LEVERAGING VOLATILITY TO BOOST AFTER-TAX RETURNS

- What's the good news about a bear market? The opportunity to lower clients' tax bills. I'm Jack Otter, Global Head of the Wealth and Asset Management Group at *Barron's*. And for this edition of the *Outspoken* video series, I'll be speaking with three experts on sophisticated strategies for tax-loss harvesting. Mike Evans and Curt Rubinas, financial advisors at UBS, and Robert Holderith, Head of PGIM Custom Harvest at PGIM Investments. Thanks for joining me. This has been a painful year for investors. Bob, can you explain how even when Mr. Market takes away some of our gains, you can use tax-loss harvesting to add back?

- Tax-loss harvesting, obviously, is a strategy used to capture losses when those losses are available in the marketplace. Those losses can be used this year or carried forward in future years to offset capital gains. And the greater the market goes down, in theory, the greater the opportunity is to capture losses.

- Mike, jump in here and explain how you're using tax-loss harvesting in your practice.

- Sure, we use it broadly across our clients' taxable accounts, both in fixed income and in equities. We'll do it once or twice a year; but this year in particular, we've probably done it three or four times for clients opportunistically. Every portfolio has some degree of beta exposure in it and, largely, the returns are going to be determined by the direction of the general market. This year has not been a great direction; and so the one silver lining in a year like this year is to go into a portfolio, realize these losses, replace them with appropriate exposure, and then carry forward where the losses which have an infinite life, they last in perpetuity. And you're setting your clients up to potentially realize gains over subsequent years completely tax-free, because of this loss, they'll be able to net it against.

- Taxes are a huge part, if not the biggest expense, in a client's economic life. Mike, how do you have that conversation, especially with your ultra-high-net-worth clients?

- Everything we do revolves around tax efficiency, from the portfolio construction to the actual management of the assets. And so you talk about what clients really need from their advisors, and obviously you need judgment in establishing a sound portfolio. That goes without saying. But I think another important aspect of what I do for my clients is providing the discipline that they might not otherwise have—discipline to rebalance their portfolio when it's least comfortable or maybe when they're feeling greedy about the market and they don't want to buy more bonds. But there's also discipline when it comes to making sure that you take tax losses on a regular basis—once or twice a year. And then when you have years like this, be opportunistic with it. That discipline is really critical.

- Can you tell us how you're using these strategies to explain to them that they'll actually end up with higher after-tax earnings in the end?

- It is something that is going to be powerful for reducing those taxes in the future and talking through them and realizing that, listen, we're realizing these losses, but we still have the potential, and maybe even better potential, to come back from where we are, right? To recover those losses and then in future years not have to pay those gains because of what we're doing this year. And when you start actually breaking down the numbers of how much they're saving, it becomes real.

- Bob, let's talk a little bit about timing. Obviously, the traditional market move is to sell those losers in December and then buy in January. Do you use the calendar? Or is it more of when something is down a certain percent?

- We always use percentage-based thresholds, and we have varying thresholds for varying securities. So securities that are more volatile, we have the ability to wait a little bit longer and have a higher threshold to trade them. And securities that are typically less volatile like municipal bond ETFs, they usually have a lower threshold. We believe in taking losses when those losses are available and not letting the calendar determine when losses are taken. You mentioned, Jack, there's that kind of January effect that occurs from people buying back into the market. December and January are historically two of the best months of the year, followed by November. So those are probably the times you don't want to be out of the market. Keeping the best securities that you can to keep you fully invested and properly invested all the time, we think makes a lot of sense, coupled with doing it opportunistically and not letting the calendar determine when losses are taken.

- So in addition to the high taxes, what are the other hallmarks of the sorts of clients who benefit most from tax-loss harvesting?

- I think this applies to everyone. Anyone who is a taxable investor, it applies to everyone. It's even more critical for those who are in the highest tax brackets, taking advantage of your taxable portfolios versus your tax-exempt portfolios and maybe even your tax-free portfolios. Taking full advantage of what the government has given you is really critical as well.

- So much of our practice is about deferring taxes, right? Creating a deferral strategy so that at the time of your passing, you get a step-up in basis and you've effectively eliminated these capital gains. So if you can structure the portfolio to take advantage of that, to be investing in asset classes that allow you to defer capital gains for a really long period of time, potentially until you pass away, that's some of the most effective tax planning that we can do.

- Bob, why don't you take that on and explain the role of direct indexing and tax-loss harvesting.

- Our goal and our job is to provide about the return of an index or a strategy and capture losses at the same time. So if over seven or eight years, a client portfolio and the index is up 55%, hopefully somewhere around there is what the goal should be for a direct indexer to provide. Along the way, since a portfolio in an S&P 500 is broken down, in our case into sectors but in some cases into individual equities, when there are opportunities to capture losses, those opportunities are picked up along the way as well. So it's kind of a dual mandate, which is interesting. A lot of clients think that you need to lose money or a portfolio needs to go down to capture losses. It's not necessarily true. Clearly, this year it has been; but last year when the market was up over 27%, there are opportunities to capture losses as well. I think what you see if you go back and look, certainly over the last six years, is that one of the mandates provides some significant benefit. In other years, the other mandate perhaps does. Clearly, last year was a good year for appreciation, and this year a better year for loss harvesting.

- It's really nice to have both of them at the same time. Curt, can you talk a little bit how you might be putting direct indexing into practice with your clients?

- Right now, when we look at specific large cap, whether it's in the U.S. or internationally, that's where we focused on direct indexing. We just found that there's a lot of opportunity there. We don't particularly think there's a ton of alpha to be had in those markets most of the time. And so we're carving out a piece of our core beta and put in direct indexing in developed non-U.S. and U.S. So it's not going to be our entire allocation, but it is going to be a big chunk of it because we're always looking at it and saying, "Alright, there's going to be some part of our portfolio and some part of our equity exposure that's going to be focused on beta in U.S. large cap and international developed," because we'd love to be able to harvest losses from there to do the things that we want to do on the fringe to maybe overweight a sector or change from a sector that we've loved for five years into something else that we want to move into so that the harvest losses from the core of the portfolio really help us to shape and adjust some of our more thematic views in the portfolio.

- Bob, Mike, Curt, thank you so much for your insights. It's great to have a way to make clients happier in a pretty tough market environment.

- Thank you.

- Absolutely. Thank you, Jack.

- Thanks, Jack.