NORTHERN TRUST
ASSET MANAGEMENT

10 WAYS TO ENHANCE TAX EFFICIENCY IN YOUR PORTFOLIO

QUINN WHITAKER, CFA
Portfolio Manager

MICHELLE KELLEY, CFA, CFP
Senior Portfolio Manager

Taxes are often the single largest cost faced by investors and have an outsized impact on after-tax wealth accumulation. A disturbing observation, however, is that much of the money held by taxable investors is managed as if it were untaxed. For taxable investors, the primary goal of investing is to maximize after-tax wealth. Investment managers who implement the key principles of tax efficiency, described below, will help their clients do just that. Although some of the examples are focused on index management, the same principles and techniques can be utilized across many different types of mandates such as factor-based strategies.

#1 Use Separately Managed Accounts (SMAs)

In a separately managed account, investors directly own each of the securities held in their portfolio. This allows for more control over tax management. For example, an SMA can distribute realized capital losses and still earn a market return while exchange-traded funds and mutual funds cannot distribute losses to investors, only gains. Additionally, an SMA account structure enables investors to incorporate any unique investment preferences or constraints that cannot be implemented with exchange-traded funds or mutual funds.

#2 Harvest Losses as They Become Available

Losses can be used to offset gains realized elsewhere in an investor's portfolio to lower the investor's tax bill. Further, losses can be carried forward into the future when they offset other gains. With regular loss harvesting, our research shows that investors can gain 1-2% a year after-taxes over a full market cycle. Volatility related to the coronavirus crisis may create some loss harvesting opportunities.

Investors can take advantage of the volatility throughout the year to harvest losses rather than waiting until the end of the year.

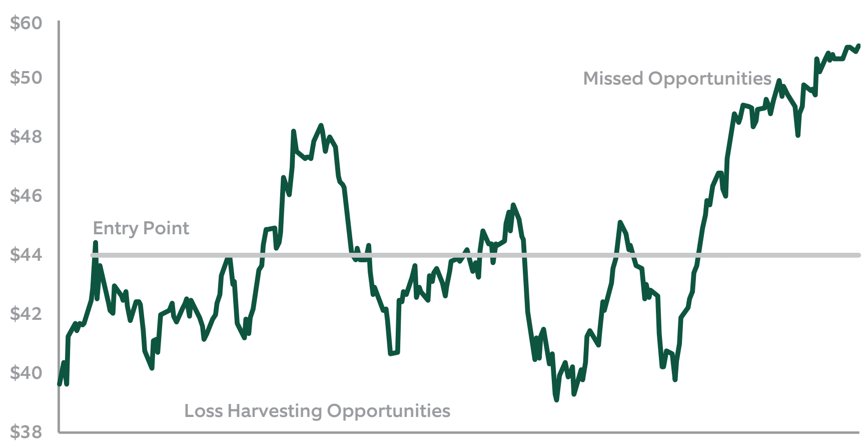
#3 Trade Regularly Throughout the Year

Investors should take advantage of the volatility throughout the year to harvest losses rather than waiting until the end of the year. By trading regularly, investors can benefit by having more opportunities to harvest losses. Exhibit 1 shows the price chart of a hypothetical stock over a 12 month period. Note that a manager purchasing shares of the stock near the beginning of the period would have had numerous opportunities to realize a loss over the course of the year despite the overall positive return.

Trading frequently can help manage risk in the portfolio, like investing cash received from dividends and corporate actions before it becomes a drag on performance, offering investors the potential to take advantage of market volatility.

EXHIBIT 1: HYPOTHETICAL STOCK: TAX OPPORTUNITIES IN A VOLATILE YEAR

This hypothetical stock moved quite a bit during a 12 month period, providing a number of opportunities for tax loss harvesting.



Source: Northern Trust Asset Management, Bloomberg. This graph does not show actual performance results. For illustrative purposes only.

We find it best to trade around the Internal Revenue Service wash sale rule, which states that a security or a substantially identical security can't be repurchased in the 30 days prior to and after a sale for a loss. This means that we are trading in our clients' portfolios roughly every 31-45 days. Trading this frequently helps to manage risk in the portfolio, invest cash received from dividends and corporate actions before it becomes a drag on performance, and take advantage of any market volatility. Keep in mind though that it is important to analyze the portfolio more frequently, even daily, to take advantage of opportunities that may arise within wash sale as they occur.

No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Any discussion of risk management is intended to describe NTI's efforts to monitor and manage risk but does not imply low risk.

#4 Take Advantage of Volatility

Historically the stock market tends to go up over time, but does not follow a smooth linear trajectory. The underlying stocks that make up the broader market have an even wider dispersion of short-term outcomes. As Exhibit 2 shows, there are always stocks that decline in price even in the face of a rising market environment. This creates constant opportunities for diligent tax-aware managers, who can take advantage of any temporary dips in price to harvest losses.

