TAX-SMART INVESTING
STRATEGIES TO HELP YOU KEEP MORE OF WHAT YOU MAKE

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The time is right to rethink investment tax management.

Taxes—especially when not managed properly—can erode investment gains and minimize progress toward your financial goals. Uncertainty about taxes can add to your psychological discomfort, as well as increase the potential to make the wrong decisions.

In times like these, **every** investor needs to examine and possibly rethink investment tax management. This article will discuss:

- The evolving tax code and what it means to you
- Why investors are likely paying more taxes than necessary
- Most important, the tools available to fight uncertainty and help you keep more of what you make—in any market environment.

Starting this year, the tax code has undergone some drastic changes. Let's take a look at them.

The Tax Cuts and Job Acts of 2017 summary

Tax	Current rules	Additional information
Individual income tax rates	10%, 12%, 22%, 24%, 32%, 35% and 37%	Top tax rate was 39.6%
Standard deduction	$12,000 (single); $24,000 (married joint filers)	Personal exemptions are gone
Long-term capital gains tax rates	0%, 15%, and 20%	No change
Net investment income tax	3.8%	Applies when modified adjusted gross income exceeds $250,000 for married filing joint or $200,000 for singles.
Alternative Minimum Tax (AMT) exemption amount	$70,300 (single); $109,400 (married joint filers)	The AMT exemption phaseout begins at $1,000,000 for married joint filers and $500,000 for all individual filers.
Corporate tax rate	21%	Down from 35%
Estate and generation-skipping transfer tax	40% (for estates over $11.2 million)	$22.4 million for a married couple
Gift tax	40% (for total gifts over $11.2 million)	Annual gift tax exclusion amount is $15,000

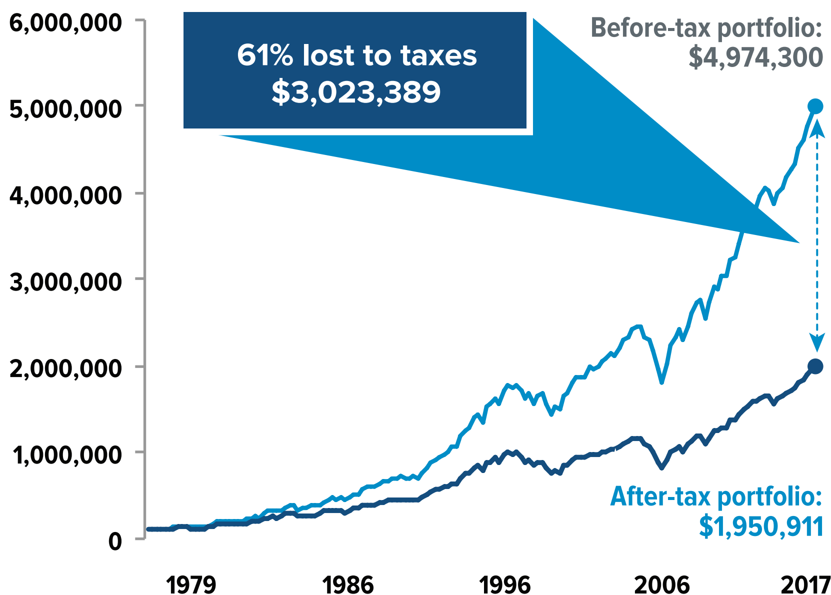
IRS, 2018 data.

How much damage could be done without tax management?

A hypothetical $100,000 portfolio invested in 60% stocks and 40% bonds in 1979 would have grown to about $5 million before taxes by 2017. However, with no efforts to mitigate the tax effect, Uncle Sam would have eaten 61% of the gain, lowering the investor's wealth to just a little more than $1.9 million.

It's not what you make, it's what you keep

Taxes reduce performance over time *(hypothetical growth of $100,000[1])*



[1]Parametric Portfolio Associates: Based on a hypothetical tax-free $100,000 portfolio invested 60% in stocks (based on the Russell 3000) and 40% bonds (based on the Barclays Aggregate) with (1) no liquidators. (2) interest income and dividends taxed annually at historical top marginal tax rates. (3) capital gains realized at 50% per year and taxed at the historical long-term capital gains tax rate. (4) portfolio is held for 38 years from (1979-2017). The intent is to portray a worst-case scenario. The portfolio would have grown from $100,000 to about $5.0 million. If the portfolio was taxed as indicated above, it would have lost 61% of its value, due to taxes paid and earnings lost on that money. Tax-managed investment strategies are designed to minimize capital gains distributions and maximize after-tax returns. Past performance is no guarantee of future results. There are risks involved with investing, including loss of principal. Index returns are for illustrative purposes only and do not represent actual fund performance. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

As of 12/31/2017.

