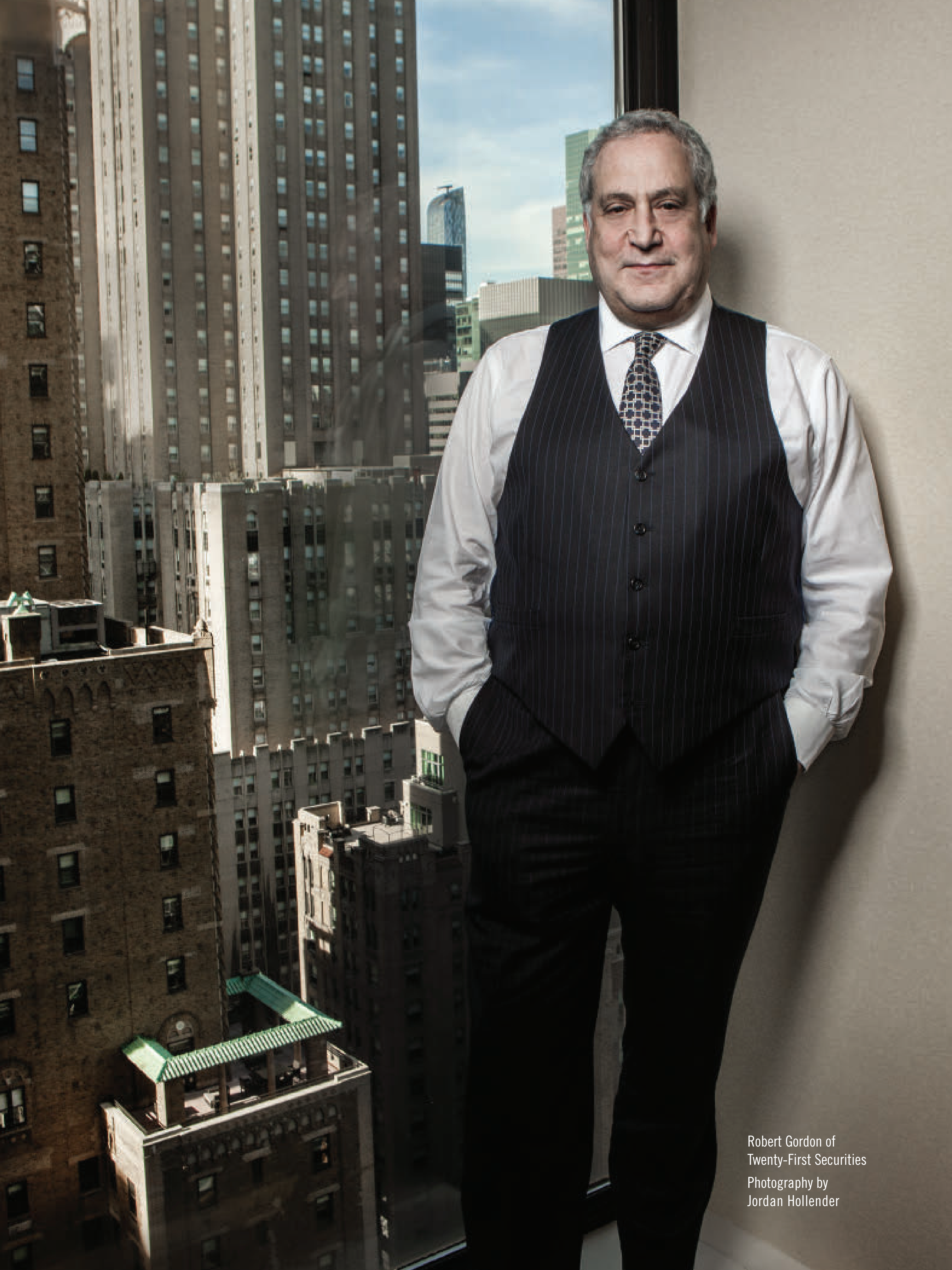
YEAR-ROUND HARVEST

TAX-LOSS HARVESTING HAS EVOLVED FROM A YEAR-END PRACTICE, BUT IS IT WORTH THE EFFORT?

