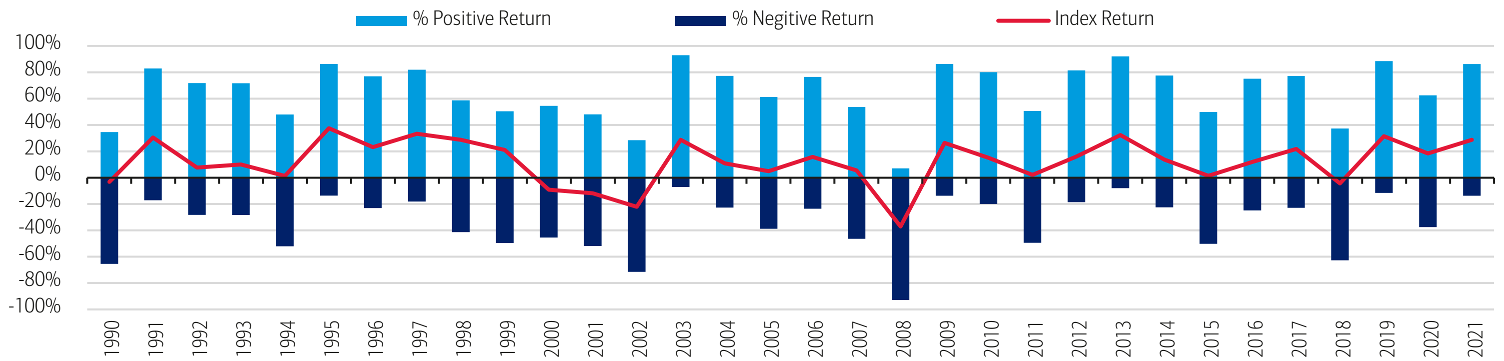
DIRECT INDEXING OBJECTIVE

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.

One of the most popular customization options implemented through direct indexing solutions is focused on tax savings or improvement of after-tax portfolio returns. The strategy invests in a subject of the underlying securities of an index, such as the S&P 500, for example, then systematically sells the stocks that have declined in value to harvest losses while maintain 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 creating losses that, at tax time help offset capital gains, thus helping investors 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 produce 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.

Exhibit 1: Leaders and Laggards in the S&P 500, 1990–2021.



Source: Parametric as of 2021. **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 expected after-tax performance?

For direct indexes focused 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 to 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 tracking error are competing objectives, so the fund manager needs to make the decision about how to balance them in their portfolio. 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.

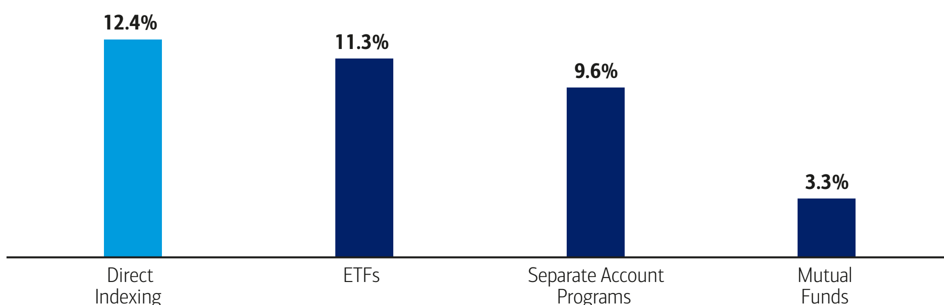
How could direct indexing be used in portfolios?

We are seeing that direct indexing strategies continue to grow in assets and popularity as the need for tax-loss harvesting and gain deferral persists. Investors seeking excess 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 also adding tax efficiency to the overall investment portfolio. Customization capabilities of these strategies also appeal to investors who are seeking custom values alignment and factor tilting.

What are projected growth trends in the space?

The direct index, manager-traded SMA market stood at approximately $363 billion in Q1 2021 according to Cerulli Associates, and assets in the space have more than tripled since 2018. According to a McKinsey study—*Crossing The Horizon*—released in October 2021, assets in these strategies are expected to more than double by 2025. At the same time, Cerulli projects investors use of direct indexing to grow at an annualized rate of over 12% over the next five years, faster than traditional financial products such as mutual funds, ETFs and SMAs.

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

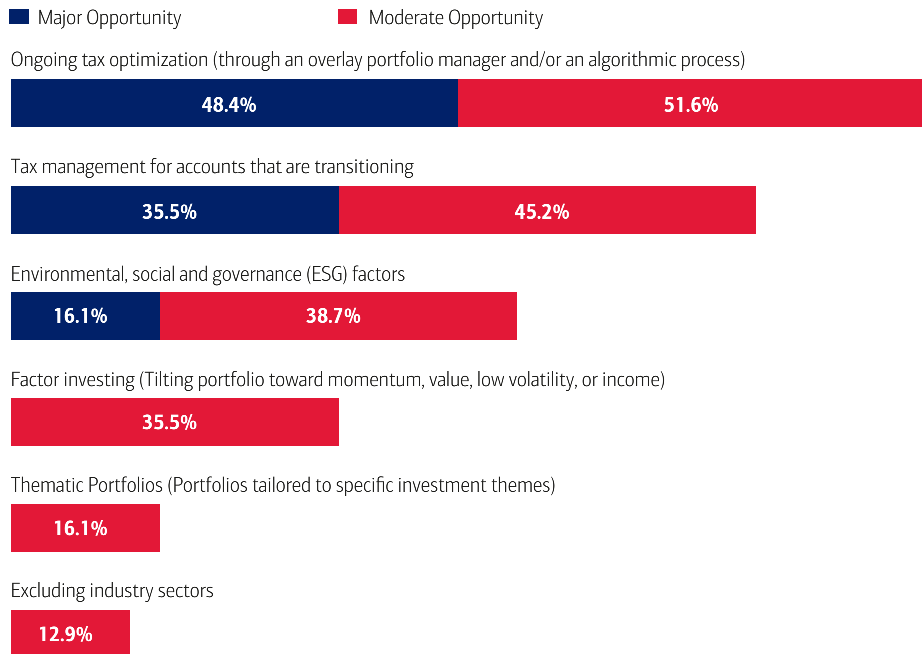


Source: Cerulli Associates, "*Improving Client Experience: Customizing with Direct Indexing*, as of August 2021.

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

Customization capabilities and tax efficiency are the key differentiating features of the direct indexes appealing to many investors. 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 combinations of restrictions and screens applied by security, groups of securities, sector, industry, country, environmental, social and governance, religious or a host of other 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.



Analyst Note: Sponsors were asked to stack rank opportunities for direct indexing on a scale of 1 to 6. Sponsors' top-ranked attributes are shown as Major Opportunities while Moderate Opportunities represent their second- and third-ranked choices. Source: Cerulli Associates, "*Improving Client Experience: Customizing with Direct Indexing*, as of August 2021.

The various functions of direct indexing may help an investor who is seeking to diversify a concentrated position or transition from another asset manager. Thus, the investor may plan to donate shares to fund charitable means, or the advisor can 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 considered to be 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 advancing stocks and selling 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. Direct indexing strategy may also be suggested in these positions as part of a charitable gifting strategy or as part of inheritance planning to take advantage of the step-up in basis provision. 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.

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.

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