A Tax-Loss Harvesting (TLH) Debrief

Quick take:

- Tax-loss harvesting (TLH) strategies are effective in reducing immediate capital gains tax liability payments for individuals, dependent on different variables.
- Such strategies may defer tax liabilities indefinitely until the taxpayer chooses a means of liquidation or even eliminate the liabilities if the taxable assets are held until death.
- Most of the benefits apply to federal taxes since states have different tax laws, sometimes limiting the advantages available on a state tax reporting level.
- The degree of success depends on many factors including applicable tax rates, income levels, size of flows, market volatility, and investment granularity.
- There are seemingly endless ways to implement a TLH strategy depending on the taxpayer's preferences – manually, automatically, algorithmically, given specific timeframes, based on tolerance bands, and more.

On the surface, the benefit of tax-loss harvesting is straightforward – to soften the tax liability burden on any individual or entity, one can seek to realize capital losses specifically to offset any capital gains, which inevitably reduces the taxable bill. However, there are a multitude of methods to accomplish this and a host of variables at play with which to consider when building a strategy. Naturally, investors alike tend to explore ways to minimize the impact taxes may have on their wealth. Thus, this whitepaper is intended to explain the benefits of adopting a TLH strategy, equipping investors with valuable knowledge and concepts.

Tax-loss harvesting (TLH) is a means to essentially extract more value out of an investment portfolio, aside from simply generating investment returns but also by generating tax savings. In its simplest form, investments that have declined in value below their purchase price, not uncommon to vastly all marketable investment securities, may be sold to generate a capital loss. This loss can then be used to offset other realized capital gains, thus ultimately lowering an investor's tax liability. The iterative process can be performed in many different manners, either automatically, manually, at specified time periods, given specified security tolerance reigns, and more which will be explained in detail below.

There are a few vitally important concepts, considerations, and factors to thoroughly understand before employing a TLH approach. At a minimum, these include the following points which are listed in no particular order.

Considerations and Factors at Play

- TLH can be used to defer tax liabilities into the future based on an investor's preference. Additionally, if an investor would like to eliminate liabilities, they must hold their taxable securities until death, at which time the securities' cost basis (or price at which the security was acquired) resets. For the most part, TLH has very little value if applied over a short investment time horizon but can be extremely worthwhile if executed over a long period of time.

- Since TLH strategies inevitably reset a portfolio's overall cost basis lower over time, the largest benefit from harvesting losses typically takes place in the early years after initially investing, assuming markets trend upwards with muted volatility and minimal additional capital is added to the portfolio in the future. The latter points are elaborated on below as being important to a strategy's success.

- The deferral of tax liabilities into the future may prove to be prosperous assuming the dollars saved from paying taxes remain invested in your portfolio and increase in value over time. Thus, the incremental benefit to an investor is the return earned on the dollars saved.

- The TLH offsetting benefit is only applicable to taxable assets, not qualified or retirement assets such as IRAs, 401(k) accounts, and other retirement assets which already benefit from the tax-deferred growth advantage.

- Tax laws vary widely when comparing factors applied on a federal versus state level. It is always prudent for an investor to familiarize themselves with any relevant laws that may apply to their situation prior to implementing a TLH strategy. For instance, it's possible for an investor to pay more in state taxes if capital losses are not offset with gains in some states like New Jersey since losses cannot be carried forward.