IF THE HISTORIC PATTERN CONTINUES FOLLOWING MIDTERM elections, which have typically seen markets performing well right into the new year, many clients, and the advisors who put them into equities, could be dancing on New Year's Eve. But whether that trend repeats or not, the happy folks on Dec. 31 will also include clients counting their losses. We're talking about advisors and clients who were able to harvest losses during this year's selloffs. It turns out that what used to be largely an end-of-the-year affair is now a year-round practice of aggressively looking for losses in a portfolio and harvesting them right away, not just to avoid short-term capital gains taxes in other parts of the same portfolio, but to also enhance performance. Tax-loss harvesting has become a tried-and-true process for balancing losses against gains.

By Dave Lindorff



Robert Gordon of
Twenty-First Securities

Photography by
Jordan Hollender

Nevertheless, there are plenty of skeptics when it comes to claims made by some tax-loss harvesting practitioners — particularly those promoting automated systems with daily monitoring for potential harvesting of tax losses. Robert Gordon, president of Twenty-First Securities, warns of "hyped benefits" that don't deliver as promised. Gordon argues that in the long term tax-loss harvesting can add perhaps an average 0.5% gain to a portfolio in annual tax alpha, if done properly. That, he adds, assumes that capital gains are being deferred, not avoided, and that they will ultimately end up having to be paid.

Gordon, whose brokers offer tax harvesting to clients, says, "It's all about capturing tax alpha, which is much more dependable than picking stock alpha — something I have never had much skill at, and that I have actually never found anyone who had much skill at."

He adds, "What you're really doing with tax loss harvesting is delaying capital gains taxes. You're not escaping them unless you keep carrying them forward until you die, because then the IRS's step-up-in-basis rule resets the basis to the time of death, so heirs don't have to pay any capital gains tax based on the old basis.

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Since a boutique company called Parametric Portfolio Associates started systematically capturing losses for wealthy investors more than two decades ago, a whole industry of specialty shops has sprung up. Some use automated software to monitor portfolios for losses on a daily basis, aggressively marketing their services not just to the rich, but even to those with as little as $50,000 in taxable investable assets.

HOW HARVESTING WORKS

Research by Michael Kitces, partner and director of research at Pinnacle Advisory Group, a wealth management firm in Columbia, Md., provides an example for the basic way that tax-loss harvesting works. Kitces starts with a security that has a basis of $100,000 that declines to $85,000.

To harvest that loss, the asset is sold, resulting in a $15,000 loss in the portfolio. To steer clear of the IRS's wash sale rule — which disallows tax savings on a loss if the security is sold and then repurchased within 30 days — a similar security is purchased and held in the portfolio for 30 days, and then sold. The original security is also repurchased after the waiting period. Assuming there is no change in the price of either of the two over the 30-day period, and that the original asset was in the portfolio long enough for any capital gains tax to be at the long-term rate, the client's investment now has a cost basis of $85,000, and there is a harvested loss of $15,000. Given a tax rate of 37.1%, this yields $5,565 in tax saving and a 5.6% tax alpha (the tax saving on the basis of the initial $100,000 security that was sold).