Investors can choose to focus on maximizing loss harvesting, to be more focused on risk, or be more balanced between risk and harvesting losses.

EXHIBIT 2: S&P 500 INDEX BREAKDOWN OF ANNUAL UP/DOWN STOCKS

Whichever way the broad equity market moved since 2003, there have always been stocks with losses. Even in up markets like 2003, 2009, 2013 and 2019 more than 50% of S&P 500 stocks had a decline.

Source: Northern Trust Asset Management, Bloomberg

#5 Balance Loss Harvesting and Tracking Error

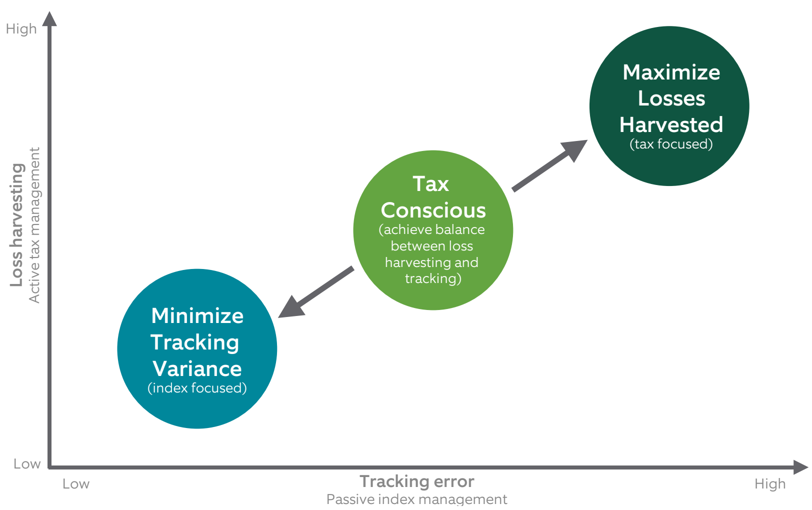
Investment managers should work with their clients to strike a balance between loss harvesting and tracking error. A tradeoff must occur between close index tracking and realizing losses. Typically, increasing expected tracking error allows for more aggressive loss harvesting, assuming there are available losses to harvest. However, at a certain point, the additional after-tax benefits begin to diminish.

Investors can choose to focus on maximizing loss harvesting, to be more focused on risk, or be more balanced between risk and harvesting losses. These needs also can change throughout the year, so regular communication between the investment manager and the client is necessary to ensure the portfolio is aligned with current goals and market opportunities.

Deferring investment gains to avoid taxes is just as important as regular loss harvesting, and it provides significant value to investors

EXHIBIT 3: THE SPECTRUM OF RISK AND TAX MANAGEMENT

Investors can choose to focus on maximizing loss harvesting, to be more focused on risk, or be more balanced between risk and harvesting losses.



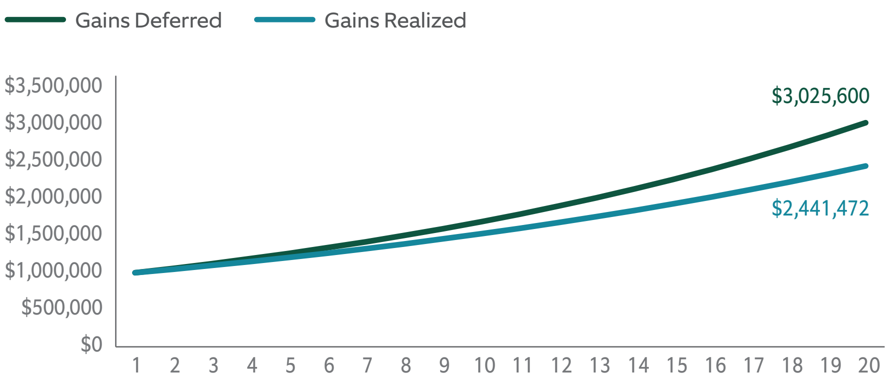
Source: Northern Trust Asset Management

#6 Defer Gains as Long as Possible

Deferring investment gains to avoid taxes is just as important as regular loss harvesting, and it provides significant value to investors. To illustrate the importance of deferring gains, Exhibit 4 shows two hypothetical portfolios with initial investments of $1 million. In the first portfolio, gains were realized by selling winners, which results in a capital gains tax payment. In the second, the gains were deferred, so no taxes were paid. The "gains-deferred" portfolio ended up 25%, or nearly $650,000, more valuable than the "gains-realized" portfolio after 20 years. This highlights the power of deferring gains, which allows taxes that would have been paid to remain invested.

EXHIBIT 4: HYPOTHETICAL PORTFOLIOS: DEFERRED VS. REALIZED GAINS

Deferring gains keeps money in the portfolio that otherwise would have been paid out for taxes. The hypothetical portfolio where all gains were deferred ended up 25% more valuable after 20 years than the "gains-realized" portfolio.



