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Taxes are certain, but don't obsess about tax reform

As tax reform wends its way through Congress, investors may be tempted to reposition portfolios as a way to lower their tax bill. Although careful tax management can make a significant impact on portfolios, particularly in a low-return environment, it rarely should drive investment strategy. Sacrificing higher returns on the altar of paying fewer taxes makes little sense. This month, we revisit the rudiments of investment returns and the path to achieving them within the context of goals, future outlook, and taxes.

Zachary Karabell
Head of Global Strategies
Envestnet, Inc.

The tax debate is heating up in Washington. By year's end, we may have a significant set of changes to current tax codes—or not. For investors, the prospects of the bill offer a series of temptations to position investments in anticipation of those changes. But while some of these possible tax changes could indeed affect how stocks and bonds behave, it may be wise for investors to resist those temptations.

What's more, if the tax code is simplified and streamlined, the net result should be to focus investors on what they should be focused on: the fundamentals driving long-term returns. Tax management is an important tool, but it must be used adroitly. Minimizing short-term gains in order to avoid paying the highest taxes can measurably benefit investors. But tax management rarely should drive investments. Remembering that will be vital, as the tax reform debate gets more heated and more people game out its possible consequences. A good stock is a good stock regardless of tax consequences; a good fund generating above-average returns is a good fund regardless of distributions; and a good bond that performs as expected and generates returns as needed is a good bond, whether it is tax-free or not.

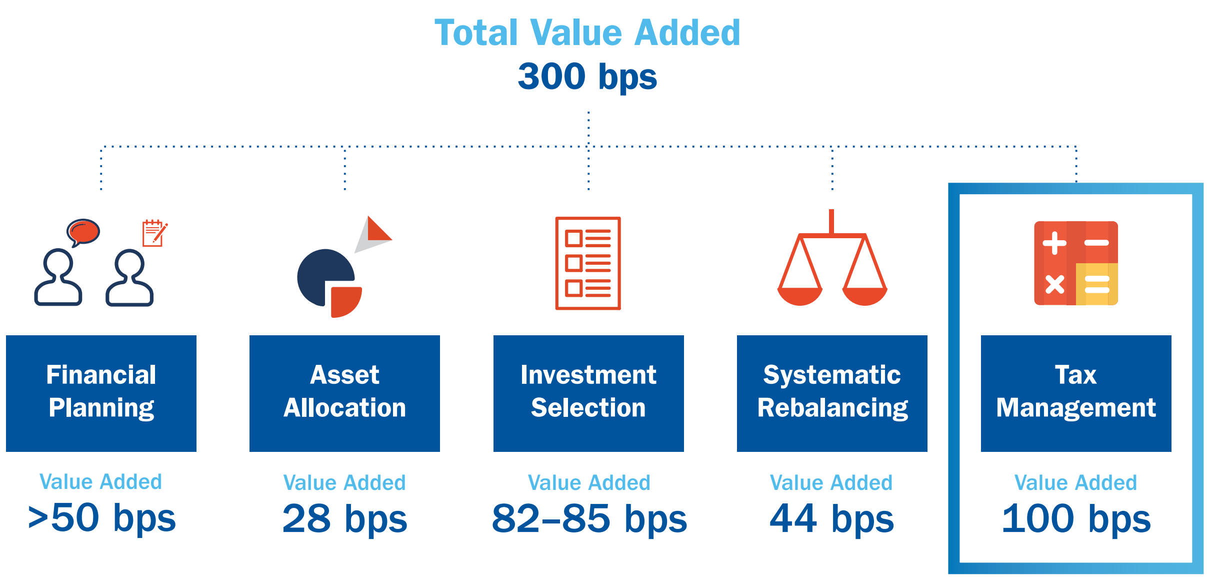
The dos and don'ts of taxes and portfolios

Financial advisors long have known that astute tax management can add significant value over time to a portfolio's returns. Envestnet's research has shown, in fact, that effective tax management can add as much as 100 basis points, or 1%, to returns over time (Figure 1). In a lower-return world, which indeed may be what is in store over the next decade, those added basis points can make a substantial difference between meeting goals or falling short.

Tax management, however, is distinct from constructing a portfolio geared toward paying fewer taxes. Investors could, of course, create an entire portfolio comprising tax-free municipal bonds. To avoid paying ordinary income tax, they could make sure to hold for at least a year all stocks with gains, thereby paying only the lower capital gains tax. They could only sell at a gain when they have losses on other equities to "harvest" and then use those losses to offset corresponding gains. But unless those strategies are combined within the larger setting of goals, absolute returns, and future prospects, they are likely to result in less optimal decisions.

