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APERIO RESEARCH

Tax Alpha: How Much Value Does Tax Management Add to a Legacy Portfolio?

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About half of the taxable accounts Aperio manages start with legacy holdings. Our research analyzes the tax benefits achieved in these accounts at inception and thereafter.

Loss harvesting is broadly recognized as a means to generate positive alpha over an index in the form of tax savings. Extensive research is available on the value of loss harvesting in indexed separately managed accounts. However, most of this research assumes that portfolios are funded with cash. Furthermore, composite reports produced by most loss-harvesting providers include only accounts that start with cash.

In practice, about half of our clients with taxable accounts fund those accounts with securities. For these "legacy" accounts, Aperio's active tax management provides two main tax benefits. The first is generated at inception. We transition the client's holdings to an Aperio strategy using tax-aware optimization, whereby we lower tracking error to a benchmark while minimizing gains. The second benefit is tax alpha[1] from ongoing loss harvesting, which is produced after the inception of a portfolio and throughout its life cycle. Tax alpha in legacy accounts is typically lower than in those that start with cash, as a highly appreciated initial holding may never convert to a loss. In this note, we analyze these two benefits by looking at the distribution of tax savings on transitions and the tax alpha attained from loss harvesting.

[1] Tax alpha is the after-tax return difference between a loss-harvesting portfolio and its benchmark, minus the pre-tax return difference between the loss-harvesting portfolio and its benchmark. The tax alpha numbers cited assume an estate/donation disposition in which a portfolio is either bequeathed or donated to a charitable organization at the end of its life cycle.

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Tax Savings on Transitions

The principles of tax-aware investing call not only for the immediate realization of capital losses but also for the delayed realization of capital gains. In most cases, transitioning legacy positions to an Aperio strategy provides an up-front benefit in the form of deferred taxes.[2] We can build a more diversified portfolio around existing positions and avoid a full liquidation of the portfolio, which can result in significant capital gains. Figure 1 shows the distribution of tax savings as a percentage of portfolio value attained from avoiding liquidation at inception. The average saving was 8.1%, with the central half of observations falling between 4.0% and 11.0%. Almost all of our taxable legacy portfolios enjoyed the benefit of migrating without the need for a full liquidation.

