Chuck LeVine & Eric Viliott

Episode 219: Talking Tax Aware with SSGA's Chuck LeVine and Eric Viliott

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley, I'll be your host. We have got a great one for you today because we're talking about something that we don't talk a whole lot about, which is public equities. And we're joined by Chuck Levine, vice President, senior portfolio manager, and Eric Viliott, vice president and senior portfolio manager of State Street Global Advisors. Gentlemen, welcome. Welcome. Thanks for taking the time to educate us today.

Eric: Thank you Stewart.

Chuck: Thanks Stewart, appreciate it.

Stewart: We are thrilled to have you. I want to start this one off the way we always do, which is to ask you, and I'm going to start with Chuck. Where did you grow up? What was your first job, not the fancy one? And then we'll go to Eric.

Chuck: Sure. So I grew up in Manlius, New York. Manlius is a suburb of Syracuse, New York. My dad went to Syracuse University and as it turns out now, my youngest son is a student there, so he'll be graduating next spring. When I look back at jobs I've had, I had some of those typical teenager jobs working in restaurants, but a neat opportunity I had was the first year I got out of college, I worked on a cattle ranch in Wyoming. I had never been out west before. I really wanted to get out there and kind of see the landscape. It was a great experience, hard work, worked six days a week, learned a lot, and really had a great experience.

Stewart: That's fantastic. How about you, Eric?

Eric: Yeah, so I grew up in Everett, Massachusetts, which is just north of Boston. It's a small kind of urban suburban town, just north of the city. And my first job was while I was in high school, I worked at the somewhat famous, especially regionally famous and maybe even world-famous, Hilltop Steakhouse, which I didn't realize at the time, but it was the largest restaurant in the world by number of seats and by revenue. And if you've ever driven north of the city, there's a 60-foot neon cactus to commemorate this place. It's no longer in business, but that's a landmark.

Stewart: Wow.

Eric: Yeah-

Stewart: That's cool. I've never heard of it. That's such a great data point. That's super cool. So I mentioned typically we're talking about fixed income and credit and things like that, private structure. But today we're going to talk about tax advantage equity strategies that you both are very, very familiar with. And what would be helpful, I think just to kind of start, is give us a little color about how you got into the seat you're in today and a little bit about that seat. So I'll go the other way this way, we'll go start with Eric this time.

Eric: Sure. So I studied business at UMass Amherst and came out and got your typical fund accounting job. And I realized this wasn't the end, but just the beginning. From that job, I quickly moved on to an investment management firm that's no longer in business and realized that the roles that you do want in this business or toward the top of this business are portfolio management. So I just kind of plotted away and did a CFA and I did a master's degree in finance and eventually worked my way into this role here at State Street Global.

Stewart: And can you talk a little bit about that role? I know you've had a recent name change of your group and just get us current on that.

Eric: Yeah, sure. So the team that Chuck and I worked for was formally known as the Global Equity Beta Solutions team. We've recently acquired a team within the company that does quantitative equity management and changed the name to be more encompassing of what we all do together, and that's now called the Systematic Equity Beta team. This team has a long history of managing index funds going back to the late 1970s. We have a global footprint. There are 60-plus portfolio managers, 20 traders and analysts, and 5 specialists that are spread all over the globe. The team itself manages mainly index funds, but we also manage alternative data, active quantitative equity that I mentioned, and tax-aware portfolios, which we'll be talking about today. And those funds are managed across commingled funds, a suite of equity ETFs, mutual funds, and institutional separate accounts. So we're all over the equity space in the way we manage these funds.

Stewart: And Chuck, just to go to you, can you give us a little bit about your background and then maybe tell us where the tax-aware team fits into the larger team that Eric just described?

Chuck: Sure. So I kind of had what I think is a little bit of a maybe traditional path up the investment management ladder, where I started with investment operations migrated into a trading position at a very small company. Luckily while I was there, I was able to start kind of dipping my toes into portfolio management and that's where I then later ended up getting hired here at State Street as a portfolio manager. Eric and I are both old-timers. We've been here 20-plus years. The group we work in is great, and we both really agree with this strategy.

So as Eric mentioned, the group we're part of manages the bulk of the firm's equity assets. The tax-aware business is a small slice of that. It's a very niche business. We kind of think of ourselves as a little bit of a boutique within a very large firm as with taxable investors, it's not as simple as just picking an index and buying it. There are a lot of other concerns that have to do with embedded gains and losses and other needs clients may have. So the nice thing about that is that we really benefit from being part of this group because there are a lot of activity within these indices. So, Standard & Poor's, Russell, MSCI, we sit with the people that are managing index funds and ETFs every day to these different available public indices and we're able to benefit just from that knowledge and pick up on the level of activity that's happening in the market.

