Investment Insight
Look on the Bright Side: Harvesting Tax Losses in Volatile Markets

Advisors know this better than anyone: volatile, uncertain markets can lead to nervous, uncertain investors. The silver lining, though, is that market uncertainty can kick-start important conversations and unearth potential opportunities — giving advisors more ways to demonstrate their value.

An interesting opportunity advisors can present to clients with taxable accounts is pro-active, intra-year tax loss harvesting. With this strategy, advisors can help investors lower their tax burdens by seeking to use market fluctuations to their advantage.

How Tax-loss Harvesting Works
Tax-loss harvesting involves selling securities that declined in price (relative to their cost basis) to realize losses. These realized losses can be used to offset realized gains, in effect, reducing the overall tax liability for a client.

In a market where most holdings trend higher, the losses needed for tax-loss harvesting can be harder to find. The losses inherent in volatile markets, on the other hand, provide fertile ground for this strategy.

Example of Tax-loss Harvesting
Consider this hypothetical example for two different investors:

Investor 1 is a buy-and-hold investor who does the following:

► Buys Stock ABC at $15.
► Over the next year, Stock ABC declines in price by 10%, finishing the year at $13.50.
► Investor 1 continues to hold the position and it proceeds to double in value to $27 by the end of year two.
► At this point, Investor 1 liquidates the position and pays taxes on the realized gain of $12.
► This results in a tax cost of $2.86 ($12 realized gain multiplied by the long-term capital gains tax rate of 23.8%), leaving Investor 1 with an after-tax value of $24.14.

Investor 2 uses a consistent tax-loss harvesting strategy, and does the following:

► Buys Stock ABC for $15 at the same time as Investor 1.
► When ABC stock declines 10% to $13.50 in the year after purchase, Investor 2 makes the decision to sell the stock and realize the tax loss of $1.50 ($15 original purchase price minus $13.50 current value).
Investor 2 takes the proceeds from the ABC sale and purchases a suitable replacement, Stock XYZ. Stock XYZ is in the same industry as ABC and performs similarly to the liquidated position.

Stock XYZ also doubles in value by the end of year two, at which point Investor 2 sells the position. Investor 2 pays taxes on the realized gain at the long-term rate, but the post-liquidation value is greater than that of Investor 1.

After taxes, Investor 2 has earned more money than Investor 1.

There are two factors responsible for this after-tax benefit to Investor 2.

1. Investor 2 realized a short-term loss, which is taxed at a rate of 40.8%. They deferred the realization of gains into year two, when the tax rate shifted to the long-term rate of 23.8%.
2. Investor 2’s tax savings from realizing the loss can be assumed to have been reinvested in the portfolio.

**Exhibit 1**

Tax-loss harvesting adds value by investing tax savings back into the portfolio. Hypothetical example.

<table>
<thead>
<tr>
<th>Year 1</th>
<th>Initial Value</th>
<th>Return</th>
<th>Ending Value</th>
<th>Realized Loss*</th>
<th>Tax Benefit at 40.8% ST Tax Rate*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor 1: Buy and Hold</td>
<td>$15.00</td>
<td>-10%</td>
<td>$13.50</td>
<td>—</td>
<td>—</td>
</tr>
<tr>
<td>Investor 2: Tax Loss Harvest</td>
<td>$15.00</td>
<td>-10%</td>
<td>$13.50</td>
<td>$1.50</td>
<td>$0.61</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Year 2</th>
<th>Return</th>
<th>Ending Value</th>
<th>Unrealized Gain</th>
<th>Tax Cost at Liquidation at 23.8% LT Tax Rate</th>
<th>Post Liquidation Value</th>
<th>Difference in Post-Liquidation Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investor 1: Buy and Hold</td>
<td>100%</td>
<td>$27.00</td>
<td>$12.00</td>
<td>$2.86</td>
<td>$24.14</td>
<td>—</td>
</tr>
<tr>
<td>Investor 2: Tax Loss Harvest</td>
<td>100%</td>
<td>$28.22</td>
<td>$14.11</td>
<td>$3.36</td>
<td>$24.87</td>
<td>$0.72</td>
</tr>
</tbody>
</table>

*Tax-Loss Harvesting Opportunity

Source: Morningstar “Sizing up the tax benefits of Direct Indexing” white paper. The tax-loss example is hypothetical and does not reflect the return of any investments. A return of 100% is unlikely and was chosen only to simplify the example.

**Using Tax-loss Harvesting**

Of course, for tax-loss harvesting to work, advisors need the ability to identify easily and efficiently which stocks their clients should hold and which they should sell (and when). Rather than owning shares in an index mutual fund or ETF, portfolios that directly own the underlying securities that
comprise an index, like separately managed account or direct indexing strategies, allow for the use of tax-loss harvesting.

Historically, direct indexing was feasible only for the wealthiest investors due to cost, complexity, and the operational burden of implementing. Thanks to advances in technology, however, direct indexing is now accessible to a broad swath of investors and their advisors.

In fact, with current technology, advisors can help their clients realize losses as they become available in their portfolios—with daily reviews that inform our trading activity. This helps advisors provide a high level of service to their clients while remaining efficient and available.

When overseeing a tax-loss harvesting strategy, daily reviews can help advisors stay on top of:

- Gain-loss realization management—identifying which stocks to sell and which to hold.
- Tax-lot consideration—selecting appropriate tax lots to trade.
- Wash-sale avoidance—keeping on the right side of IRS regulations.

**Add Value During Challenging Markets**

While we all hope that markets go up, sometimes this isn’t the case. That’s when investors have an uncomfortable choice to make: either stay the course or liquidate holdings. During these challenging times, tax-loss harvesting can help advisors demonstrate their value to clients by offering the potential for value on an after-tax basis.

**Disclosures**

Use of a tax loss harvesting strategy does not guarantee that an investor will be able to reduce their tax liability in any given year, could be limited by existing tax regulations and market performance, and could produce losses that cannot be offset. The results of a tax loss harvesting strategy will vary and depend on an investor’s overall financial and tax situation. Use of a tax loss harvesting strategy can result in increased trading activity in an investor’s account, which could in turn result in additional trading costs, investment restrictions, or income tax impacts. The performance of securities purchased to replace those sold for tax loss harvesting purposes may be worse than the original securities.

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