Source: Northern Trust Asset Management. Each portfolio had a $1 million starting value and appreciated 6% each period. One portfolio realized gains each time period equal to 5% of the beginning of period value while the other did not.

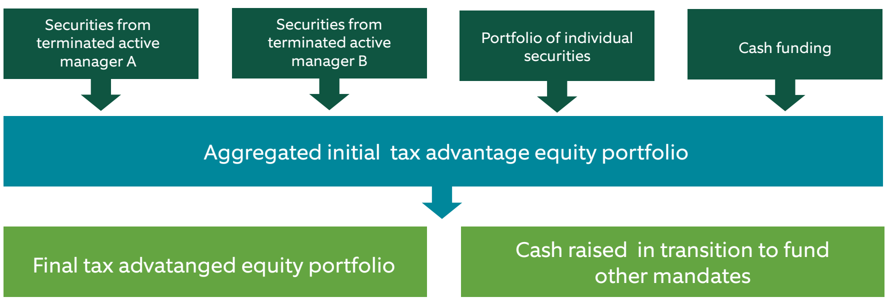
#7 Transition Portfolios Efficiently

Portfolio transitions are another opportunity for managers to defer gains. When a manager is rebalancing to a target allocation or raising cash, the most tax-efficient lots should be sold. Similarly, when looking to fund a new manager or receive assets from a terminated manager investors should consider funding with securities in-kind. By funding in-kind, the investor is able to continue to defer gains and transition efficiently.

When a manager is rebalancing to a target allocation or raising cash, the most tax-efficient lots should be sold.

EXHIBIT 5: PORTFOLIO TRANSITION BREAKDOWN

Tax-conscious investors should use in-kind securities to transition portfolios wherever possible.



Source: Northern Trust Asset Management

#8 Manage Consequences of Harvesting Losses

When investors regularly harvest their losses, they reduce the overall cost basis of the portfolio. This creates the potential liability of deeper embedded unrealized gains over time. Here are three ideas to consider that serve to refresh a portfolio:

Gifting: Securities with steep unrealized gains can be an ideal source to meet charitable goals. A skilled manager can select specific tax lots for gifting that will maximize tax deductibility, control tracking error and reduce the embedded gains of the portfolio. If the gift is replenished with cash, the purchase of new securities refreshes the portfolio cost basis and creates new loss harvesting opportunities.

Strategic gain realization: Realizing gains now instead of deferring them may make sense in some cases and can serve to refresh a portfolio. This could be a strong option if a portfolio has many lots with shallow unrealized gains, there is an expiring loss carryforward, or tax rates are expected to be higher in the future. In each case an investor can seek to realize as much in gains as desired, by selling appreciated tax lots, and then immediately reinvest the proceeds without giving up any market exposure.

Add cash to portfolio: Similar to prior examples, infusing the portfolio with new cash and purchasing securities at current prices creates new tax lots that increase the portfolio's cost basis. This should in turn increase the opportunity for future loss harvesting.

#9 Use Sophisticated Systems

Each of the above principles is moot if the manager lacks the investment management systems needed to implement a tax aware investment strategy. The aim of a tax manager sounds fairly simple: match the return of the benchmark and realize losses. But those are two opposing goals and not as easy to implement in practice as they sound.

In order to harvest losses, the portfolio can't look exactly like the benchmark. Further complicating the matter are 1) the IRS wash sale rule, 2) different tax rates that apply to different holding periods and different investor types, and 3) the hundreds, sometimes thousands, of individual tax lots that need to be maintained and accounted for.

Investors will benefit most from tax management powered by sophisticated systems that maintain unique tax lots, consider risk preferences, maximize after-tax value added, consider transaction costs, and adhere to the wash sale rule.

#10 Take Advantage of Experience

The final principle of tax-efficient investment management is that experience matters. The Tax-Advantaged Equity team at Northern Trust Asset Management has more than 35 years of experience in active tax management for clients ranging from high-tax institutions and individuals to foundations and endowments.

We implement a flexible, diligent process that balances tax management and tracking error in order to meet our clients' unique tax, risk and investment objectives. We review our clients' portfolios each day to monitor risk, cash levels and the available opportunity set to add tax alpha. When trading in our clients' portfolios, we start with the client's chosen benchmark and layer on any investment constraints or guidelines. We take into consideration any upcoming index changes or rebalances, and we factor in trading costs to make sure that the value of a realize loss isn't eroded by transaction costs.

Finally, we leverage proprietary risk and optimization tools to manage unintended exposures and maximize added value after taxes.

Considerations for Factor-Based Strategies

The principles of tax-efficient investment management can be applied to factor-based strategies as well. However, additional considerations must be made.