Stewart: You mentioned client needs, and it leads me to my next question, which is what are some of the unique needs and requirements when insurance companies are looking to put general account assets to work in the public equity market?

Chuck: Yeah. So we kind of view this question through the lens of, as I mentioned, public equity with broad-based indices, known indices. And at a very high level, we think what insurance company needs is beta exposure, you need to pick an index and you need some type of gain-loss control. We work with a bunch of insurance companies, some of them care about this gain-loss control because of the impact on taxes, other ones care more so on how these gains and losses flow through to their income statement. So we kind of let the clients drive what is of paramount importance to them.

So when you kind of get past those two basic needs, it gets a little more specific, and the main thing we think insurance company needs is flexibility. And that's the real benefit of this strategy being in a separate account format, every portfolio is a little bit different. We may have three portfolios all with the same benchmark and they're all a little bit different. History of cash flows might be different, realized gain-loss preference might be different. Sometimes that gain-loss preference changes throughout the year. A client may want to be gain-loss neutral for the first six months and then something happens elsewhere in their portfolio and at year end, they actually want us to target a certain gain amount or maybe a certain loss amount.

What we also see in these accounts is that certain clients for various reasons have need for restrictions. Whether that is at the sector level, the industry level, specific security, we're able to accommodate that. We have a handful of clients that will tilt towards some type of factor or something such as dividend yield, we're able to do that. And really kind of the way we view it is that after tax and realized gain-loss control, it's not an afterthought. It's part of the investment process. So as we're managing accounts to build a portfolio that delivers a benchmark return, we're simultaneously taking into account the realized gain-loss impact from these trades.

Stewart: I am having flashbacks of when I ran money for insurance companies and you talked about the gain-loss constraints, how they change throughout the year, and that turns out to be you end up with portfolios that have some degree of dispersion. So that's interesting and it takes me to my next question. I mean, I'm quite sure that that requires an extraordinary investment in investment technology and infrastructure. Eric, when we think about the difference between tax-aware, passive, and traditional indexing, can you talk about how you draw that distinction?

Eric: Yeah, sure. So with traditional indexing, basically the portfolio manager is going to own every security within the index to within, less than one basis point, say. And by doing so, they're going to deliver the exact return of the underlying index. With tax-aware, if we allow for a little bit of active risk, we can do a lot on the tax side. On the full replication side, if there's a constituent change or an index rebalance, basically that portfolio has to make that change and there's no consideration for taxes whatsoever. On the tax-aware side, we can add a little bit of active risk and either harvest losses or actively target gains and deliver that same pre-tax return roughly as the normal indexing provider would. But we're also allowing for strong control over realized gains and losses.

Stewart: So, just to clarify, you use the term full replication and I use the term traditional indexing. Are those synonymous or is there a difference there.

Eric: In our world, those would be considered synonymous terms.

Stewart: Okay. And so Chuck, can you talk a little bit about the investment process? I mean, this can become complicated quickly with these different gain-loss constraints and so forth. Talk to us about how you're dealing with that.

Chuck: Yeah, so you can probably explain this strategy in two sentences, which is we buy a lot of stocks in the index and we care about gains and losses. From there, it gets much more intricate for all of these accounts. As we mentioned, all as SMA format, we're using a tax-aware optimizer. Within the optimizer, we're using a fundamental medium-term risk model. The risk model, we kind of think of it as a huge data file that breaks stocks down into very granular levels. So it will look at industry exposures a specific company has, it defines that stock based on style and risk factors such as size, value, growth, momentum. There are actually 68 industry groups and 13 of these risk factors within the risk model. That's kind of the basic US risk model. We also use a global risk model, which includes all that same information, but additionally adds country and currency data.

So what the optimizer allows us to do is to have a lot of control in the output of any trade we do. So there's two main things that we're looking at within any given optimization. So we care about what is the objective of this optimization. The objective to lower active risk is the objective to come up with some desired gain-loss amount and it's typically one or the other. Beyond that, there are a lot of different constraints we use such that we don't let the optimizer go wild. It does a really good job, but without certain constraints it will do trades that really don't add a lot of benefit. So we try to have a lot of input over what are the trades and what are the final outcome for this portfolio.

So some of the constraints we use are turnover, we can limit the size of trades. We can, as I've mentioned before, restrict certain stocks from not being purchased. We have different bounds set on sector misweights, on country misweights, on industry misweights for portfolios with a dividend yield. That's where we're putting in a targeted yield. And really what the optimizer does is let us hone in on what we think to be for that trade, kind of the perfect outcome. It's not uncommon for us to put together some analysis with different trade options, send that to a client and then have a quick discussion and say, "Hey, this is your portfolio now, these are a couple different options for trading. What do you think looks good? What fits your needs right now at this time?"