Out with the old, in with the new

"Taxes take an enormous bite out of an investor's return — but the good news is that you can do something about it," said Brian Langstraat, CFA, Chief Executive Officer, Parametric Portfolio Associates, whose firm helps investment managers implement tax management strategies.

Historically, according to Langstraat, most investors and their financial advisors have focused only on cutting taxes in November and December or only in years in which investors have earned capital gains.

Firms like Parametric argue that there is a better way to help protect the investor's return throughout the market's ups and downs. It begins with the admission that tax management cannot be a part-time endeavor. Given the potential damage of overpayment, the management of taxes must be a cornerstone of an investor's planning process. It calls for employing new techniques and strategies from investment managers and more sensitivity to the tax consequences of portfolio implementation.

"Investment return is number one; tax management is 1A," said Steve Konopka, Director, Investment Services with SEI. Konopka admits to being frustrated when investors and their advisors ignore tax management until year-end, at which point options are limited.

"If the investor only does tax management at year-end and the market has gone up, there's not much that can be done at that point," he said. "But managing taxes throughout the year means the investor can take advantage of the ups and downs of the market and benefit from that volatility."

Parametric's Langstraat believes "Investors need a consistent, systematic, year-round approach to tax management in their portfolios." However, there are minimal opportunities with traditional mutual funds because tax management is mostly limited to deferring capital gains or minimizing dividend distributions.

More to the point, the manager of a traditional mutual fund buys and sells securities with the interests of the fund in mind, and not necessarily the tax consequences of the investor. It's for this reason that we offer tax-managed funds and tax-efficient separate account strategies.

Tools to ease your uncertainty

The growing list of tools available to managers of tax-managed portfolios and other tax-advantaged investments reflects their growing popularity. Think of each as navigational tools to help you stay on course to your financial destination. While none of these tools is guaranteed, each can be very helpful in managing tax consequences.

Tax-lot accounting: A method of accounting for a securities portfolio in which the manager tracks the purchase, sale price and cost basis of each security. This allows the manager to "swap" a batch of stocks with long-term gains for a batch with smaller, short-term gains.

Loss harvesting: Allows the manager holding a stock at a loss to sell all or part of it to realize the loss and create an "asset" that may help offset some future gain.

Wider rebalancing ranges: A wider rebalancing range can help reduce the number of trades made to your portfolio within a range of the target allocation—say a 60% equity and 40% bond allocation, which may lead to lower realized capital gains and corresponding taxes.

Gain-loss offset: Involves selling securities at a loss that have dropped in price at year-end to help offset gains from selling securities that have increased in price.

There are other tools that fall within the category of "tax-aware" trading: delaying the sale of stocks that are about to become a long-term holding; identifying the most tax-advantaged stock sales for the purpose of making charitable donations; and identifying the most tax-advantaged (high-cost basis) stocks to sell for investors seeking regular income from their portfolios.

Techniques designed to produce potentially higher after-tax returns

- Tax-lot accounting
- Loss harvesting
- Wider rebalancing ranges
- Tax-aware trading
- Gain/loss offset
- Transition of low cost-basis stocks

Knowledge is only power if you use it.

Now that you know more about managing taxes on your investments — and the potential benefits you can reap from it — what can you do to take advantage of that knowledge?

- **Involve your advisor.** Set up an appointment to review your account's tax efficiency, the effects (good and bad) of your current tax management process, and what short- and long-term steps you need to take.
- **Keep taxes top of mind.** Successful tax management is not seasonal. If you wait until year-end to consider tactics, you'll never get the most benefit. You should be "tax-management-minded" on your investments year-round and in every market condition. Your advisor will make sure it happens so you don't have to worry.
- **Stay on top of changes.** The tax situation changes almost daily. Keep up (both directly and through your advisor) with changes — or potential changes — that could affect you. Plan accordingly. Your advisor can be of invaluable assistance.

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