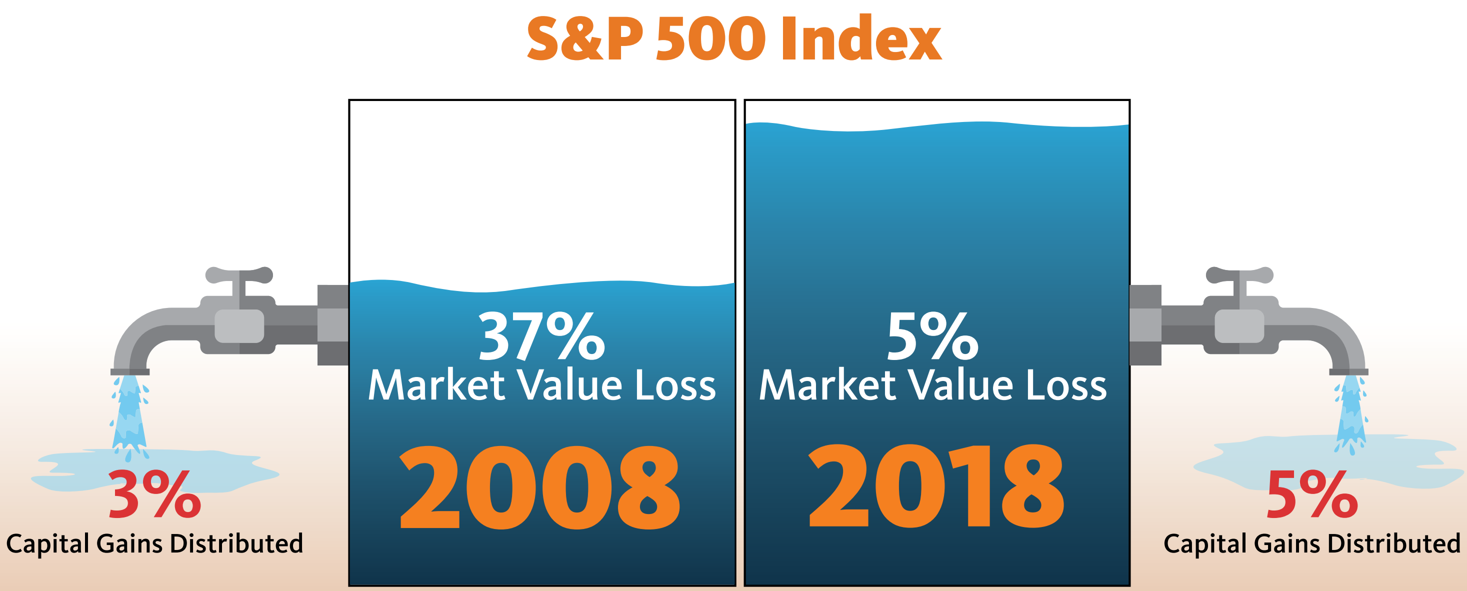
Tax Drag:
Don't let it keep you down.

Diversification and rebalancing are cornerstones of successful long-term investing. And yet, just about every change you make to your portfolio—an allocation adjustment, or even a distribution—can generate harmful side effects: taxes.