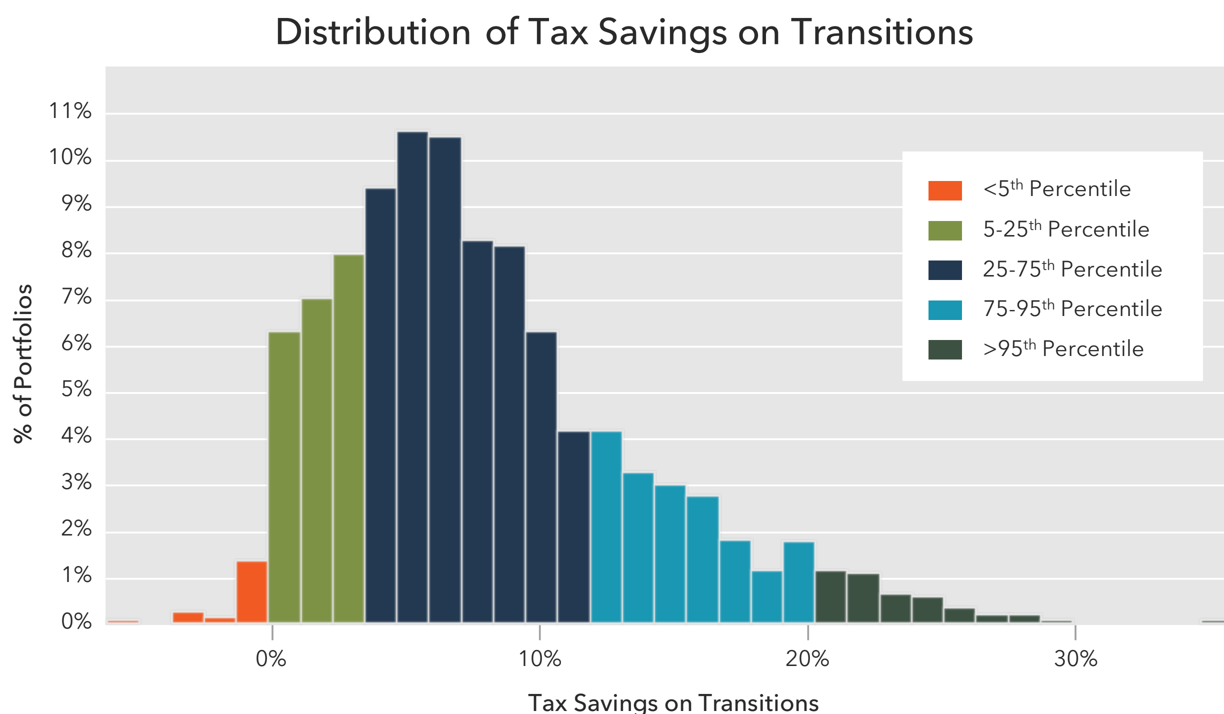

Figure 1: Tax alpha from deferred taxes generated by transitioning portfolios at inception. Data from 4/12/2011 through 12/31/2020. Includes 1,822 taxable open and closed standard loss-harvesting portfolios funded with legacy positions. Excludes accounts with a margin feature and accounts where the initial transition required a full liquidation (such as accounts funded solely with exchange-traded funds). Each account's effective short-term and long-term capital gains tax rates as of 12/31/2020 are used in the calculations. Tax alpha numbers assume an estate/donation disposition where a portfolio is either bequeathed or donated to a charitable organization at the end of its life cycle.

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[2] $Deferred\ Taxes = \frac{ST_{UGL(0)} * ST_{TAX(Curr)} + LT_{UGL(0)} * LT_{TAX(Curr)}}{MV(0)}$

$ST_{UGL(0)}$: Unrealized Short Term Net Gains or Losses at Inception

$LT_{UGL(0)}$: Unrealized Long Term Net Gains or Losses at Inception

$ST_{TAX(Curr)}$: Highest Applicable Short Term Capital Gains Tax Rate as of 12/31/2020

$LT_{TAX(Curr)}$: Highest Applicable Long Term Capital Gains Tax Rate as of 12/31/2020

$MV(0)$: Total Equity + Cash Value at Inception

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Tax Alpha from Loss Harvesting

Legacy portfolios typically contain appreciated positions and therefore should yield a lower future tax alpha than portfolios started with cash. The ratio of cost basis to market value (CB/MV) at inception is a good predictor of a portfolio's potential to generate tax alpha, as shown in Figure 2. We grouped legacy portfolios by initial CB/MV and averaged their annualized tax alpha over the next five years. As a baseline, we also considered portfolios launched from cash. As expected, tax alpha increased with initial CB/MV. We saw a five-fold increase in tax alpha in portfolios with higher basis than market value relative to the lowest CB/MV group (20%–40%). Tax alpha in portfolios that started with cash was on par with their initial CB/MV (100%).

