Tax Trading for Clients: Harder Than It Looks

A large part of our job as wealth managers extends beyond pure investment management. Tax-managing portfolios is key to maximizing our clients' overall financial well-being, which is the true overarching goal of our services. Tax time and the increased volatility recently are reminders that each year there are likely opportunities in our clients' portfolios to harvest losses, especially intrayear. But there are also a lot of considerations. It's not as simple as identifying share lots with the biggest losses, choosing acceptable swaps for them, and avoiding wash sales at the end of each year. Tax-loss harvesting is hardly a one-size-fits-all value-add. Depending on the niche an advisor is serving, and each individual client's situation, many variables may be involved:

- **Defining tax-trade opportunities.** We don't swap in and out every time a security suffers a small 5% dip, even for stocks, but what decline does trigger evaluation? Whatever magnitude of decline you choose, it should be established before the year begins for each broad class of securities—as firm policy or at least as guidance for yourself or any advisors working under you. It should also probably depend upon each asset class's average volatility (the higher the volatility, the larger the band).

- **Is there a suitable substitute vehicle?** We try to recommend or approve multiple options in each sub-asset-class on AdvisorIntelligence (our web research service for advisors) to facilitate this. Or else, we recommend specific index vehicles we think offer the best combination of methodology, liquidity, expenses, and sponsor quality for each asset class we cover. Cash is always an option short term, client personality permitting.

- **Exit strategy.** We need a plan for how to reverse the trade. What happens if the market rises immediately after the swap? Do you move back to the target security and take a short-term gain, which can negate some of the tax benefits? Or if price moves up quickly, do you wait for gains to turn long term and introduce tracking error to the portfolio you'd prefer the client be in? We think it's a best practice to have answers to all these questions hashed out beforehand. Whether they're right or wrong is highly dependent on the client.

- **Are there gains to offset?** If a client has gains elsewhere in the portfolio, the value of tax-trade opportunities increases enormously. In the absence of realized gains, can losses be applied to other forms of income and how long would any excess losses likely be carried over for? The length of tax deferral can impact the true tax benefit as we mention below.

- **Avoiding material year-end distributions.** Taking time to assess the impact of tax-loss harvesting opportunities (or even realizing small gains) ahead of scheduled year-end taxable fund distributions can add value for clients. The amount of value added will vary depending on the tax that would be due on the estimated distribution if the position was held on record date, any gain or loss realized from selling the position prior to record date to avoid the distribution, the tax due on any potential distribution that a replacement fund may be making, and transaction costs. We recommend a free resource that publishes estimated fund distributions and important tax dates for many of the funds we use in our model portfolios, and/or recommend, to aid subscribing advisors in this work. We also share this information with our private clients' tax advisors.

- **Tax-rate differentials.** Unless a client's future tax rate will be 0%, taxes are merely deferred. This means it's important to have an understanding of what the client's realistic tax rate will be when any deferred taxation is eventually incurred. Barring estate tax implications, holding a core investment for an entire lifetime eliminates taxation completely through the step-up of basis at death. This is a competing option to tax trading for some clients.

- **The time-value-of-money effect.** Often overlooked is the effect of the time value of money. Even if tax rates will be higher or the same in the future, realizing losses earlier may still make sense from a time-value-of-money perspective, but this depends on what your assumptions are for the other variables: the discount rate, how far into the future the taxes will be deferred, what the client's tax rate will be then, etc.

For advisors with businesses dominated by mass-affluent clients or HENRYs (High Earners, Not Rich Yet), the benefits of tax-trading are not as clear-cut compared to high-net-worth (HNW) clients with large tax bills and potential future estate liabilities. In general, the robo-advisors are targeting the non-HNW groups and one of their big selling points is that they automate tax trading, despite the fact that the benefits are lower or possibly absent for these types of clients.

If you have prospects or clients in this group where the robos or similar offerings are your competition, it could be impressive to show how you've thought through the issue in a sophisticated way. There have been some high-level screw-ups in recent years among purveyors of Internet advice. We have an opportunity to explain how automating tax management without human judgment can lead to suboptimal decisions. The appearance is that tax-trading is universally beneficial and commoditized. However, this is an area where we think the human advisor still beats the algorithm. Make that case!

Why the Focus on Year-End?

Year-end is a typical time to think about taxes and portfolios, but shouldn't we be screening for tax-mitigation opportunities year-round? Investments can be subject to a drawdown earlier in the year! This is why setting policies on tax trading is important. A prudent long-term planning policy needs two key components to be effective (more on this decision architecture framework in "Investor Behavior: The Psychology of Financial Planning and Investing" by Baker and Ricciardi, Chapter 11):

- It should *encompass a broad range of scenarios* that may present various outcomes over time as markets and client situations change.

- And it should be *specific enough to enable decisive action* when necessary, especially when the world changes and uncertainty (fear) arises.

At Litman Gregory, we also look for tax-trading opportunities when cash moves in or out of client accounts and at every rebalancing or tactical adjustment. At the same time, we often say we try not to let the tax horse drive the investment cart: the investment implications should always be paramount as the so-called tax alpha is generally lower than many think. As a firm that's had in-house research expertise for over 30 years, we've found that our time is best spent focusing on finding investments that will produce the highest pre-tax return, as that's frequently the best predictor of after-tax returns. But our wealth managers that oversee trading for client accounts can seek to add value by opportunistically executing tax trades and coordinating with clients' accountants and tax/estate attorneys.

—Chad V. Perbeck, CIMA®, and Eric R. Figueroa, CFP®

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