Stewart: So let me strap on my CIO helmet for a second and ask a couple specific questions. As an insurance investor, can I tilt if we're talking about the S&P 500 index, with your customization capabilities, can I industry tilt or can I avoid an industry or avoid a country if I... For example, if I have a lot of exposure in my liability book or elsewhere in my investment portfolio that I want to manage my exposure to that industry, is that sort of thing possible as well?

Chuck: Yeah, that's absolutely possible. You can either completely step away from an industry, you can tilt towards one. Another thing we see from clients is that sometimes they will blend certain benchmarks together if that kind of gets them into a certain segment of the market. For example, one thing we know insurance companies like is income, whether it's through the form of dividend payments or interest off bonds. So we have some accounts that might blend, say an S&P 500 benchmark with a value index to give them a little bit of an extra dividend yield boost. So in those types of circumstances, when a client comes to us with that type of question or say, "Hey, we're thinking about this," that's kind of where we go into analysis mode and we kind of present options. We may not have a strong opinion on if something's better or worse, but we can kind of share the caveats of a certain approach with a client and eventually arrive at something that works for them that we're able to implement.

Stewart: And so what about repositioning, do you have a recent example of how an insurer has used this strategy to reposition a portfolio?

Chuck: Yeah, so I'll give a real quick example. So I have one client, it's a medical malpractice insurance company and they needed to do a couple of different things. They were de-risking, they wanted to take some money out of equities. Additionally, they wanted to try to boost the yield on their fixed income portfolio. So those required fixed income trades resulting in losses of about $25 million. What I was able to do on my side is raise the money they needed, which was about $50 million, target a gain amount of $25 million such that their overall rebalance was basically a gain-loss neutral trade. So they were able to get money out of equities, avoid taxes, and I think they said they increased the yield on their overall fixed income portfolio by about 60 bips.

Stewart: And that's as we all know, a winner all the way around. So the technology that allows that to take place is... I mean I know enough about that tech to be dangerous, and that's a tremendous capability to be able to tune the gain-loss number that finely, which is really interesting. Is there an example of late where a client is using this strategy for a unique implementation of akin to what I described a moment ago?

Eric: Stewart, so just this week we had an insurance client, a property and casualty client of mine, reach out to us. We manage several portfolios for this client and they had another portfolio managed with a manager outside of our group. And they forwarded over their tax lot holdings for that account, they were very concerned, they wanted to raise some money for an asset allocation shift. They wanted to raise roughly $30 million and they asked us, "Hey, if we have this portfolio manager do this who is not considering taxes, what would that look like?" Meaning if they were to sell off a slice of that portfolio, what would that look like using our accounting method, which is HIFO, "And what could you do in your group if we were to move this portfolio over to you?" So we took those in-kind assets in to our systems and it turns out this was a fully replicated portfolio. So literally one basis point of tracking to an S&P 500, which is unusual.

A lot of times when we see these accounts come in, it'll be an active manager that they're unhappy with performance, but this is a passive manager which would be performing right in line. But it turns out the portfolio was embedded, 90% of it is basically unrealized gains, there's only 1% of unrealized losses in the portfolio. And if that previous manager were to just cut a slice of it and keep all the misweights close to zero, that would've resulted in roughly $17 million in gains on the $30 million withdrawal. We took the holdings, put them into our optimizer, ran a series of optimizations at slightly higher tracking errors. We knew they were accustomed to having low tracking error in the account. And by just moving active risk up to 10 basis points, we were able to reduce their realized gains by roughly half. And if we were to even go higher on active risk, we were able to offer a gain-loss neutral scenario on raising that money. So the client was very happy with that and it looks like those assets likely will be coming over to us to manage.

Stewart: Yeah, that's tremendous technology. I mean the ability to do that is... I mean, I can clearly see how that would be very advantageous and to be able to take that in synthetically and model it is super cool. I've learned a lot about this tax advantage approach. If you could give us a couple of takeaways for our audience as an insurance investor that is not familiar with these kinds of capabilities, what's a couple of takeaways we can give to our audience?

Chuck: So I'll throw out a couple of things. Eric and I are very used to this strategy. We've been working on it for a long time and I feel like there are a lot of investors that just don't know about it.

Stewart: I would agree with you. I think... And part of the reason for this podcast is like this is really an interesting capability and it's like I wonder how many people know that you would go to State Street to get that done. So I think it's really helpful to our audience.

Chuck: Yeah. And I think SSGA has a fantastic reputation in the marketplace, but as I mentioned at the beginning, this is a niche strategy. It's not the strategy you think of when you think of SSGA. So we try to make sure that people internally at the company and externally by whatever means we can or aware of it so we can give examples of what we're doing for other insurers. And maybe it fits, maybe it doesn't, but we just think that if an insurance company has some type of long-term allocation plan to equity that this is really a good option.

