Investment Insights
Three Tax Advantages When Using SMAs

Tax Advantages for Investors
Investing in equities can lead to significant tax bills from capital gains. But how you invest can make a considerable difference in the timing and the amount of the tax burden. Investors in some equity mutual funds are poised to be hit with considerable tax bills again this year, especially those in mutual funds with high turnover.

Unlike mutual funds, our Select Equity Portfolio range benefits from the SMA, or separately managed account, structure. Our portfolio managers also employ tax management tools in an effort to deliver the best after-tax returns. The tax advantages of this approach can be distilled into three key points, which are explained overleaf.

Key Takeaways
➤ Some investors in actively managed equity mutual funds may face hefty capital gains tax bills, especially among funds with high turnover.
➤ At Morningstar Investment Management, we seek to minimize any adverse tax impacts in three ways.
➤ In our Select Equity Portfolios with our SMA structure, low turnover and proactive tax-loss harvesting are used in our custom series for taxable accounts. This reduces friction for the investor and may help them reach their goals faster.
Three Methods to Keep the Taxman at Bay
Investing in stocks can be a costly strategy. Between fees and taxes, the drag on an investors' returns could be meaningful, especially if the investor opts for a high turnover solution. This message applies at any time of the cycle, but especially following an extended period of market gains. As such, we highlight three methods that will keep more money in an investors' pocket.

1. **Keeping turnover low.** Funds that have high turnover rates tend to suffer in a few ways. Primarily, they turn more of their paper gains/losses into realized ones, often resulting in a tax drag. Conversely, low turnover funds often defer the tax, allowing compounding of unrealized gains to work.

2. **Use the right structures.** Understanding the pros and cons of your structures can prove fruitful. Specifically, some investment vehicles trigger capital gains tax at inopportune times. For example, you won’t inherit embedded unrealized gains with the SMA structure. But with a mutual fund, you can be hit with a capital gain distribution shortly after buying into a fund, even if you didn’t benefit from the gain or worse, incurred losses. This was experienced late last year, where many investors accepted a tax bill on their mutual funds in the midst of a downturn. Morningstar, Inc.’s own Christine Benz addressed the topic in late 2018, highlighting the tax burden felt by investors at that time:

   *Mutual fund capital gains distributions were easy enough to shrug off in 2016 and 2017, as stocks posted double-digit gains in both years. Yet as capital gains distribution season dawns in 2018, investors in many equity mutual funds are barely clinging to gains for the year, and some may have even experienced losses in their holdings. The fact that many mutual funds are likely to dish out capital gains distributions that are on par with—or even higher than—years past adds insult to injury.*

   This is one of many reasons to think about your structure carefully.

*Proactively harvest losses.* Not every investment will deliver gains, but there is a real art in making the most of your losses. By proactively harvesting these losses, which can be used to offset gains or income, it is possible to improve the after-tax outcomes. In other words, we try to make lemonade from our lemons.

Separately Managed Account Structure Can Shine at These Times
This demonstrates one benefit of Morningstar Investment Management’s Select Equity Portfolios, which invest via separately managed accounts. Our clients have an individual cost basis for each security in their portfolio. So, when they open an account, they don’t inherit embedded gains like they may with a mutual fund. Also, our clients won’t be hit with capital gains arising from other investors’ redemptions.

Additionally, our natural tendency to keep turnover low may also benefit investors’ tax bills—we think twice before realizing large capital gains. Although the tax will have to be paid eventually, the value of deferral can be quite significant, especially when compounding over many years. Finally, we’ve been
proactively harvesting losses in custom series portfolios (All-Cap Equity, Equity Income, Capital Appreciation, Small/Mid-Cap Equity, and International Equity ADR) held in taxable accounts.

That said, we will not let tax considerations alone drive our investment decision-making. We’ll also examine other factors, including the relative attractiveness of other investments, risk considerations, sector and industry alignment, and transaction costs.

The bottom line: Our goal is to maximize our clients’ long-term after-tax returns in a manner that is consistent with their investment objectives and risk tolerances.
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