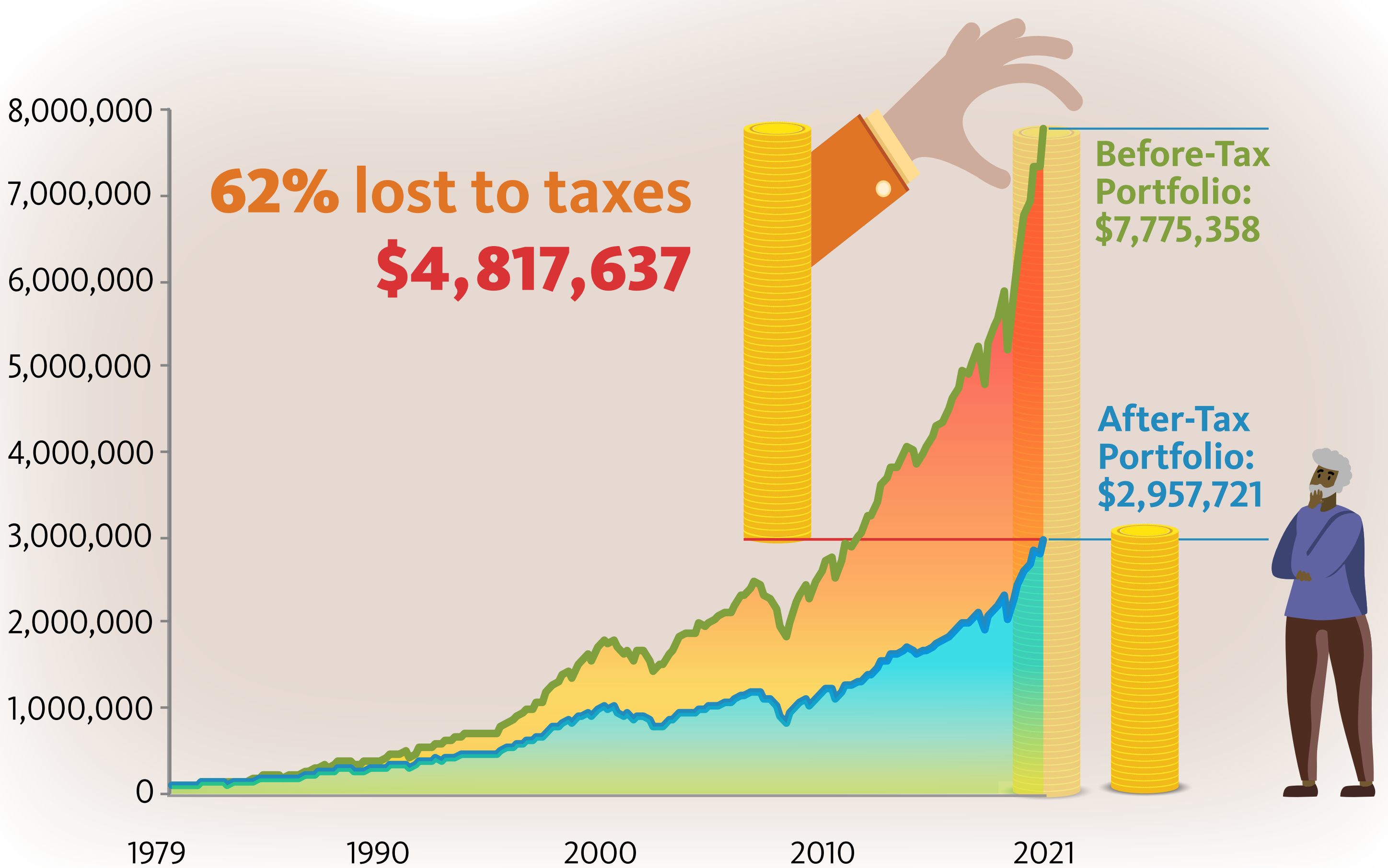
With taxable accounts, realized capital gains—the profit you earn when selling an investment—can result in taxable events. But tax triggers aren't just limited to winning trades. Mutual funds often distribute capital gains in calendar years when they post losses. The S&P 500 Index was down by about 5% in 2018, but U.S. equity funds distributed 5% in capital gains on average. In 2008, the S&P 500 lost more than one-third of its value, and U.S. equity funds still distributed average capital gains of more than 3%.[1]



What happens when tax consequences go unmanaged?

Taxable distributions in years with deeply negative performance leave little wonder to why taxes are the single largest drag on performance over the long-term.[2] A hypothetical $100,000, 60-40 stock-bond portfolio could forsake up to 62% of its total return to long-term capital gains over a 40+ year period (see below chart).

