Benefits of Tax Harvesting

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Investors face challenges on many fronts in today's environment. Investment returns are usually the first focus, followed by fees. However, inefficient tax management — which is often not high on a client's radar — should be a higher priority, as it can potentially wipe out a significant portion of a client's pretax gain. Tax expenses can easily dwarf all other costs and can erode nearly 52% of returns, when looking at high-cost tax states such as California.

A portfolio of actively managed stocks and bonds can be tailored to fit client-specific needs and objectives, and done in a more tax-efficient manner.

While many tax management strategies exist, one very effective strategy which is often underappreciated is active tax loss harvesting. Often people wait until the end of the year to realize losses in securities. This is often not an opportune time. It can become easy to end up selling into weakness, thus realizing an even larger loss. A better technique is to harvest losses actively during the year. In a well-diversified portfolio, each stock plays an essential role in providing exposure to a specific economic or market factor. They each also play a specific role in the context of the risk management of the overall portfolio. We seek to sell securities at losses during the year, and then buy a correlated stock (one that provides similar exposure) to replace it.

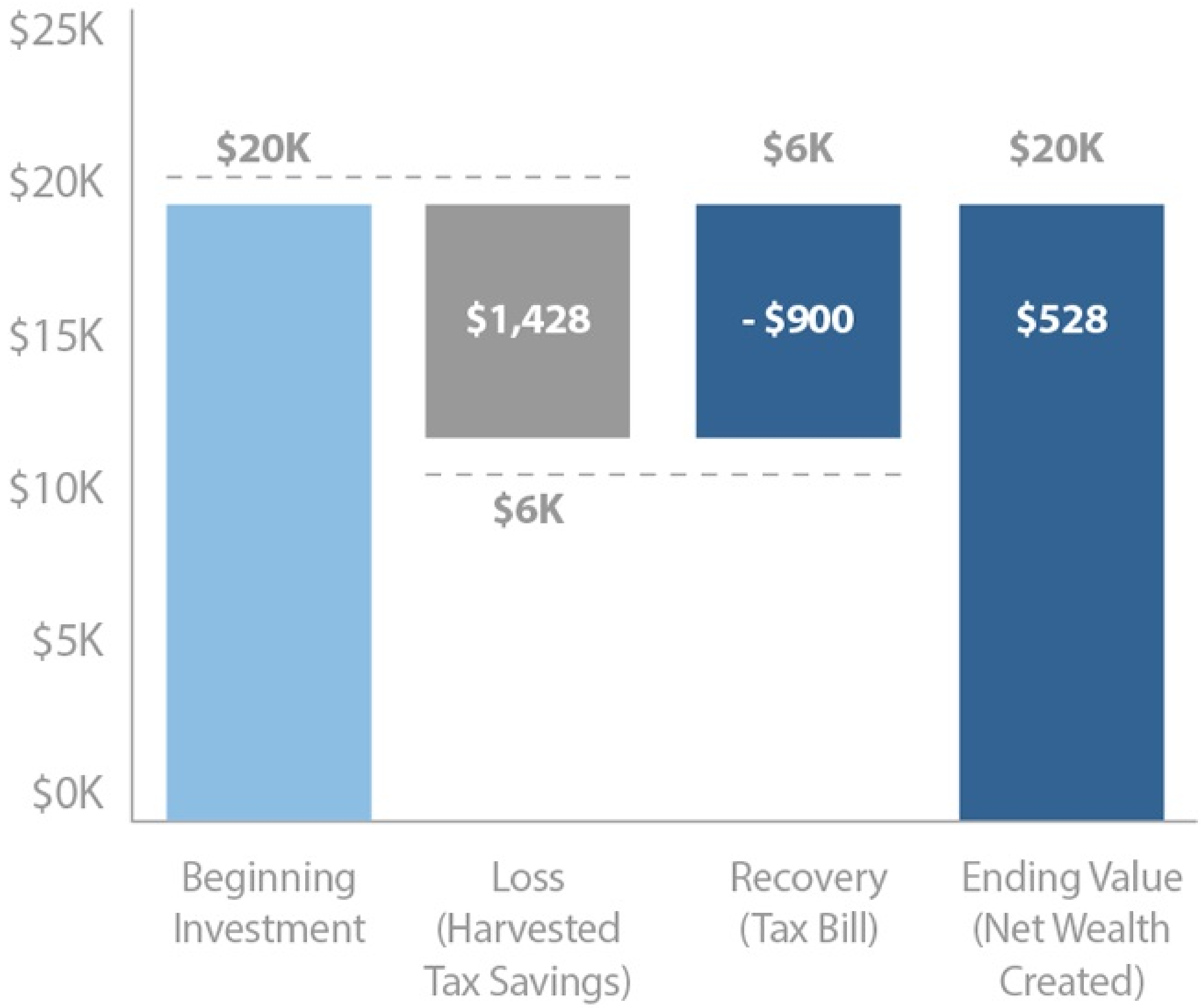
The client receives three benefits:

- The investor can "harvest" a valuable loss.
- The portfolio remains balanced at the desired risk level.
- It allows for zero cash drag. With an investment staff of 50 individuals, sourcing best ideas and replacement ideas is not a problem.

Tax loss harvesting can have a significant positive impact on the portfolio over time. Benefits include:

1. **Tax Deferral** – Harvested losses can be applied to unavoidable gains, such as diversifying a low-cost concentrated stock position or the sale of a piece of real estate. Savings generated from the reduced tax bill should be reinvested. Assuming even a growth rate of 5% over a 10-year period, a single dollar of deferred tax would be worth $1.63.

As an example, if you harvested a $6,000 loss, the tax savings at 23.8% would be $1,428. If the stock were repurchased at the lower cost and recovered the $6,000 loss, the resulting gain would only be taxed at a 15% rate for $900 of subsequent taxes. As a result, harvesting the tax loss now (at 23.8%) and repaying it in the future (at 15%) creates $1,428 – $900 = $528 of "free" wealth, simply by effectively timing the tax rates (see chart). When added to the pure tax-deferral benefits, the opportunity for tax bracket arbitrage creates significant additional wealth opportunities over time.



2. **A Change in Tax Brackets/Lower Future Tax Rates** – In some instances, an individual may have income in or near the top tax brackets and a capital gains tax rate of 23.8%. However, if he or she anticipates retiring soon, the associated capital gains rate will fall to 15% in the future, and the deferral of a gain will become even more relevant. The possibility also exists that the Trump Administration will be successful in cutting future tax rates. In this context, the economic value of harvesting the loss is not merely the opportunity to invest the tax savings; wealth can also be created simply by managing the tax position and being able to benefit from the difference between the current and future tax rates.

At Westwood, we are investing in technologies which will help us increase our tax-efficiencies over time. We currently offer a variety of investment vehicles, including separately managed accounts, which consist of a portfolio of individual stocks and bonds, managed in a manner which is tax-efficient for our clients. We can also work with clients with low-cost basis stocks, aiding in reducing positions in a tax sensitive manner and customizing the redistribution of capital into a risk-adjusted portfolio, appropriate for their risk tolerance and overall investment goals.