Mary Lukic

Episode 179: Don't Make Taxes a Drag - Capturing After-Tax Alpha with Custom Equity Solutions

GUEST Q & A

Stewart: Welcome to another edition of the InsuranceAUM.com podcast. My name's Stewart Foley. I'll be your host. Today's topic is tax-advantaged equity and we're joined by Mary Lukic, Head of Tax-Advantaged Equity at Northern Trust Asset Management. Mary, thank you very much for taking the time with us today.

Mary: Thanks. It's great to be here, Stewart.

Stewart: It's your first podcast, so we're excited about that. And I want to start this one off the way we start them all. Where did you grow up? What was your first job? Not the fancy one. And what do you think makes insurance asset management so cool?

Mary: So I grew up in Chicago, born and raised. I remember taking the Addison bus to Wrigley Field, so grew up a Cubs fan, back when bleacher seats were $6. So, the good old days. My first job was Montgomery Wards.

Stewart: Oh, there you go.

Mary: So Montgomery Wards was actually founded here in Chicago.

Stewart: Absolutely. Was the first catalog retailer. They were effectively the Amazon of their time.

Mary: Yeah. So I was in ceiling fans and paints, so I was mixing paints and selling ceiling fans. And insurance, when I think about insurance and the landscape, the institutional market has a lot of non-taxable assets. It's dominated by DB, DC, retirement, ERISA. So the pockets of assets where there's taxable considerations, to me that's interesting, because that's where you can come in and have creative solutions, try to solve some complex problems, and that's what we do. So that's what makes it interesting from my perspective.

Stewart: So, this is not my world, equities or tax-advantaged equities, either one. So you're going to have to do some education where I'm concerned today. And I think it's fair to say that tax-advantaged equity is a tried and tested method among insurers. It's certainly not new, but can you give us a little bit of background and at a high level, what constitutes a tax advantaged equity strategy?

Mary: So, it isn't new. Here at Northern Trust, we've been running tax managed strategies for 35 years. We work with institutions, insurance companies, high net worth individuals. Insurance companies make up a vast majority of our institutional assets. And why we found success within this segment, it's because it's a customized SMA platform. So you have a lot of flexibility and customization available to you, when you think about the exposure that you're looking to get, benchmark-like returns, US large cap, broad cap, international. And then on the tax side, we're coming in and adding value from a tax perspective. And so that's where the alpha is created. The active tax management insurers have that flexibility, the lever to control realized gains and losses. And why that's important for that segment is because gains and losses flow in through their income statement. So having that control is really critical and that's what this strategy aims to do.

Stewart: So would you categorize it, is it active? Or is it passive? Or how does it shake out from that lens?

Mary: So it's, from a pre-tax side, benchmark-like returns, so there's no surprises and that actually works well in this community as well, because insurers like that feeling of going into their investment committees and boards and saying, "Look, we're delivering the benchmark exposure that we're looking for, and the tracking differential is minimal." So you've got benchmark-like returns, passive from a pre-tax side, and then it's active from the after-tax side. Whatever your tax goals are, we can accomplish that. So, a lot of times insurers are looking to realize losses. They can use those losses to offset gains in other parts of their portfolio, other active managers, alternatives. And so you reduce that tax liability. Sometimes you need gains, sometimes you need to be tax neutral. So we have some insurance companies who like to have that tax neutral outcome, but it's the control over the realized gains. That's where the active component comes into play.

Stewart: And that's really helpful and it helps me in the way that I'm thinking about this too. So, with regard to the benefits of tax-advantaged equity, which we're going to refer to as TAE, in volatile markets, can you talk a little bit about how the volatility impacts the strategy?

Mary: Yeah, and we get that question oftentimes and sometimes as it relates to in really high returning markets, how do you actually add value? How does volatility impact what we do for our clients? And so, there are moments throughout the year when stocks go up and down. So we all want upward trending markets. I like upward trending markets too, but from my perspective, I appreciate the volatility, because it gives me those opportunities to harvest losses for clients, to harvest gains, to achieve their tax objective. And even in, say, 2019 equity markets were up 30%, there were still stocks at some point throughout the year that were down 5%, down 10%, more than 10%. We had the regional bank crisis earlier this year, where there was some pressure within a certain segment of the market.

And so what's important is that you're taking advantage of that volatility. Whether it's Northern Trust as your tax manager or any other tax manager, you want that investment philosophy in the investment process to include regularly looking at the accounts. We're looking at our accounts on a daily basis. We're looking for those opportunities where there's been stacks or industries that have declined and we can go in and harvest those losses for our clients.