Stewart: That's fantastic. I've learned a bunch today and I certainly appreciate you both being on. I've got a couple of fun questions for you out the door, and given that there's two of you, there's going to be a twist. So the first question is, what is a piece of advice that you would give your 25-year-old self if you were early in your career in this business, knowing what you know today? I'll start with you, Eric, just to kick it off and then I'll come to Chuck.

Eric: Sure. I would say that, and I've heard this before, time is your most valuable asset and it's finite. It could end at any point for any of us. As I get older, I reflect on this as my parents' age and I've lost loved ones and so forth. So time to build relationships with family and friends, time to work on your goals, time to knock something off your bucket list, just really time for compounding returns, even in investments. Really think about your time, and how are you using it, and are you using it in the way that benefits you and your family the most.

Stewart: Outstanding. Chuck, how about you?

Chuck: So I'm going to take a little bit of a different approach. That was a great answer by Eric. I kind of think back to when I first started working and I had a couple jobs that taught me a lot, but they weren't that glamorous and you could figure out what you were doing for the day and be kind of isolated working on it. And it really took me a while to step outside of that and not only ask for help from other people, but try to learn a little bit more about what other people are doing maybe 15 or 20 feet away from me. So I think it's very easy to get focused on the task at hand. And some jobs, part of the job is interacting regularly, but if you don't have one of those jobs, I think making a little effort to expand your horizons, see what other people are doing and just ask for help. If you get stuck on something, there's value in spending time and figuring something out, but there's also a lot of value... Maybe you talk to someone who's already figured out this problem and has a good approach to taking care of it.

Stewart: It's the way you learn. It's the only way to learn is just to ask questions. It's really important. So the last question I've got for you is kind of this here's a twist. So we typically ask who would you most like to have lunch with alive or dead and you've got a table of four. And so given that there's two of you, we're going to play a little different game here and say, who would you most like to have lunch with alive or dead? You each get one and you got to agree on the third. How about that one? So who's your pick Eric first?

Eric: Sure. There's a lot of historical figures I would love to meet, but I did lose my grandfather early while I was in high school, and then he was a super interesting man. He served aboard the USS Hancock in World War II in the Pacific and then had a storied career at the Boston Globe. And he passed away while I was 16 years old or so. But it would be great to hear his stories as an adult and have that relationship to just extend for one more day.

Stewart: Very cool. How about you, Chuck?

Chuck: So I think I would pick someone like Michael Jordan. I was a huge basketball fan growing up. Growing up in Syracuse, it is not a professional sports town, the university sports or what people follow. So when I was in high school and even college, that was my sport to follow was college basketball and Michael Jordan was everywhere. I followed him in the pros and I feel like in the last handful of years through social media and reading I've done, I've learned more about the guy when he played than I knew when he was playing. I don't know if you guys remember this, but when Covid first kicked in, that's when Netflix released that kind of extended documentary they did on Michael Jordan and I'm just fascinated with the guy. I think he is driven to a fault, but you can't argue with the results the guy has had. And when I look at things he's done and look at the attitudes he has, I'm wired differently than he is. We both had some success in our lives, but he really is at the pinnacle of getting the most out of people around you and pushing yourself to get the job done.

Stewart: That's fantastic. All right, so we've got Eric's grandpa, Michael Jordan, Chuck, Eric, who's the fifth one we're going to agree on? Are you guys both Celtics fans? Are we possible we're going to get an agreement there?

Eric: I'm a Boston sports fan for sure. I don't know, Chuck, do you have someone in mind?

Chuck: Yeah, not really. One thing Eric and I both share is we both enjoy IPAs, India pale ale beers. So we may even just go way downstream and find some guy that started the brewery and has a beer we like and try to make a weekend out of it.

Stewart: That would be quite a table. That sounds like a great... We're going to get an IPA brewer, Michael Jordan, and Eric's grandpa, and you two. I think that I want to join that lunch table if I could. That sounds like a lot of fun.

Eric: That would be a hoot.

Stewart: Absolutely. I just really appreciate you guys coming on. I've learned a lot today, and we've been joined today by Chuck Levine and Eric Viliott, both vice presidents and senior portfolio managers at State Street Global Advisors. Gentlemen, thanks for being on with me.

Eric: Thanks so much, Stewart.

Chuck: Thanks, Stewart.

Eric: Appreciate it.

Stewart: My pleasure. If you have ideas for podcasts, please shoot me a note at stewart@insuranceaum.com. Please rate us like us and review us on Apple Podcasts, Spotify, Amazon, Google Play, or wherever you listen to your favorite shows. My name's Stewart Foley and this is the InsuranceAum.com podcast.