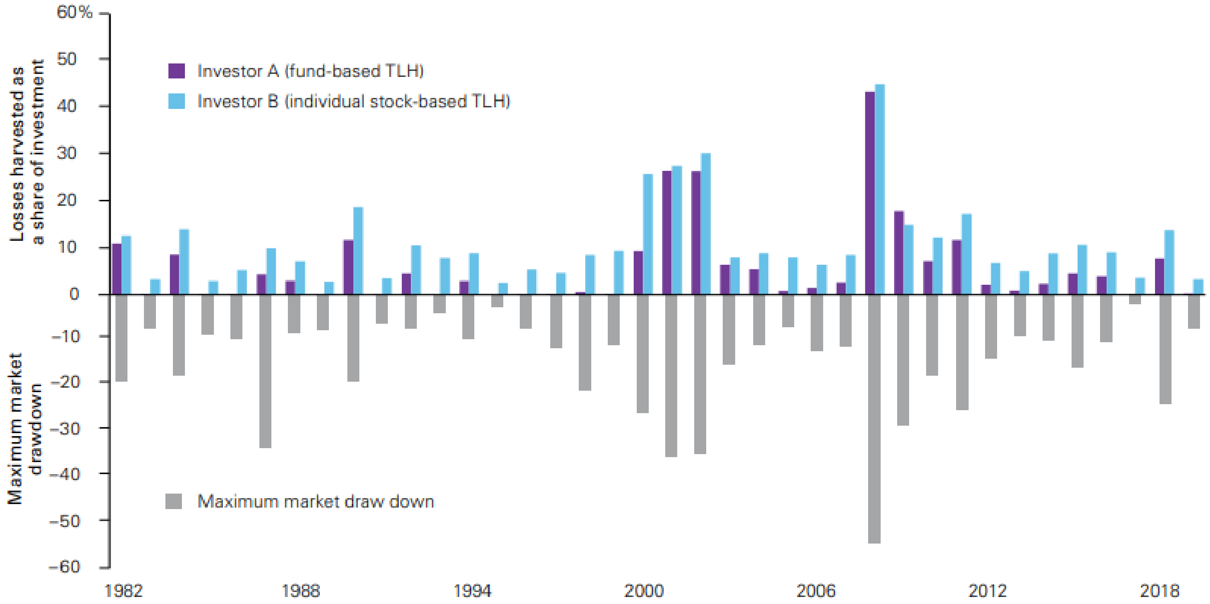
- Wash sale management is a complex yet critical component as part of the TLH process. To begin, a wash sale violation is a sale of a security at a loss and repurchase of the same or substantially identical security shortly before or after the sale. To be more specific, the repurchase must not occur within 30 days of selling the same security for a loss. To avoid this, software programs are designed to monitor and prevent this from occurring. However, for an investor to remain fully invested in the market for those 30 days or longer, typically an investment deemed "not substantially identical" to the original loss harvesting candidate security is purchased for the temporary period.

- Each TLH strategy has its own unique trading costs to consider. For example, the bid/ask spread (implicit cost) may differ between a U.S. stock and a less liquid foreign market stock, which should be evaluated if trading to realize a capital loss. Also, a strategy's management fee (explicit cost) slightly detracts from the overall value-added.

- The dispersion of returns between an investment harvested for a loss compared to the replacement security may drive how much or little the portfolio value rises or falls. Typically, if available, a replacement is selected to provide similar economic exposure as the original loss harvesting candidate security.

- Any degree of success to an individual from a TLH strategy depends on different factors such as but not limited to:
    - An individual's current versus future tax rates
    - The sizing, frequency, and ability for an individual to continually invest in a TLH strategy in the future
    - Frequency of realizing and magnitude of capital losses
    - The future level of market volatility which enhances loss harvesting opportunities
    - The level of investment granularity since individual securities tend to provide more opportunities to harvest losses compared to pooled funds

More granular portfolio construction often provides more harvesting opportunities



Source: © The Vanguard Group, Inc., used with permission.

Methods and Process

There are many different methods with which TLH strategies can be implemented. To name a few of the more common ones used in today's environment, these include the following listed in no specific order which can easily be mixed and matched together in many ways:

1. The simplest method is to manually identify and take advantage of TLH opportunities near the end of any calendar year. This rudimentary process is straightforward and allows the investor to sell securities up to a target aggregate loss amount, all tax lots with losses greater than a prespecified threshold, or even specific tax lots based on their own preference.

2. Another, much more automated approach is sometimes referred to as tax-lot cycling. Typically, software algorithms are set up to automatically harvest a loss once it surpasses a pre-set dollar or percentage threshold, and immediately reinvest the proceeds into an equivalent, but not substantially identical replacement security identified to provide similar economic exposure. All types of model portfolios are fair game using this approach since they can be constructed in many fashions with various levels of detail. The key to success is to ensure a robust list of replacement securities is available to retain market exposure and avoid creating any wash sale violations.

3. A separate method becoming increasingly popular in today's environment is known as direct indexing incorporating a tax-loss harvesting component in the process. Many notable wealth and asset management firms have either acquired a direct indexing strategy or built one internally. Essentially, an investor would be investing in a strategy deliberately designed to provide passive index exposure, pre-determined prior to investing, while simultaneously actively harvesting tax losses for their own use. It is a very quant-heavy approach, which seemingly has a wide range of customization available to take advantage of.