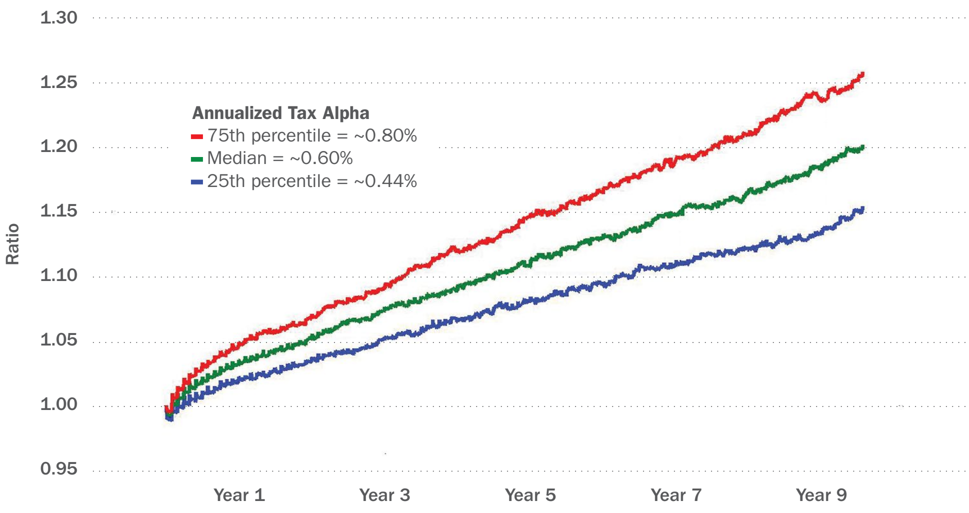
That seems all rather obvious, but investors sometimes lose sight of the forest for the trees. It's vital to strike the right balance between tax optimization and overall returns. Take the old cliché of holding on too long to equity winners. A stock that has run up 50% or more might be a good candidate for taking some profits (though it all depends on what type of company and what business—an early-stage biotech name may still have many more multiples in front of it). Not taking profits in the fall of a calendar year in order to avoid paying taxes on the gain only makes sense if the investor has a high conviction that the name won't decline in the months ahead. It does no good to hold onto a stock that has run up 50%, only to see it decline by 20% a few months later, either because of market conditions or having run too far, too fast. Not selling may avoid a tax bill on the gain, but better a tax bill on the gain than having no gain to tax. A net gain of 30% after taxes

Figure 1:
Value-Added Tax Management: Up to 100 bps



Source: Capital Sigma, The Return on Advice by Envestnet | PMC, 2016

Figure 2:
Quantitative Tools and Portfolios Offer Potential for "Tax Alpha"



Source: Envestnet | PMC

(assuming an investor is in the highest tax bracket and pays short-term taxes on that 50% gain) is better than no gain at all.

The same goes with "harvesting losses." It makes eminent sense to use losses to offset gains, but here as well investors must find the right balance. You wouldn't want to harvest losses if there is a high-level of conviction that a company is about to enter a better cycle. If the unrealized losses are soon to be reversed, because management is about to turn the company around, or a new cycle is about to begin, then harvesting losses leads only to managing taxes at the expense of substantial future gains. If investors sold Amazon a few years ago after a bad earnings call, they might have used the losses to offset gains in other funds or single stocks, but they also would have missed out on doubling the value of their holdings over the next few years as Amazon rallied.

Similar challenges exist with bonds. Not selling a bond with a significant price gain because of potential tax consequences, and instead waiting until it approaches closer to maturity, can be tempting. But if that gain is due to factors such as easy monetary conditions or bouts of momentum and euphoria, then taking that gain while it exists and paying taxes on it may be far superior to waiting until it reaches maturity and par.

Some of the most efficient tools for tax management are automated. They can assess the entire portfolio, with risk score and probable returns relative to valuation, along with a host of other variables. They then can arrive at a programmatic solution that optimizes returns and reduces possible liability.

But those tools should be used in conjunction with an investment menu that begins with goals and objectives and is constructed accordingly. Yes, some investors have set needs and goals: knowing that a municipal bond will return 2.75% after taxes with metronomic regularity can be useful. So too, on a similar principle, could an annuity. But anything that is managed to provide lower taxes and absolute certainty is something that will inevitably sacrifice potential higher returns. There is no free lunch. Cue the cliché music.

What to do about the debate

The common-sense approach that takes all of these questions into consideration can be lost in the fray of the pending tax bill debate. Yes, some provisions could shape how portfolios are managed, including changes in what shares investors or advisors are allowed to sell first. But focusing on tax optimization above all is usually the wrong focus, because it obscures the bigger picture of meeting goals. The adage for companies, “you can’t cut your way to profit” can be adapted to taxes—investors can’t focus primarily on paying less tax as a way to meet their ultimate needs. With financial assets like stock, bonds, and funds, investors can focus on tax optimization as a way to reduce tax liability on gains generated by fundamental positioning, but only if that fundamental positioning is sound in the first place. Real estate and fixed asset investments are different, of course, but in the world of financial markets, taxes are the downside to the upside. Investors should do everything they can to pay only what they must, but should focus on the overall returns, balancing tax management with fundamentals. Doing one or the other can lead to less optimal results; doing both in balance can be a potent way to achieve goals. ■

November Takeaway:

How (or whether) tax reform will play out is still unknown, yet investors may view the hype as a reason to take gains now to preempt higher taxes in ensuing years. Tax optimization and management are vital tools that can add measurable and often substantial benefit, but they should be used in conjunction with fundamental positioning. Sacrificing potential returns to avoid paying tax on a stock that has run up substantially is seldom prudent, nor is holding a bond to maturity to escape paying tax on a significant short-term price gain. Sound fundamental positioning means considering tax optimization within the framework of meeting investment goals and objectives and the basics of long-term investment returns. Investors should be guided to forego the urge to focus primarily on paying fewer taxes as a way to meet their ultimate needs. A tax bill on the gain is better than having no gain to tax.