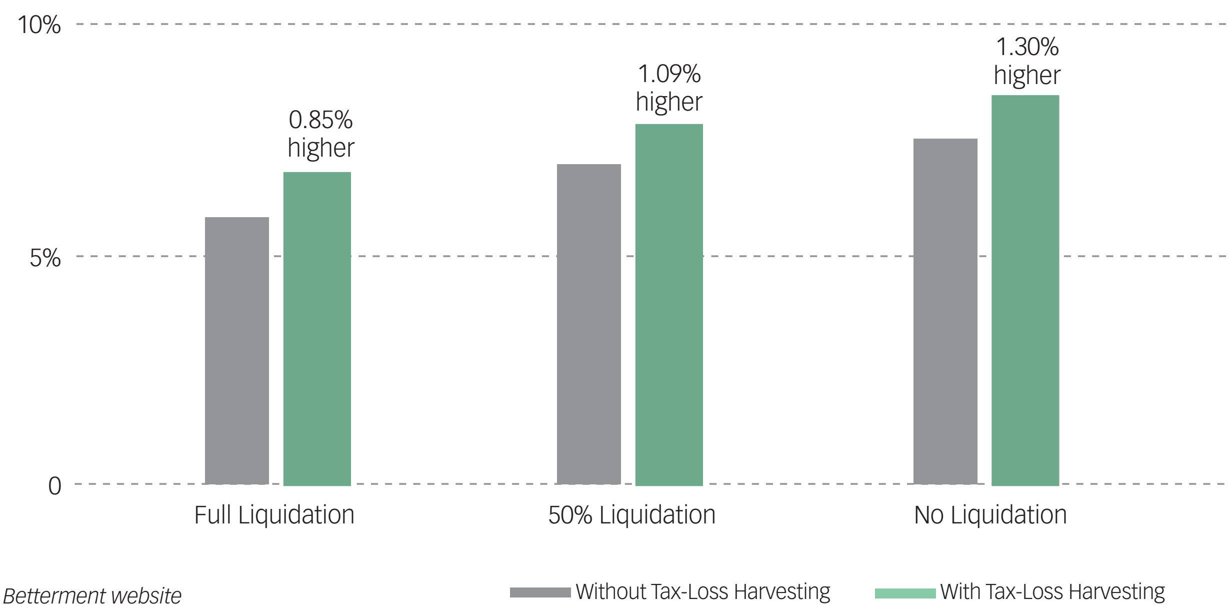
Kitces is quick to point out in his example that the investor ends up not just with a tax saving, but with an asset that now has a basis of just $85,000, instead of $100,000. He notes that if this asset appreciates back up to $100,000, the investor will be left with a gain of $15,000 going forward, and a potential liability for that gain of the same $5,565. In other words, the transaction ends up being a wash, except that the client has the use of the deferred tax of $5,565. If invested to return 8% per year, the client could expect a gain of $442.20.

Twenty-First Securities' Gordon observes: "Obviously, the best way to deal with this is to harvest tax losses and then hold on to the assets that you bought at a new higher basis until you die, so nobody has to pay any capital gains on those securities. But if you can't do that — if you are going to need that money at some point — you have to accept that there's no free lunch. The taxes will eventually have to be paid on the gains."

VARYING APPROACHES

Paul Bouchey, managing director of research at Seattle-based Parametric, says the tactic offers real benefits in a number of ways. Parametric was a pioneer in offering tax harvesting and is now one of the largest firms in the field, managing about $20 billion in tax-efficient mandates. "If you assume an investor who is in the highest tax bracket, living in a high-capital-gains state like California, and who has a lot of short-term gains in a portfolio, you could see a gain of 1% to 2% in a portfolio through tax harvesting," he says. But he hastens to add, "Our experience is that when you first start tax loss harvesting, you get the most bene-

TAX ALPHA FOR CLIENTS EARNING $500,000+ (2000-13)



Source: Betterment website

fit, but as you go forward, the opportunities to harvest tax losses decline. But even a portfolio gain of 0.5% to 1% from tax loss harvesting is still a big deal."

Some companies promise more than that, saying that through daily automated monitoring of a portfolio, they can find and harvest tax losses from the volatility in a portfolio and smaller short-term dips in an index, even absent a major market downturn.

"What we're doing is really very different from the type of tax-loss harvesting that has been done for decades, where advisors would just look for losers in a portfolio at the end of the year, sell them and then balance those losses against the assets that showed gains," says Adam Nash, CEO of Wealthfront, a firm in Palo Alto, Calif., specializing in tax-loss harvesting.

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Wealthfront offers two types of tax-loss-harvesting approaches, Nash says. In 2012, the company began using ETFs covering 11 different asset classes, with at least two ETFs being used in each class. "So for U.S. equities, for example," he explains, "we have a Vanguard and a Schwab ETF — different but both similar and both cheap." He explains the process: "Say the market goes down in early September. Our software will detect that and would sell shares of Vanguard and buy Schwab, so you get to write off the loss. But when the markets recover, you're in position to capture the gain, and since you hold equities obtained at a lower basis, you pay long-term gains, which you won't have to pay for decades."

