Tax policy has been a source of much political debate over the past several years. Tax rates for higher income investors increased in 2013, and there is a good chance that our fiscal issues may be addressed at least partly with additional tax increases. While higher tax rates are generally unwelcome, the silver lining to this cloud has been that clients and advisors have begun to pay greater attention to tax issues, and for good reason.

A number of academic studies\(^1\), \(^2\), \(^3\) have estimated that taxes can erode around 2% of a client’s investment returns. Other research \(^4\), \(^5\), \(^6\) has found that employing tax management techniques such as tax loss harvesting and HIFO accounting (selecting the highest cost tax lots when selling positions) can mitigate a significant amount of this impact.

Much of the research on the impact of tax management techniques has been based on simulations and very low turnover strategies. The purpose of this case study is to review the actual experience from the application of tax management techniques to real world portfolios that are diversified and actively managed.

\(^1\) Lipper Analytics 2010 Tax Study
\(^6\) Horvitz, Jeffrey E. and Jarrod Wilcox, “Know When to Hold ‘Em and When to Fold ‘Em: The Value of Effective Taxable Investment Management.” Journal of Wealth Management, Fall 2003.
Case Study Overview

One of the challenges of evaluating the efficacy of tax management is identifying an appropriate benchmark for comparing after-tax returns. Since taxes are highly dependent on each client’s cost basis and holding period, an appropriate benchmark should begin not only with the same portfolio but with the same start date and cost basis in the underlying holdings.

This case study makes just such a comparison between pairs of accounts. In the results section we will examine results for two types of accounts:

- Seed accounts, which were funded with seed money, and
- Tracking accounts, or paper portfolios, which are not actually funded or traded but are managed as if they are actual accounts. Simulated trading activity occurs at essentially the same time that it occurs in actual accounts invested in those strategies.

For both types of accounts this study compares the results of pairs of accounts, one of which is tax managed and the other managed without regard to taxes (i.e. a tax-exempt account). This comparison provides a couple of useful pieces of information. First, it shows whether the tax management techniques had much impact on the pre-tax returns. Ideally they should not and the pre-tax returns would be very close. Second, by comparing the after-tax returns of each pair of accounts, it demonstrates the after-tax benefit gained from the employment of these techniques.

Both the seed accounts and tracking accounts are composed of combinations of separately managed account strategies as well as mutual funds and ETFs. These strategies were all implemented in a unified account (i.e. a single custodial account/registration), and the implementation and tax overlay was conducted by the Managed Portfolio Advisors® (MPA) division of NGAM Advisors, L.P., a manager specializing in overlay management. These portfolios were rebalanced back to target allocations when asset class weightings drifted excessively and changes to the managers included in the portfolio and/or target allocations occurred periodically. The seed and tracking accounts were invested in line with the same allocation models used to invest actual client accounts and all portfolio changes were implemented concurrently.

Tax Management Techniques

There are a wide variety of tax management techniques that can be employed as part of a tax overlay. The primary techniques employed as part of the tax overlay applied to these accounts include:

- **Tax loss harvesting.** The tax overlay process employed involves looking for opportunities to harvest unrealized losses in positions so that they can be used to offset gains generated elsewhere in the portfolio. This is done in a systematic manner throughout the course of the year, and the proceeds of loss harvested securities are invested in an ETF to preserve asset class exposure. A risk model is also used to help ensure that the portfolio does not deviate excessively from the recommended portfolio.

- **Short-term gain deferral.** For many investors the difference between the tax rates that apply to long-term capital gains and short-term capital gains can be significant. When positions are being sold in portfolios, MPA may defer trades for certain accounts that have significant gains associated with those positions and are relatively close to reaching the one-year holding period that would qualify those gains for treatment as long-term.

- **Optimal tax lot selection.** Custodians will typically resort to some kind of standard accounting process (often First In First Out or FIFO) when identifying which tax lot is being sold unless they are instructed otherwise. In many cases, however, there may be other tax lots that would generate less tax liability for the client. When implementing sales of securities in client accounts, MPA may look across a client’s entire portfolio to find the optimal tax lot from a tax perspective.

- **Avoiding wash sale rule violations.** The IRS’s wash sale rule prevents taxpayers from using a realized loss to offset gains if they purchase the same or a similar security within 30 days of the sale. Avoiding these kinds of occurrences can be difficult in a diversified portfolio when the various investment managers are acting independently. As an overlay manager coordinating activity across the entire portfolio, MPA can prevent most of these types of situations from occurring.