Taxes Reduce Performance Over Time – Hypothetical Growth of $100,000



As of December 31, 2021. † Parametric Portfolio Associates: Based on a hypothetical tax-free $100,000 portfolio invested 60% in stocks (based on the Russell 3000) and 40% in bonds (based on the Bloomberg Barclays Aggregate). Assumptions: (1) no liquidations. (2) interest income and dividends taxed annually at current top marginal tax rates. (3) capital gains realized at 50% per year and taxed at the current long-term capital gains tax rate. (4) portfolio held for 41 years (from 1979-2021) The intent is to portray a worst-case scenario. The portfolio would have grown from $100,000 to about $7.8 million. If the portfolio was taxed as indicated above, it would have lost 62% of its value, due to taxes paid and earnings lost on that money. Tax-managed investment strategies are designed to minimize capital gains distributions and maximize after-tax returns. Results will vary as the amount of federal income tax paid depends on both the investor's tax bracket and how long the investment is held. Past performance does not guarantee future results.

As with many long-term investing models, tax impact can become more magnified with time. A nearly imperceptible difference driven by tax drag in the first decade can become obvious at 20 years. By year 30, let alone 40, you could be facing a serious, overwhelming, shortfall.

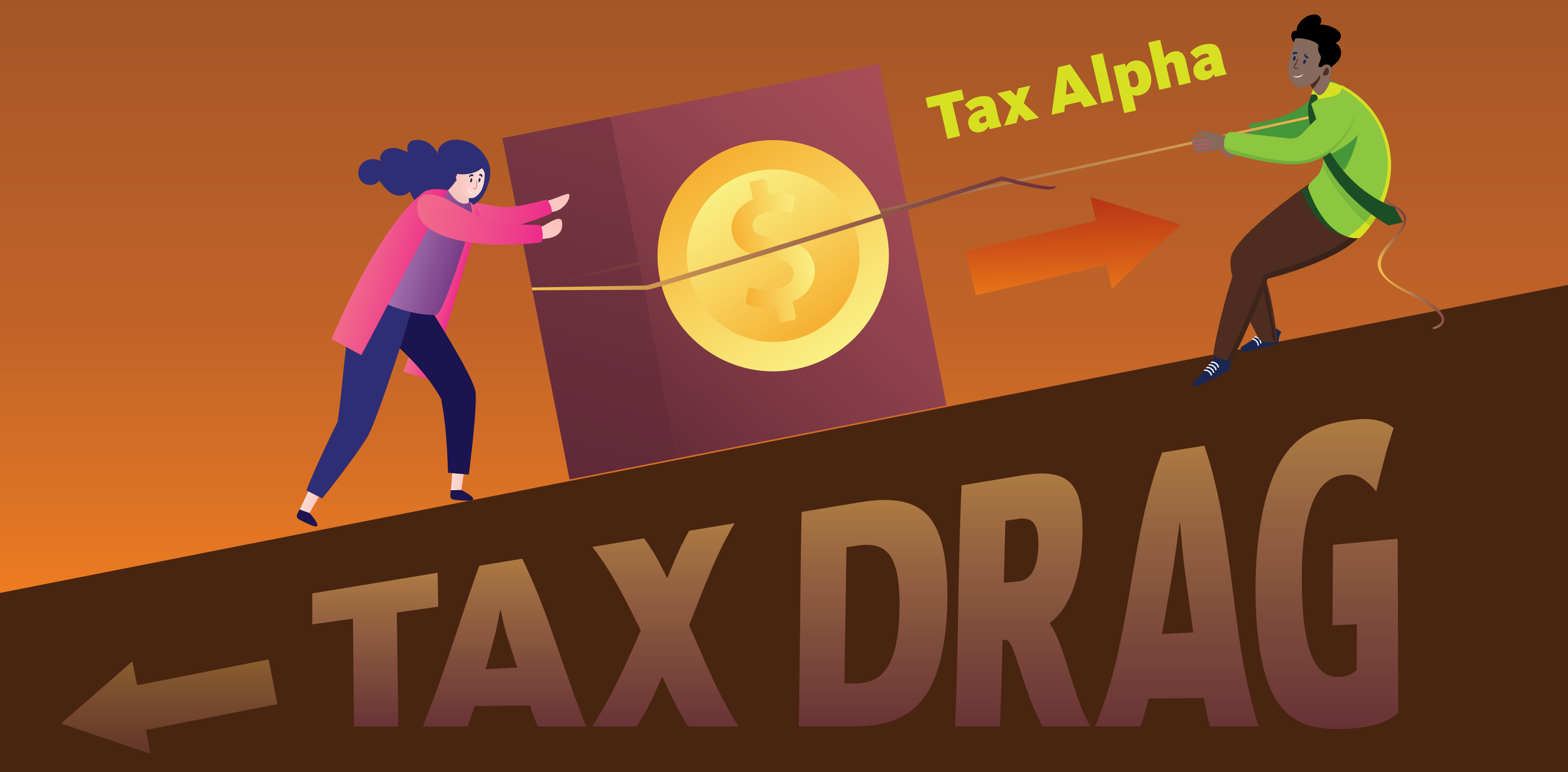
Tax alpha: An antidote?

