55ip's Approach to Active Tax Management

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Introduction

Investors are confronted with an increasing array of choices. Whether it be what investment strategy to follow, what products to use or how to get advice, the number of options is nearly endless. Yet with all these choices, one thing is certain – taxes matter to most investors. And in a world where returns are low, taxes matter even more.

Knowing that you can only spend what you earn after taxes, the three key tenets of 55ip's investment approach are:

- Incorporate a broad set of return drivers across asset classes, sectors, regions and factors
- Minimize downside exposure through dynamic risk forecasting (and not forecasting returns)
- Systemically harvest tax losses

Incorporating additional return drivers and forecasting risk are key elements of the 55ip goal of delivering out-performance relative to benchmarks with lower drawdowns and volatility. But for the taxable investor, dynamic tax management can be an additional source of value derived from 55ip research-driven and rules-based approach to investing.

The Choices Investors Face

While it would be nice if investment strategy and tax management decisions aligned, this unfortunately isn't always the case. And when they don't, investors need to make decisions.

As an example, think about the investor who has a simple two position portfolio that holds 60% equity/40% bonds and is looking to manage after-tax returns. If the value of the equity holding rises and the bond holding falls such that the investor now has a 65% equity/35% bond portfolio, she would be faced with the following three choices:

At 55ip, we believe in applying a research-driven and rules-based approach to help the taxable investor thoughtfully generate after-tax returns.

- Sell equity/buy bonds – rebalance to her target asset allocation but realize a taxable gain
- Sell bonds/buy equity – realize a loss, which can lower her near-term tax bill, but further skew her asset allocation
- Do nothing – deviate from her target asset allocation and miss the tax-loss harvesting opportunity

Certainly, all three scenarios involve trade-offs and doing nothing, while the easiest, may indeed offer the fewest advantages to the thoughtful investor.

Unfortunately, some investors tend to muddle their investment and tax choices over time and therefore miss opportunities to realize value on both fronts.

At 55ip, we believe that investment decisions come first. By dynamically forecasting risk (but not returns), 55ip strives to outperform the static "buy-and-hold" strategy embraced by many investors. Adding active tax management into the investment process then provides the after-tax investor with an additional opportunity to meet her investment goals.

55ip Approach to Active Tax Management

The 6 key elements of 55ip approach to active tax management are:

- **Construct portfolios that are intrinsically tax efficient:** Different approaches to investing generate different levels of near-term taxes. As an example, a momentum strategy, where one holds gainers and sells losers, will be inherently more tax efficient than a value strategy, which may look to buy stocks as they become less expensive (decline in value) and sell stocks as they become more expensive (increase in value). Understanding and incorporating these differences, when both strategies seem attractive, creates portfolios that are inherently more tax efficient.

- **Take advantage of a broad array of returns drivers:** A key component of the 55ip approach to managing assets is to incorporate a broad set of return drivers (asset classes, sectors, regions, factors). Having granular exposure to a broad range of asset classes allows for a variety of tax-loss harvesting opportunities given the dispersion of returns across asset classes.

Implementing these 6 elements in a systematic and scalable fashion is integral to the 55ip's approach to asset management.

- **Use tax efficient investment products (ETFs):** Exchange Traded Funds (ETFs) are powerful tools for managing taxes as they infrequently distribute capital gains relative to mutual funds.

- **Thoughtfully select ETF proxies:** The investor's goal in tax-loss harvesting is to find a replacement security (or securities) that has (have) nearly identical characteristics to the security being sold. This is very difficult to do using mutual funds when there is not enough real time transparency about what you own or with individual securities where individual companies simply don't have substitutes. It can be done however using ETFs. Of course, some ETF investors do this using a fairly simplistic approach, i.e., substituting out S&P 500 exposure with Russell 1000 exposure. However, the simple approach doesn't always work given the best proxy isn't always a single ETF and that the markets are dynamic, e.g., correlations between various ETFs can change over time. 55ip approach is to continually evaluate proxy selection to identify the most efficient approach to replacing securities when implementing tax-loss harvesting.