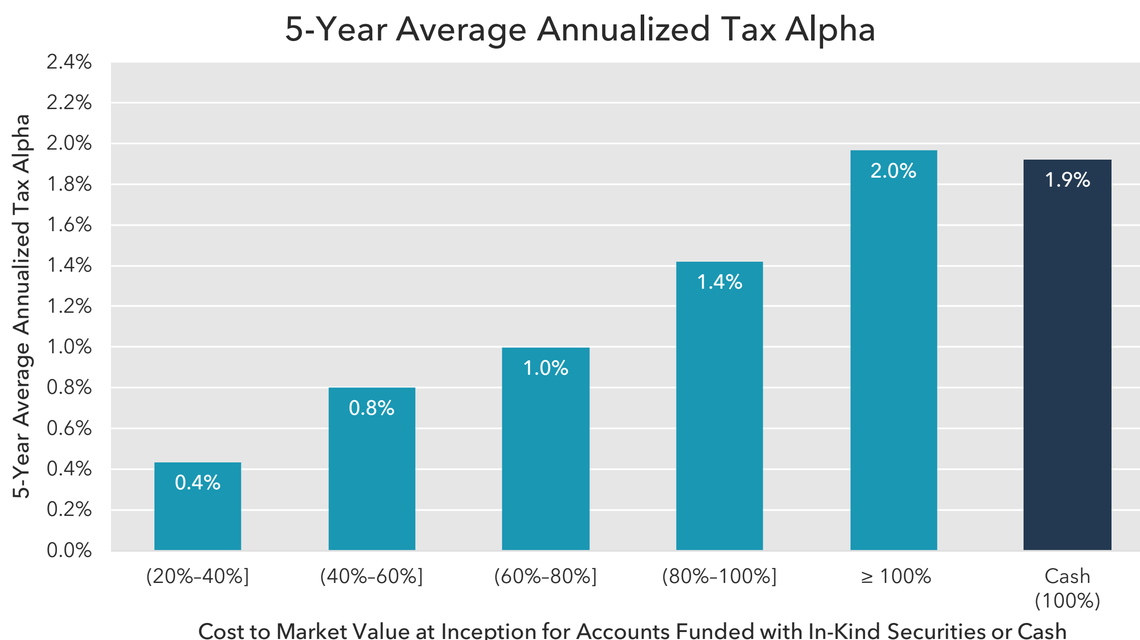

Figure 2: Average annualized tax alpha at the first five-year horizon for standard loss-harvesting portfolios funded with legacy positions, grouped by initial cost to market value (measured at the end of each account's inception month), and with cash. Data includes 457 open and closed taxable separately managed accounts funded with in-kind securities and 474 open and closed taxable separately managed accounts funded with cash. The earliest inception date is in June 2006, and the end date of our dataset is March 2021. Returns to the initial and final partial months of every account are excluded, as are accounts that are managed to take gains and accounts that lack a shadow benchmark.[3] Tax alpha numbers assume an estate/donation disposition in which a portfolio is either bequeathed or donated to a charitable organization at the end of its life cycle.

[3] A shadow benchmark is a simulated portfolio representing a target benchmark index (e.g., S&P 500, MSCI EAFE, etc.). It starts with the same market value and cost basis as the initial investment and "shadows" the investor's actual cash flows and tax rates over time. The shadow benchmark is designed to simulate client-specific cash flows and estimate after-tax benchmark returns by assuming that the benchmark is subject to the same capital gains tax rates for withdrawals as the actual portfolio. In the shadow benchmark, taxes are paid/harvested proportionately across all tax lots; whereas, in the actual portfolio, lots are relieved according to the specified tax lot relief methodology, with the goal of minimizing the tax liability resulting from the cash flow. This after-tax treatment of cash flows distinguishes a shadow benchmark from a standard (non-shadow) benchmark.

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Conclusion

A large portion of the capital gains taxes embedded in a legacy portfolio can generally be deferred by transitioning to an Aperio strategy in a tax-efficient manner. Subsequent loss harvesting provides additional tax alpha, which tends to be higher for portfolios with fewer embedded gains at inception. With tax-aware optimization, a portfolio goes through a powerful transformation. Losers are sold, yielding a tax benefit to the investor in the presence of outside gains, and replenished with new securities while maintaining close index tracking. Through the deferred realization of capital gains and disciplined loss harvesting, our clients may enjoy the tax benefits of their investments.

Disclosure

The information contained within this paper was carefully compiled from sources Aperio (now part of BlackRock) believes to be reliable, but we cannot guarantee accuracy. We provide this information with the understanding that we are not engaged in rendering legal, accounting, or tax services. In particular, none of the examples should be considered advice tailored to the needs of any specific investor. We recommend that all investors seek out the services of competent professionals in any of the aforementioned areas.

With respect to the description of any investment strategies, simulations, or investment recommendations, we cannot provide any assurances that they will perform as expected and as described in our materials. Past performance is not indicative of future results. Every investment program has the potential for loss as well as gain.

Due to the complexity of tax law, not every single taxpayer will face the situations described herein exactly as calculated or stated; i.e., the examples and calculations are intended to be representative of some but not all taxpayers. Since each investor's situation may be different in terms of income tax, estate tax, and asset allocation, there may be situations in which the recommendations would not apply. Please discuss any individual situation with tax and investment advisors first before proceeding. Taxpayers paying lower tax rates than those assumed or without taxable income would earn smaller tax benefits from tax-advantaged indexing or even none at all compared to those described.

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