With regard to factor-based strategies, the overall value proposition is straightforward to many investors. They invest in risk factors that over time have been proven to be compensated. This includes small size, value, low volatility and momentum strategies. These tend to be more actively managed strategies. However, turnover is sometimes quite high in an effort to achieve the desired factor exposure.

The good news is that sophisticated managers can incorporate a tax management overlay on factor strategies. This involves regularly harvesting losses and efficiently trading around strategy rebalances. It also involves examining and potentially altering the pattern of realized gains and losses resulting from strategy turnover. The challenge, however, is in making sure that the factor exposure the investor is trying to achieve isn't degraded by the application of the tax overlay. Finally, applying a tax overlay to factor-based portfolios provides an additional benefit to taxable investors: During times when a particular factor is out of favor in the market, at least the tax-efficient manager is harvesting losses.

LEARN MORE

To learn more, please visit our tax-advantaged equity or contact our team at gm_tae@ntrs.com

How helpful was this paper?

This report is provided for informational purposes only and is not intended to be, and should not be construed as, an offer, solicitation or recommendation with respect to any transaction and should not be treated as legal advice, investment advice or tax advice. Recipients should not rely upon this information as a substitute for obtaining specific legal or tax advice from their own professional legal or tax advisors. References to specific securities and their issuers are for illustrative purposes only and are not intended and should not be interpreted as recommendations to purchase or sell such securities. Indices and trademarks are the property of their respective owners. Information is subject to change based on market or other conditions.

All securities investing and trading activities risk the loss of capital. Each portfolio is subject to substantial risks including market risks, strategy risks, advisor risk, and risks with respect to its investment in other structures. There can be no assurance that any portfolio investment objectives will be achieved, or that any investment will achieve profits or avoid incurring substantial losses. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment. Risk controls and models do not promise any level of performance or guarantee against loss of principal. Any discussion of risk management is intended to describe (NTI) or its affiliates' efforts to monitor and manage risk but does not imply low risk.

Past performance is not a guarantee of future results. Performance returns and the principal value of an investment will fluctuate. Performance returns contained herein are subject to revision by (NTI) or its affiliates. Comparative indices shown are provided as an indication of the performance of a particular segment of the capital markets and/or alternative strategies in general. Index performance returns do not reflect any management fees, transaction costs or expenses. It is not possible to invest directly in any index. Net performance returns are reduced by investment management fees and other expenses relating to the management of the account. Gross performance returns contained herein include reinvestment of dividends and other earnings, transaction costs, and all fees and expenses other than investment management fees, unless indicated otherwise. For additional information on fees, please refer to Part 2a of the Form ADV or consult an NTI representative.

Forward-looking statements and assumptions are (NTI) or its affiliates' current estimates or expectations of future events or future results based upon proprietary research and should not be construed as an estimate or promise of results that a portfolio may achieve. Actual results could differ materially from the results indicated by this information.

Hypothetical portfolio information provided does not represent results of an actual investment portfolio but reflects representative historical performance of the strategies, funds or accounts listed herein, which were selected with the benefit of hindsight. Hypothetical performance results do not reflect actual trading. No representation is being made that any portfolio will achieve a performance record similar to that shown. A hypothetical investment does not necessarily take into account the fees, risks, economic or market factors/conditions an investor might experience in actual trading. Hypothetical results may have under- or over-compensation for the impact, if any, of certain market factors such as lack of liquidity, economic or market factors/conditions. The investment returns of other clients may differ materially from the portfolio portrayed. There are numerous other factors related to the markets in general or to the implementation of any specific program that cannot be fully accounted for in the preparation of hypothetical performance results. The information is confidential and may not be duplicated in any form or disseminated without the prior consent of (NTI) or its affiliates.

This information is intended for purposes of NTI and/or its affiliates marketing as providers of the products and services described herein and not to provide any fiduciary investment advice within the meaning of Section 3(21) of the Employee Retirement Income Security Act of 1974, as amended (ERISA). NTI and/or its affiliates are not undertaking to provide impartial investment advice or give advice in a fiduciary capacity to the recipient of these materials, which are for marketing purposes and are not intended to serve as a primary basis for investment decisions. NTI and its affiliates receive fees and other compensation in connection with the products and services described herein as well as for custody, fund administration, transfer agent, investment operations outsourcing, and other services rendered to various proprietary and third-party investment products and firms that may be the subject of or become associated with the services described herein.

Northern Trust Asset Management is composed of Northern Trust Investments, Inc. Northern Trust Global Investments Limited, Northern Trust Fund Managers (Ireland) Limited, Northern Trust Global Investments Japan, K.K, NT Global Advisors, Inc., 50 South Capital Advisors, LLC, Northern Trust Asset Management Australia Pty Ltd, and investment personnel of The Northern Trust Company of Hong Kong Limited and The Northern Trust Company.

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

northerntrust.com