He notes that holding the newly purchased replacement assets in these trades is possible because "most of Wealthfront's clients are young, and they're making significant contributions to their fund every month." This situation means the fund always has new assets with a relatively high basis when investors need to liquidate part of their portfolio.

In 2013, Wealthfront added a second tax-loss harvesting vehicle: an S&P-based index called the Wealthfront 500. With this product, the client holds the 500 stocks that are in the S&P. Wealthfront's software scans daily for harvestable losses in those stocks.

"What we do," Nash says, "is look at sets of stocks that are similar, like, say, Coke and Pepsi. Say on a given day, there are 27 stocks that have lost value and are candidates for tax loss harvesting. You find similar stocks that as a group did well, and then you sell the losers and buy a replacement for the same amount."

Although Wealthfront's computers monitor its 17,000 clients' accounts on a daily basis, Nash says such tax harvesting maneuvers actually are done only when the losses are sufficient for them to make sense. "Last year," he says, "90% of the tax alpha we generated happened in only a few weeks of the year."

He claims that the company's automated approach can yield annual portfolio after-tax gains of up to 3%. Partly, he says, that gain comes from replacing short-term gains with long-term gains, and partly it comes from having the use of deferred taxes to invest in the fund. He adds, "We did an analysis showing that even if you liquidated fully at the end of 30 years of holding this fund, you would get to keep almost all of the tax benefits harvested because of compounding."

Betterment, which entered the tax-loss-harvesting field in June, also uses an automated approach. Dan Egan, head of investments for the New York-based firm, says this year has provided a "textbook case to show why automated tax loss harvesting is a really good idea."

He explains: "The S&P was up 9% by the end of October, which is very positive. If you just tried to do tax-loss harvesting annually at the end of the year, this year you'd end up probably saying, 'I don't have any losses to harvest.' But if you looked at your portfolio through the year, you would find that there were plenty of drops in the market that offered tax offsets."

On its website, the company claims its automated approach can offer investors two times the gain realized by competitors in the field — mean annual tax offsets of 1.94% vs. 0.95% for TLH methods used by other automated services.

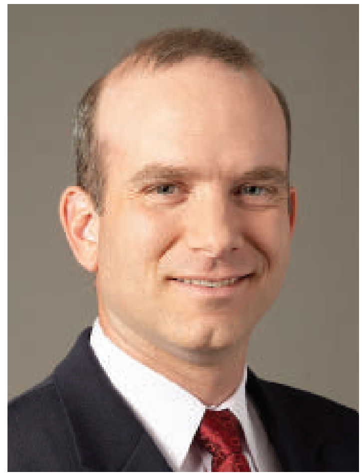
Egan concedes that over time it can be hard to keep finding tax losses in a portfolio that isn't adding new assets, but he says that this isn't likely to pose a problem for most of the firm's 2,000 clients, as "about 80% of our clients are making automatic payments each month, so there are new entry points all the time."

Although Betterment serves clients with taxable accounts as small as $50,000, he notes that "if the investor is in a low tax bracket, tax harvesting doesn't make much sense. If you're in a lower capital gains bracket, you should be harvesting your gains, not your losses."

Rusty Vanneman, chief investment officer at CLS Investments, an Omaha-based investment firm, says, "For a taxable investor, there is an incredible advantage to be had in using tax loss harvesting. Of course there are transaction costs – commissions and time – but it can still be advantageous when you net all that out. It can be a lot of work, but these days a lot of it is being automated."

He says, "What I find is challenging is that when a market goes down, a lot of clients can get paralyzed. And you have to be able to explain to them why you are just selling and taking those losses in their account. A pet peeve of mine is people who say they're tax efficient because they have low turnover. The reality is that if you're tax efficient you will have high turnover!"