- **Deliberately identify tax lots:** Tax lot accounting matters because it determines the size of both realized gains and losses. While there are multiple approaches to tax lot identification, 55ip believes that HIFO (Highest In/First Out) delivers the most value as it allows investors to recognize the greatest level of losses and the lowest level of gains.

- **Actively harvest tax losses:** For many, tax-loss harvesting is an end-of-year exercise. However, this approach has the potential to miss the many opportunities that exist for tax-loss harvesting between January 1st and December 31st. As an example, in 2015, the S&P 500 (as measured by the SPDR S&P 500 ETF) went from $205.54 per share at December 31, 2014, to $208.69 at November 30, 2015 – a 1.5% gain. However, an astute investor watching the market would have seen the ETF priced at $199.45 on January 30, 2015, thereby creating the opportunity to generate a 3.0% loss. At 55ip, we look for opportunities to harvest tax losses monthly in order to create value for the investor.

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Active Tax Management Adds Value

It's easy to understand the cost of taxes – particularly every year around April 15th. But while the cost of taxes is easy to understand, the value of tax management isn't quite as easy to quantify for the investor balancing investment and tax management strategies. That's not to say there is no value in managing taxes (as there is), but the thoughtful investor needs to consider three key issues when evaluating the value of tax management:

- The degree of asset class exposure in her portfolio
- The time frame over which the portfolio is invested
- The alternative to investing in a tax-managed portfolio

Asset class diversification is a cornerstone of portfolio construction and holding a wider range of asset classes often allows for greater opportunities for ongoing tax-loss harvesting.

The time frame is critical for two reasons. For starters, active tax management typically leads to a deferral of taxes – with the taxes needing to be paid at some future point. And given the value of compounding, the longer the taxes can be deferred, the higher the value of active tax management. Secondly, time frame matters as markets move in a variety of ways such that some time periods may show mostly gains, some may show mostly losses and some may show a combination of gains/losses – thereby creating different ranges of opportunities for active tax management.

Finally, the thoughtful investor needs to understand her options relative to investing in a portfolio that is dynamically managed from both an investment and tax perspective. A static portfolio holding one or two index funds may be highly tax efficient but generate a lower level of returns.

Conversely a high turnover strategy that isn't tax managed may generate higher pre-tax returns but lower after-tax returns.

That said, 55ip has analyzed the value of active tax management and like other asset managers, we believe it can deliver value to the taxable investor. For example, in evaluating 55ip Global Macro relative to a high turnover, non- tax managed strategy, we believe there is around 80 basis points of annual value delivered through our active tax management approach.

Bringing It All Together

Investors invest for many reasons – ranging from providing for retirement to creating wealth for future generations. Whatever the reason, one way for taxable investors to better meet their goals is to thoughtfully manage not just their pre-tax returns but their post-tax returns as well.

Systematically combining dynamic investment and tax management can be a key source of value relative to the static "buy-and-hold" approach adopted by some investors. A key element of this is incorporating active tax management using ETFs with an eye towards improving how many are implementing tax harvesting today using infrequent tax-loss harvesting techniques, inefficient tax accounting practices and/or simplistic methods for proxy selection. At 55ip, we believe in applying a research-driven and rules-based approach to help the taxable investor thoughtfully generate after-tax returns.

[1] 55 Global Macro analysis based on back-test data from January 2007 to April 2016 results in 81 basis points of annual value delivered from active tax management. Analysis evaluates 10.90%
pre-tax and 7.35% post-tax return for Global Macro (32.6% effective tax rate) relative to a high turnover/non-tax managed strategy delivering similar post-tax return of 7.35% and with a 40% effective rate (12.25% pre-tax return). The historical returns for the 55 Global Macro strategy have been computed by 55ip based on allocations mandated by the 55 Global Macro strategy. Historical (or model) performance results have certain inherent limitations. Returns exclude management fees as taxes are the result of trading activities and therefore taxes are computed on gains/losses prior to management fees. 55 Global Macro analysis also includes complete liquidation of the strategy in 2016.

Tax Rates as of 2016

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