Now let's put on our physicist caps. When you move a heavy object across the floor, you feel friction. It's working against you. With investing, tax drag can work against long-term wealth accumulation in the same way. However, tax alpha can help you push back.

There are a variety of tools to harness tax alpha. The most widely known—tax-loss harvesting—can help generate more than 1% in excess return per year over the long term.[3]

But implementation methods vary wildly. Blanket approaches may fail to capitalize on market volatility and the opportunities it can provide.

Markets don't consult the calendar before selling off or rebounding, but many people think of tax-loss harvesting as a fourth-quarter exercise. Investors may stand to reap great long-term benefits from daily evaluation of potential tax "assets" without impacting returns.



[1] Data on average capital gain distributions for U.S. equity funds sourced from the Investment Company Institute's 2022 Factbook.
[2] "Is Your Alpha Big Enough to Cover Its Taxes? Revisited." Arnott, R; Berkin, A; Bouchey, P. Investments & Wealth Monitor, January/February 2011.
[3] "An Empirical Evaluation of Tax-Loss-Harvesting Alpha." Chaudhuri, S; Burnham, T; Lo, A. Financial Analysts Journal, June 30, 2020.

Tools for tackling taxes.

Let's take a closer look at techniques and solutions for potentially generating tax alpha.

Tax-lot accounting is a method of accounting for a securities portfolio in which the manager tracks the purchase, sale price and cost basis of each security. This allows the manager to "swap" a tax lot with a more tax advantageous lot that may have been purchased by a different manager at a different time.

Tax-loss harvesting allows investors holding a stock at a loss to sell all or part of it to realize the loss and create an "asset" that may help offset a future gain. In bear markets and highly volatile markets, the turnover from loss harvesting is expected to be greater; in bull and low-volatility markets, turnover should be less.

Gain-loss offset involves selling at a loss securities that have dropped in price at year-end to help offset gains from previously sold securities that had increased in price.

Managing the holding period is used to determine how the capital gain or loss should be taxed because long-term investments (greater than one year) tend to be taxed at a lower rate than short-term investments.

Tax-managed solutions can be applied to your entire portfolio—for example, in the case of a tax overlay, which orchestrates tax strategy from a top-down perspective. Other types of tax-managed techniques apply to the components of a portfolio—including products like tax-efficient managed account strategies, tax-managed mutual funds, exchange-traded funds, and more.

These approaches seek to maximize after-tax returns for investors with assets in non-qualified accounts, where you can invest as much or as little as you want and withdraw at any time.

3 ways to build a year-round tax strategy with your advisor

Rather than waiting until year-end or tax season, consider meeting with your advisor to explore tax management techniques that can help deliver meaningful results in every market condition. Remember these goals when planning your year-round tax strategy:

1

Don't just set it and forget it.

Unmanaged taxes can cost you more over the long run.

2

Choose investments that are meant to help safeguard against tax drag.

Tax-managed mutual funds, ETFs and managed account strategies have been developed for this sole purpose.

3

Keep more of what you make.

Earn tax alpha by employing tax management techniques across your entire portfolio year-round.

For more information, talk to your Financial Advisor.

Definitions:

Rebalancing: The process of returning the values of a portfolio's asset allocations to the levels defined by an investment plan. Those levels are intended to match an investor's tolerance for risk and desire for reward.
Glide Path: The asset allocation mix of a target-date fund, based on the number of years to the target date.
Tax Alpha: The potential value created by implementing effective tax management strategies in an investment account.

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