Slightly more cautious in its approach is Robert W. Baird's Private Wealth Management Group, which Peter Duback, managing director and director of product strategy, says has been offering systematic tax loss harvesting to clients since 2007. He says, "Our platform is based upon mutual fund investments, and since 2007 we've had a system that will automatically harvest any tax loss of more than $500



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-Tim Steffen, Baird

in a fund — by plugging in an ETF as a place holder for 30 days — if the client opts into the approach." The trading, he says, is handled internally by the firm and costs "about the same as a standard rebalancing."

"It's hard to quantify how much a portfolio can gain from tax loss harvesting," he says. "It depends upon each client's portfolio. But it's important to point out that such gains are not the purpose of the process."

Duback's colleague Tim Steffen, Baird's director of financial planning, adds: "It's the old adage: Don't let the tax tail wag the portfolio dog. Unless the tax issue is so overwhelming it overrides everything else, you should only be selling an asset for good investment reasons, not to harvest a loss."

HARVEST WITH CAUTION

Robert Arnott, chairman and CEO of Research Affiliates in Newport Beach, Calif., is skeptical about what he says are inflated claims being made about the benefits of tax loss harvesting. "Let's not oversell or over-hype a good idea," he says. "What can happen with tax loss harvesting is if you do it too aggressively, or you harvest too fast, you can end up with a portfolio with just capital gains in it. So this is something you ought to do judiciously."

He adds, "Maybe you could get a 3% gain in a portfolio through tax-loss harvesting in the first year, but what about the fifth year? You reach a point, longer term, where you've got no more losses to harvest. Tax-loss harvesting is a very good idea for many portfolios and is too important to just ignore, but if someone's telling you they can keep generating 2 to 3% a year in gains out that long, run the other way!"

> **"TAX-LOSS HARVESTING IS A VERY GOOD IDEA FOR MANY, BUT IF SOMEONE IS PROMISING 3% A YEAR, RUN THE OTHER WAY!"**

Tony McEahern, head of wealth planning at Wells Fargo Private Bank, says: "Tax loss accounting, to be useful, needs to be specific to the individual client. In the past two years, we've had people with substantial gains and insufficient losses. I'd say you'd be hard-pressed to find people with losses they could utilize for tax loss harvesting right now. And if you have gains, you want to realize them by selling, and many of our clients who do that don't have any losses to use against those gains."

His advice for many clients, he says, is to carry forward losses, which can be done endlessly under IRS rules, and to use them during a year when a portfolio realizes significant gains.

McEahern calls daily tax loss harvesting "crazy," and "a kind of day trading." In practice, he says, "Any good investment advisor looks at client accounts quarterly to see if there are any capital gains or losses to match up, so as to reduce or eliminate taxes. You do it quarterly to be on top of things, and to have that information for the tax preparer at year's end. But daily monitoring just doesn't make sense."

James Spiro, an advisor and managing director with Morgan Stanley's office in New Orleans, agrees with McEahern on that point. "I think daily monitoring of a portfolio for potential losses to harvest is a little extreme. I'm not a fan of routinely scrubbing a portfolio for losses. I think you're adding a lot of complexity to an account and trying to be too clever by half doing that."

Spiro says, "I know most people are not fans of the tax process, and don't like paying taxes, but I remind them that the goal of investing is to try and generate profits, and if you generated profits, you're going to pay taxes, so to a certain extent you should be able to accept that and say 'mission accomplished.'"

He says he'll routinely recommend that clients near the end of the year look over their portfolio for losses that can offset capital gains, but he says they should not sell assets just to generate a tax loss and "let the taxes drive the investment decision."

Gordon, meanwhile, warns that there is risk for those who expect to keep rolling over higher basis holdings used in the process of tax loss harvesting, with the goal of avoiding future tax liabilities. He notes that the IRS long ago imposed the wash sale rule requiring a 30-day minimum period before repurchasing an asset, because the practice was viewed as "simply a tax dodge."

He cautions that the IRS may "change the rules again" some day to make tax loss harvesting more difficult. While such rule changes are not typically retroactive, he notes, they could leave advisors and their clients who were aggressive tax loss harvesters flat-footed and stuck holding a lot of assets with much higher bases come liquidation time. **OWS**

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