Results

In Figure 1 we present the pre- and after-tax returns for the pair of seed accounts, which have the longest history of these pairs of accounts. The figure below shows the pre-tax and after-tax returns (both pre- and post-liquidation) for the pair of seed accounts invested in an equity allocation model.
As intended, the pre-tax returns of the two portfolios were very close (9.84% versus 9.86% or 2 basis points of annualized performance difference). On an after-tax basis, however, the benefits of employing the tax management techniques are quite evident. On a pre-liquidation basis the tax-managed portfolio outperformed the standard portfolio by an annualized 0.87%, with the non-tax-managed seed account returning 9.04% after-tax and the tax-managed seed account gaining 9.91% per year. On an after-liquidation basis this difference narrowed slightly to 0.67% per year (8.88% versus 8.21%). (Note: Pre-liquidation after-tax returns are calculated assuming all positions held at the end of the period are retained. Post-liquidation after-tax returns are calculated assuming all remaining positions are liquidated at the end of the period being considered.)

The tracking accounts provide additional data points with similar results. The time period these portfolios have been managed is slightly shorter, but they span a broader range of asset allocation models and manager combinations. Figure 2 plots the annualized returns for the 12 tracking account pairs against their equity separate account allocation percentages. While tax management techniques are not applied exclusively to equity separate account strategies within the portfolios, it is in these types of sleeves that the greatest impact can be realized. As shown in the chart, the after-tax return difference increases as the equity separate account allocations increase.

**Tax Management and the Market Environment**

Not surprisingly, it is easier to be tax efficient in a bear market. As opposed to a bull market, where much of the trading activity in a portfolio is likely to generate realized gains, in down markets it is much more likely that gains will be smaller or clients may experience net realized losses. Other factors, such as market volatility levels and the dispersion of returns of stocks within the market can also have a significant impact. Some of this impact can be illustrated by comparing returns for tracking accounts established at the start of 2012 with tracking accounts following the same allocation model that were established at the start of 2014.

As shown in Figure 3, the tax alpha generated in the 2012 vintage tracking account was significantly higher than for the 2014 vintage account in the first 12 months after inception. Overall, the market returns for each year (2012 and 2014) were quite good and somewhat similar, with the S&P 500 generating a total return of 16% in 2012 and 13.7% in 2014. There were some meaningful differences in market behavior, however. There were more significant drawdowns in 2012, including one that approached 10%. This also occurred earlier in the year, soon after the initial cost basis in securities had been established in the account and before many of these...
positions had a chance to appreciate. In 2014 the largest pullback in the market occurred much later in the year and after there had already been significant market appreciation. This meant that although the market pulled back, for many securities held in the portfolio the price may not have declined to the point where a loss could be harvested. 2012 also saw higher volatility levels in the market and wider dispersion in security returns, both of which can also contribute to more loss harvesting opportunities.

The maturity of an account, especially in periods of prolonged bull markets, can also impact the potential for tax alpha in a given year. Figure 4 shows the tax alpha generated in the 2012 and 2014 vintage equity allocation tracking accounts in 2014.

The tax alpha generated in the 2012 vintage account was much lower in 2014 than for the 2014 vintage account. This is not surprising as the 2012 vintage account had been invested for 2 full years prior to 2014, during which time the S&P 500® appreciated more than 50%. The 2012 vintage account therefore started out 2014 with much lower cost basis on most of the securities held in the portfolio than the 2014 vintage account, which established its cost basis on 12/31/13. As a result, there would have been fewer opportunities to conduct loss harvesting in the older account.

**The Life Cycle of an Account**

During the course of managing an account numerous events and activities occur that have tax consequences. Managers sell some securities to buy others, asset classes drift away from targets and require rebalancing, managers are replaced and target allocations may be adjusted as new capital market projections are factored into asset allocation models. All of this results in trading activity that generates realized gains and losses. Figure 5 shows the cumulative realized gains and losses for the tax-managed equity allocation seed account since its inception.

After the account initially opened there were relatively small amounts of realized gains and losses on any given day. Since the equity market was generally declining during this initial period, the cumulative realized gain/loss line gradually trends downward. Roughly every 31 days the account went through a loss harvesting cycle, so there is a larger realized loss amount on those days and the cumulative losses gap down. In June 2012 several changes were made to the allocation model this account was aligned with. This included adjustments to the asset allocation targets but also some manager changes. At this time the market had not recovered from the previous decline so net losses were realized. From that point on the equity market generally trended upward. The normal trading activity by managers began to generate realized gains, causing the cumulative realized gains to move slowly upwards. Periodic loss harvesting offset part of that
increase, but the ensuing strong equity market returns resulted in more realized gains. Manager changes, which required the liquidation of most of the terminated managers’ holdings in June 2013 and October 2014, also contributed to the realization of more gains. During this period the loss harvesting opportunities were scarcer so the offsetting realized losses were modest. Despite the strong equity markets over much of this period, however, the account still had very limited cumulative net realized gains since inception. This is due in large part to the loss harvesting that occurred in the challenging market environment during the months after the account opened. During this period realized losses were banked that were able to be used to offset later realized gains.

