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Keeping Your Gains with Tax Losses

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Imagine that great news comes from a client – the business is finally selling. The bad news – they have to pay taxes. The next question: How do I avoid taxes?

There are a few ways, but one is to have capital tax losses. These losses can be used to offset capital gains from a large transaction. Alternatively, the tax losses can be carried forward to future years when other portfolio holdings generate capital gains.

Of course, we would prefer not to lose capital to have those booked. What if the largest piece of your portfolio could help?

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A typical portfolio has the largest weight in US Equities. Below is a basic allocation with 50% held in US equities.



What if we turned the largest allocation into an asset that generates tax losses?

One can do this using an index-based approach. A stock index tracks a collection of stocks, such as the S&P 500 Index, which tracks the largest companies in the US.

Indexing stocks began in 1970 with institutions. In 1975, the first index-based mutual fund was launched. In 1993, the first exchange traded fund (ETF) was launched to track the S&P 500 Index. Our firm began using separate accounts, or direct indexing, over a decade ago with a third-party manager. To lower fees in 2019, we began managing these portfolios in-house.

Today, there are opportunities to add greater gross exposure to create the opportunity to book more losses for tax purposes. In addition, one can run these at different risk levels, at, say, half or even lower for those that prefer less exposure to market volatility. This can be changed over time to meet the target allocation.

The savings from avoiding taxes can be significant. For example, if $500,000 is taken in losses over a few years, this can save $150,000 in taxes. On a $1 million portfolio, this means additional capital of 15%.

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Portfolio Value	Tax Losses	Tax Savings at 30% Rate	Tax Savings as Percentage
$1,000,000	$500,000	$150,000	15%
$1,000,000	$250,000	$75,000	8%
$1,000,000	$100,000	$30,000	3%

Direct indexing has other benefits beyond tax efficiency.

Customization – Investors can control exposure based on their preferences by choosing which stocks, industries, or sectors to include or exclude. This could be based on an investor's investment views or values.

Risk Management – Diversifying exposure by owning stocks tailored to an investor's risk and investment objectives can more closely align with a long-term financial plan and allocation goal.

Transition – With concentrated positions or a portfolio with unrealized gains, investors can potentially move a portfolio closer to the benchmark while minimizing tax consequences.

Charitable giving – A tax-efficient way to support causes by gifting appreciated stock.

A direct indexing approach has risks. This includes tracking error or the variation of returns around the index. In addition, there is risk of executing the strategy without proper tools and software.

Direct indexing can potentially improve the tax efficiency of a portfolio. The strategy works well before or after a personal transaction or as a transition plan for a fully invested portfolio. There are risks to be mindful of, but increasing the total capital base while being mindful of taxes will not go out of style.

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