Stewart: You mentioned insurers wanting control over their gains and losses, and I remember running money where we would have gain-loss collars, for example. Talk about the flexibility that this platform brings to balance I guess the needs of clients who are, some need gain, some need losses. How do you work through that?

Mary: So the first thing we want to understand is; what are your tax objectives. So what is your goal right now? Is it, do you need losses? Do you need gains? Do you need to be tax neutral? And we're working with the clients, the consultant to understand what their portfolio situation is, so that we can implement the strategy accordingly. So say you implement a portfolio and you have a cashflow. So if you have a cash need, you have flexibility and customization in terms of how are you going to implement that cashflow. If you just own an ETF or a mutual fund, you just have to take the unrealized gains. It's just a slice of the lots that you own. Maybe you own one or a handful of lots.

Within this type of a strategy, you might have thousands of tax lots, benchmarked to a US large cap or broad cap strategy. And so as we're raising cash, we have the ability to take down the highest cost lot first. So you're taking down lots that are at unrealized losses, or not as deeply embedded gains. And you also have the lever of, well, if you increase estimated tracking error, you have the potential to minimize that gain impact. And so we work with the clients and consultants to determine; what do you need as it relates to this cashflow and this outcome from your tax side?

There's customization around... So say for example, you might have losses on your fixed income portfolio, and we had an insurer this year who was able to raise cash in their equity sleeve, rebalance to their asset allocation targets, because they had losses in fixed income and were able to realize gains on the equity side. So there's a lot of different options and customizations that you can think about from a tax side and we can deliver that and we can be flexible throughout the year, because I think flexibility is another component of this. We know that client circumstances can change, and so having that ability to go from one objective to the next and have your manager be able to pivot is also important.

Stewart: Yeah, that's really helpful. And you mentioned the fixed income markets producing unrealized losses for a lot of folks, and I've heard this term, tax alpha, but I'm not sure what it means. So can you help me understand tax alpha from a tax-advantaged equity strategy?

Mary: So, basic, simple example would be you're realizing losses and you're creating tax alpha, because you can use, in your portfolio, gains and offset the losses that we realize with gains in your other part of your portfolio. So that creates tax alpha, because you don't have to pay as much in taxes, you get to keep that money in your pocket, that money can be invested in the market, earn compound interest rates. And so that's the tax alpha that we can create. But as I just mentioned in my cashflow example, you can also create tax alpha by deferring gains, by saving on cash raises. So instead of taking that slice of unrealized gain position, you're able to defer the realization of capital gains, you're also creating tax alpha. So it's really that ability to add after tax wealth, to be customizable in terms of how you deliver what the client needs from a tax perspective at any given point in time.

Stewart: That's really helpful Mary, and thank you for that. So, if I can customize on the after-tax side, can I customize on the pre-tax side as well?

Mary: Yes. So, one of the benefits of a customized SMA platform, so when I think about customization, I do think about it from both sides of the equation. The exposure side, you can start with; what's your benchmark? What's the allocation you're looking for? You can choose from a market cap weighted benchmark. You could choose from a specialty type benchmark, a defensive or low volatility benchmark. A lot of our insurers tend to think about that in terms of their allocation. If you don't like the market cap weighting of say value and growth, you can customize that. So you can create a custom benchmark that's 80% value, 20% growth.

You also have the ability to add restrictions. So you can restrict an individual security, you can restrict an industry or a sector. Some of our insurers restrict tobacco, for instance, the tobacco industry. So you have all of those capabilities in terms of customizing your exposure. When you think about international, you could also think about that in terms of one account. If you like the world allocation, you can open up a world account or you can open up two accounts, so that you can tactically allocate between regions, US and international developed. So there's a lot of different options that you can think about.

The last thing I'll mention here, we here at NTAM, Northern Trust Asset Management, have what we call a factor-based approach. And so there are combining factors such as high quality, low volatility, defensive, and so you can also layer tax management on top of a factor-based approach, so that you can get your exposure via the factor strategy, but also have the benefits of the tax overlay.

Stewart: It's really interesting, because back in the day, when I was running money live, and the earth was still cooling, I had two clients that were both over a hundred years old, both total allocations, total portfolio size of something like a hundred million dollars and equity exposure of around 50%, and some of these positions that they had, had very large gains in them that they had held for many years. So, when you have gains, when you come across, I'm sure you've seen this in other portfolios, how do you deal with that? Just as an example.

Mary: So of course we would be happy to take cash as part of a funding, but oftentimes our clients are coming to us with in-kind assets and those could be assets that were terminated from an active manager. They could be assets that were managed in-house, a combination of some cash, and those are the funding strategies that we're usually dealing with. We have an insurer that we're actually onboarding this week, matter of fact, and they had in-kind assets, that they were managing in-house, the portfolio manager is retiring and they've decided to institutionalize that and hire a tax manager. It's a 50 stock portfolio, as you mentioned, with very old and largely embedded gains.