4. A final, simple, yet thorough means to harvest more capital losses than gains is to integrate a tax-efficient rebalancing framework (sometimes called a Tax Overlay Solution). There may be many variables that can contribute to an effective rebalancing approach. These include over or underweighting a specific investment or even tax lot based on its unrealized gain or loss at any time, employing different tax lot relief methods when liquidating shares, and even what's known as "short-term gain deferral". The latter feature refers to retaining a specific tax lot if it will soon be considered "long-term" and is held at a substantial short-term unrealized gain. "Long-term" refers to holding a security for at least 365 days or longer while a "short-term" lot is a tax lot held for less than 365 days. This may create some additional tracking error, which can be considered a trade-off to save some on taxes due.

Volatility is alive even during a bull market

S&P 500 Index Statistics	2019	2020	2021
Stocks with greater than a 10% max drawdown (% of index)	82.9%	99.8%	91.7%
Stocks with greater than a 25% max drawdown (% of index)	23.2%	92.8%	20.6%
Stocks showing a loss for year (% of index)	12.8%	40.2%	14.0%
S&P 500 total return	31.5%	18.4%	28.7%

As shown in the chart above, intra-year volatility exists despite the steady climb in stock prices. In 2020, the number of stocks in the S&P 500 with at least a 25% drawdown during the year at some point was about 93% of all index constituents due to early panic brought on by the pandemic. Nevertheless, throughout the entire year, the index rose by more than 18% rewarding patient investors.

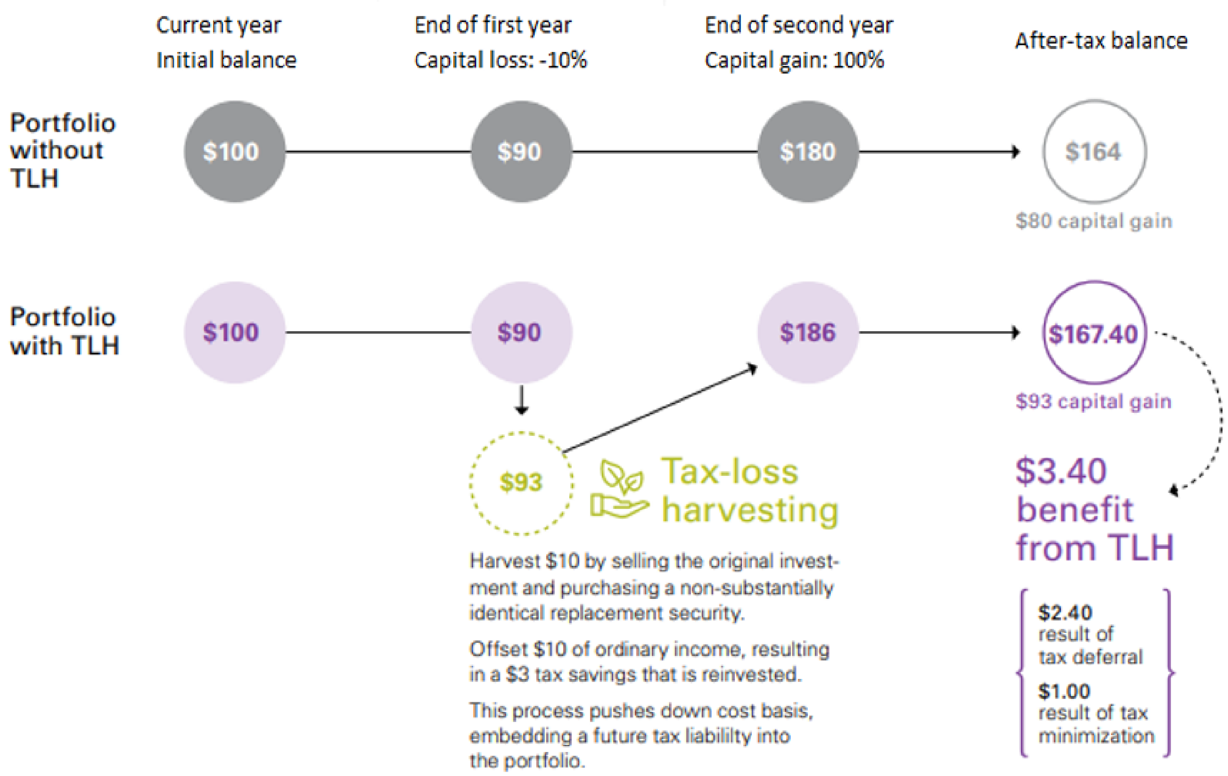
Source: Bloomberg & Morningstar as of 12/31/2021

