

Tax Loss Harvesting: What is it and why is it important in my portfolio?



KEY TAKEAWAYS

- The primary goal of a tax managed direct index strategy is to achieve index returns pre-tax, and outperform index returns on an after-tax basis.
- Investors can generate superior after tax returns ("Tax Alpha") by harvesting losses in their portfolios to offset gains and income taxes.
- Harvesting losses does not mean investors have to sacrifice achieving index/benchmark returns.
- A significant number of strategies, including active SMA, mutual fund, and ETF vehicles, underperform their benchmarks by a significant margin when looked at on an after-tax basis.

There are few things in investing that are both important and controllable. Opinions vary on what these things are, but most of the investment community agrees that costs and taxes are two of the most important factors to consider when managing a portfolio of investments. In this article, we will highlight the importance of taxes, specifically tax loss harvesting.

The concept of Tax Loss Harvesting is understandably difficult to comprehend as we are ingrained to view gains as good and losses as bad. Consequently, most investors stop here and ask themselves, "why would I want losses in my portfolio and how can that be a good thing?" The answer is two part; (1) pre-tax returns should always be a primary objective of the taxable investor, but an equally important objective is (2) what steps should I be considering when looking at after-tax returns? David Swensen, head of the Yale Endowment and creator of The Yale Model, famously stated in 2007 that, "A minuscule 4 percent of funds produce market-beating after-tax results with a scant 0.6 percent (annual) margin of gain. The 96 percent of funds that fail to meet or beat the Vanguard 500 Index Fund lose by a wealth-destroying margin of 4.8 percent per annum." Or in other words, it's incredibly difficult to beat index/benchmark returns on a pre-tax basis, and even more difficult on an after-tax basis. The primary tool used to combat the deterioration of returns on an after-tax basis is tax loss harvesting.

Below are some important topics to understand when discussing tax managed portfolios and tax loss harvesting:

- Tax loss harvesting is a tool that is best utilized in a separately managed account. The taxable investor needs to own each individual security to claim the losses, which cannot be done in commingled portfolios like ETFs and mutual funds.

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- A well-executed tax managed solution should seek to target index/benchmark returns on a pre-tax basis while harvesting losses throughout the year to provide superior after-tax results.
- Losses are used to offset gain obligations elsewhere in your portfolio. Additionally, the short-term and long-term status of the gains/losses are important.
- A tax managed account that utilizes tax loss harvesting does not completely eliminate an investor's tax obligation. It simply defers the obligation while capitalizing on the compounding effect of not paying taxes immediately.

So how does tax loss harvesting work? Primarily, there are three ways a tax loss harvesting strategy can improve tax efficiency and generate superior after-tax returns. (1) Investment losses help to reduce taxes paid by offsetting a taxable investor's gains and income, (2) losses can be carried forward and deferred indefinitely to other periods if you do not immediately have gains to offset, and (3) a taxable investor can use up to \$3000 of losses to offset ordinary income on federal income taxes as well. Another concept to consider when harvesting losses is the type of gain/loss. Securities held for under a year are subject to a short-term loss/gain and those held longer are considered a long-term loss/gain. Short term gains are subject to the investors ordinary income tax rate. The highest tiers can be upwards of 37% or even higher if subject to the NIIT. Long term gains however are subject to a much lower capital gains tax rate.

How does harvesting losses effect pre-tax returns? An investor does not have to settle for inferior pre-tax returns to successfully implement a tax loss harvesting strategy. A tax managed direct index portfolio buys a basket of securities with the goal of tracking the investor's desired benchmark/index. The portfolio is then managed on an on-going basis using an optimization process that analyzes dozens of underlying risk factors (sector, market cap, value, growth, etc.) to build a portfolio that walks and talks like the underlying index. When a security is at a loss, the security is flagged in the system for tax loss harvesting, the security is sold, the loss is harvested, and the optimizer selects another security, or basket of securities, to replace the security that was sold at a loss. After this process, the portfolio behaves the same as it did before; continuing to capture the index return while also harvesting losses.

In summary, a tax managed direct index account can help you achieve index returns on a pre-tax basis and outperform on an after-tax basis. The goal of this article is simply a high-level overview of tax loss harvesting to help explain its importance in achieving superior after-tax performance. Please keep an eye out for additional articles that discuss this concept more in-depth. Additional topics include Tax Alpha, Tracking Error, Wash Sale Rule Violation, and Customization including SRI/ESG and factors.

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