Conclusions
Taxes can erode an investor’s realized return and the impact can be significant. With tax rates having already increased for some investors, it is especially important now to consider ways to mitigate the impact of taxes on investment portfolios.

Great care should be taken when interpreting the results summarized in this case study. The improvement in after-tax returns achieved in these accounts cannot necessarily be extended to all accounts or extrapolated over longer time periods. As we have shown, there are a number of factors that can impact the magnitude of tax benefits that may be realized by employing a tax overlay. To summarize, key findings include:

- **Taxable portfolios can benefit from the use of tax management techniques.** Even after fully liquidating a portfolio the increase in after-tax returns can be significant.

- **Equity separate account strategies provide the most opportunity for adding value on an after-tax basis.** Maximizing the use of separate account strategies for a portfolio’s equity exposure can help improve after-tax returns. This isn’t to suggest that allocations to equities should be increased but that where equities are being used in a portfolio, there may be some tax benefit to using separate account strategies if tax management techniques are being employed.

- **The tax efficiency of investment strategies may depend on the market environment.** Bear markets create more loss harvesting opportunities. During strong markets it is more difficult to find opportunities to enhance after-tax returns, especially by loss harvesting, so the benefits of tax management may be lower, though still beneficial. Volatility levels and the dispersion of returns across the securities in the market can also impact the potential for generating tax alpha.

This case study has examined the potential benefits of employing a number of tax management techniques as part of a tax overlay process. These techniques should be employed in a thoughtful manner as tax considerations must be weighed carefully against other investment considerations. The topics addressed in this paper are also fairly limited in scope and are focused on enhancing the after-tax returns of investment portfolios. There are many other techniques that can be employed to help manage an investor’s tax situation including estate planning, investment and vehicle selection, and choosing which asset types to locate in tax deferred versus taxable accounts. Clients are best served when taxes are taken into consideration in all aspects of their financial planning.
NGAM Advisors, L.P. does not offer tax advice. Clients should always consult with their tax advisor to discuss their personal situation.

The two of seed accounts examined in this case study were both invested in portfolios composed of identical asset allocations and the same combination of separate account strategies, mutual funds and ETFs. Both accounts were incepted on 5/4/11 and therefore began with essentially identical portfolios and the same cost basis and purchase date for the underlying securities. The initial allocations for these accounts included 7 separate account equity strategies constituting 69% of the portfolio. The remainder of the accounts were invested in mutual funds and ETFs. 100% of the accounts were allocated to equities at inception. The trading for these accounts was done simultaneously with the trading for live client accounts. This includes individual trades communicated by the separate account managers as well as asset allocation changes and manager changes. The asset class drift monitoring and rebalancing was also conducted in the same manner as it was for actual client accounts. The pair of seed accounts underwent a change in asset allocation targets as well as manager changes in June 2012, and additional manager changes in June 2013 and October 2014.

Each pair of tracking accounts was also invested in portfolios composed of identical asset allocations and the same combination of separate account strategies, mutual funds and ETFs. All 2012 vintage tracking accounts were incepted on 12/31/11 and each pair therefore began with identical portfolios and the same cost basis and purchase dates for the underlying securities. All 2014 tracking accounts were incepted on 12/31/13 and each pair of these also began with identical portfolios and the same cost basis and purchase date for the underlying securities. The tracking accounts spanned various risk categories and each pair had different allocations to separate accounts versus mutual funds and ETFs and varying splits between equities and fixed-income. The tracking accounts were all invested in accordance with asset allocation models used for actual client accounts. Changes to asset allocations, manager changes and trades in the underlying separate account strategies were all implemented consistent with the manner and timing that they were implemented in actual client accounts. Asset class drift monitoring and rebalancing as well as loss harvesting for the tax-managed tracking accounts was also conducted in the same manner that it was for actual client accounts. Since the tracking accounts were paper portfolios and did not represent actual assets, the trade execution was simulated. Trades for the tracking accounts were generated at the same time these trades were generated for actual client accounts. Instead of these trades being actually executed as they were for actual client and seed accounts, however, these trades were assumed to be executed at the current market price of the security being traded.

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