And so, what we did with this, in this situation, is we provided the consultant and client analysis. So they were looking at US large cap, broad cap, and a defensive benchmark. So we compared their holdings to different benchmarks, provided different options in terms of; okay, you've got this 50 stock portfolio, what would happen if we diversified that closer to your intended benchmark? What would be the gains necessary to get there? Because you have to sell down those stocks and buy other stocks, round out that benchmark exposure.

And they settled on a benchmark and they decided to implement the net-zero scenario and net-zero, what we mean by that is, we're offsetting gains and losses, so we're taking no net gains. They were not comfortable taking any gains in this tax year. So we were able to sell down some securities for gains, some securities for loss, so we netted that tax impact. We went from 50 stocks to maybe 75 stocks. So we chipped away at that diversification effort, lowered the estimated tracking error by a bit, and we'll continue to work with the client and consultant, so we'll revisit this in the early new year to see if there's any gain appetite. Maybe there's more losses on their fixed income portfolio that they can use, but we'll look for opportunities where they can take gains, where they're comfortable taking gains and continue that transition process.

Stewart: So this has been phenomenal and Mary, I have learned so much about tax-advantaged equity on our podcast. And I guess what I'd like to ask you is what would you like to leave our audience with in terms of a couple of nuggets that they can take away? And then I've got a couple of fun questions for you on the way out the door, if you're willing.

Mary: So, in terms of nuggets, I would say we're in an industry now where there's a lot of focus on personalization. What is that customization that we all want to see in our portfolios? Whether that's from an exposure side or from a tax side. I think it's just important for insurance companies and clients, in general, to partner with investment managers that have those capabilities, that can deliver those customized solutions and that can work with clients, whether that's delivering on the complexities from a tax perspective, whether that's helping them from a regulatory reporting perspective, but having that collaborative partnership I think is key for this industry.

Stewart: It's interesting, because my experience is this, sometimes insurance companies' objectives change. They had a really bad loss year and they need gains, and next year they're having a great year and they need losses. And it's like things change. So, can you talk a little bit about the level of communication with your clients and how you deal with their changing circumstance?

Mary: Yeah, so I think circumstances change often, and as we talked about, customization is key, but having that flexibility is also important. So, communication with your clients is important. We need to understand what those nuances might be within those individual portfolios, so that we can maximize the benefits of this strategy. If you have a need for gains, for instance, because of things happening in your portfolio, the more that we can be part of those conversations, the more that'll trigger some solutions that we can implement on our side. And so having that communication flow, having a process, whether you're setting up quarterly calls with your consultant and client. Maybe it's an annual cadence. Maybe it's "Let's check in a few months before the end of the calendar year," because that's when some of these tax numbers become clearer in terms of what's happening and some of those needs might become clearer. So, having that process in place really helps you to maximize all the benefits that you can get from this type of a customized SMA platform.

Stewart: That's terrific. Thank you so much. I've learned a lot today and I really appreciate it. I've got a couple of fun questions for you on the way out the door. There's optionality here. You can take either or both. Lots of our guests take both, no pressure. So, the first one is: what's the best piece of advice you've ever gotten or given? And the second one is: who would you most like to have lunch with, alive or dead?

Mary: So, in terms of advice, I really like the concept of 'carry as you climb'. And the reason that resonates to me is really from the people aspect. So as we're evolving as leaders within your organization or within the industry, thinking about the people that you work with, helping to develop the future leaders and emerging leaders and talent that will be continuing the good that we do, creating all these solutions, working with clients. So I think just from the people perspective, building those relationships, I really like that 'carry as you climb' theme. And then, so my grandma passed when I was in middle school and it was enough time for me to get to know her, but not enough time to really ask some of those questions around who she was and thoughts she was having at different points in her life. And I think now that I'm an adult and have a family, it would be really nice to have lunch with my grandma.

Stewart: I think that's so nice. My grandmother raised me and I think it's really interesting. I've thought many times along those same lines. Grandmas are pretty special. So, thanks so much for joining us today. I really appreciate it, Mary, and I've learned a lot about tax-advantaged equity; and thanks for taking the time.

Mary: My pleasure. Thank you.

Stewart: We've been joined today by Mary Lukic, Head of Tax-Advantaged Equity at Northern Trust Asset Management. If you like what we're doing, please rate us, review us, and like us on Apple Podcast, Spotify, or wherever you listen to your favorite shows. My name's Stewart Foley, and this is the InsuranceAUM.com podcast.