Measuring the Effects

Arguably, the final important component required for a TLH strategy to be of value is to demonstrate its efficacy to investors using after-tax performance, which differs from the standard pre-tax performance we all are accustomed to seeing for investments. Additionally, there are different metrics that can be displayed to show the value added by TLH. Some common ones are termed harvesting yield, tax savings, and the most well-known is tax alpha. Put simply, tax alpha is defined as the difference between a portfolio's excess after-tax return and the excess pre-tax return. However, computing tax alpha is not always simple and requires a lot of calculations on the backend. Using recent studies incorporating data over the past 90 years, it has been found that on average an investor facing a capital-gains tax rate of 25% can enhance an equity portfolio's annual return by 1.1% to 1.4% by employing a TLH strategy[i]. These gains are not guaranteed and depend on various inputs as described above.

The following graphic taken from Vanguard showcases the value earned by a TLH strategy when compared to a portfolio not incorporating a TLH approach. All values shown are theoretical. During the first year, assume a -10% return and a 30% tax rate that applies at year-end. During the second year, assume a 100% return and a 20% tax rate that applies at the year-end final liquidation. By using TLH, the benefit includes $1 of overall tax minimization (the amount by which the $3 of tax savings on ordinary income at the end of the first year outweighs the $2 of tax owed on the additional $10 long-term capital gain resulting from the reduced cost basis). It also includes $2.40 of a tax deferral benefit (representing the $3 gain from reinvested deferred taxes less 20% capital gains tax owed upon liquidation).

Two sources of TLH benefit



Source: © The Vanguard Group, Inc., used with permission.

<u>Conclusion</u>

Tax-loss harvesting may be a highly valuable way to improve the tax efficiency of a portfolio and asset base, but it is important to understand it should not interfere with overriding strategic investment objectives. These include broad diversification and integrating an optimal asset allocation mix. Since tax-loss harvesting eventually lowers the cost basis of a portfolio, investors may consider different long-term management approaches. Using the portfolio as a charitable donation or even passing the entire portfolio onto heirs through an estate at a stepped-up cost basis are two approaches considered by many rather than ultimately realizing embedded capital gains and paying taxes. In conclusion, tax-loss harvesting should ultimately be considered as a fundamental component of nearly all individuals' strategies in some manner that fits in with their goals and objectives.

Disclaimer

This commentary was written by Craig Amico, CFA®, CIPM®, Associate Director, Noreen Brown, CFA®, Chief Wealth Strategist and Steven Melnick, CFA®, Associate Director at Summit Financial, LLC., an SEC Registered Investment Adviser ("Summit"), headquartered at 4 Campus Drive, Parsippany, NJ 07054, Tel. 973-285-3600. It is provided for your information and guidance and is not intended as specific advice and does not constitute an offer or solicitation to buy any securities mentioned. Hypothetical results do not represent actual client experiences. All investing is subject to risk, including the possible loss of money invested. Summit is an investment adviser and offers asset management and financial planning services. Indices are unmanaged and cannot be invested into directly. Summit and its affiliates do not provide tax or legal advice. Please consult with your tax and/or legal advisors before taking any action that may have tax and/or legal implications.

Data in this paper is obtained from sources that we and our suppliers believe to be reliable, but we do not warrant or guarantee the timeliness or accuracy of this information. Consult your financial professional before making any investment decision. Past performance is no guarantee of future results. Diversification/asset allocation does not ensure a profit or guarantee against a loss. The attached materials, URLs, or referenced external websites are created and maintained by a third party, which is not affiliated with Summit Financial LLC. or its affiliates. The information and opinions found within have not been verified by Summit, nor do we make any representations as to its accuracy and completeness. Summit Financial, LLC, and affiliates are not endorsing these third-party services, or their privacy and security policies, which may differ from ours. We recommend that you review these third-party's policies and terms.

[i] According to the Wall Street Journal article "Just How Valuable is Tax-Loss Harvesting?"