Mitigating taxes while transitioning to a new strategy

Russell Investments Research

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Realigning a client's taxable portfolio to a new investment strategy can be cumbersome and often generates taxes. This is particularly the case when repositioning an equity portfolio with appreciated shares and the corresponding embedded gains. Here we discuss two tax efficient approaches to transition an equity portfolio populated with low basis shares to a new strategy:

1. The ***Timeline*** **approach** which moves the existing portfolio to the new strategy over a set number of years.
2. The ***Tax-Budget*** **approach** which moves the existing portfolio to a new strategy while limiting taxes or capital gains per year.

While these taxable events can impact equity portfolios comprised of individual stocks, mutual funds, or both; for the purpose of this paper, we are focusing on the transition of portfolios holding individual securities (separate accounts) and not mutual funds.

Introduction

Common reasons clients need a tax effective transition solution:

- **Concentrated stock position**
  An investor has too much risk tied up in a single holding, such as company stock, creating a desire to transition to a diversified portfolio.
- **Insufficient diversification**
  The investor has built their own portfolio and it lacks diversification across industries and sectors.
- **Waning conviction in the existing strategy**
  The investor (and/or the advisor) have little conviction in the forward-looking active performance of the investor's current equity portfolio.
- **Large unrealized gains**
  The investor has significant unrealized gains and desires a gains deferral strategy.

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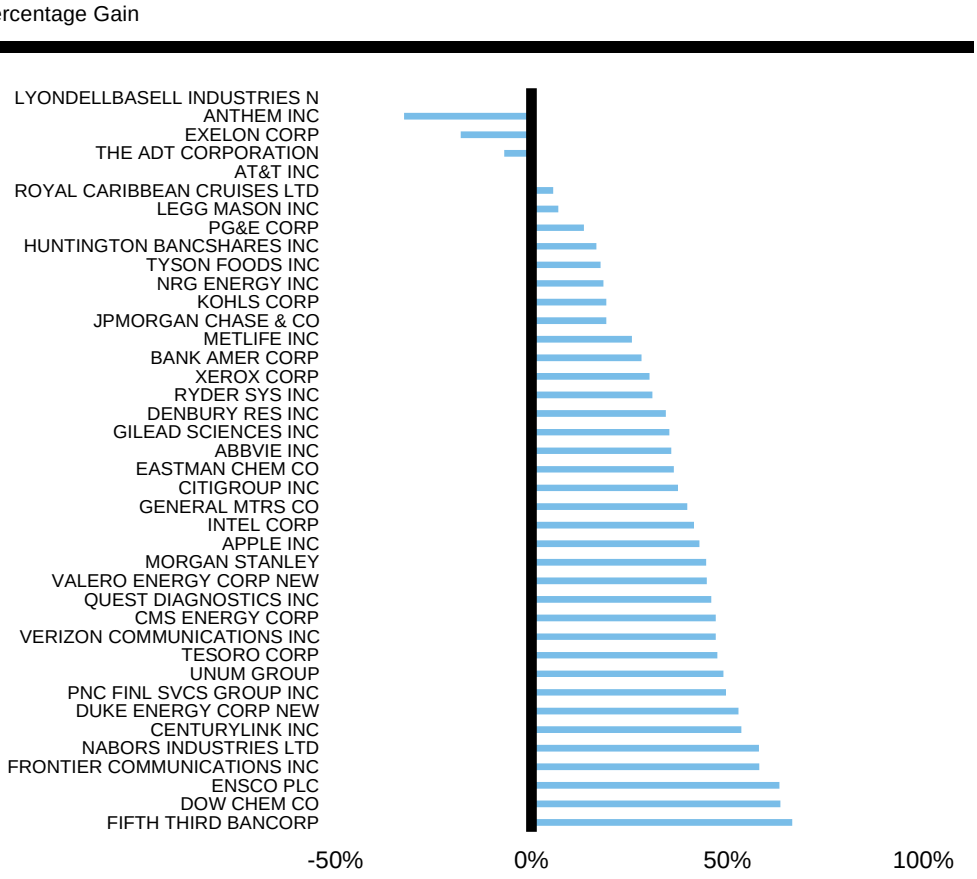
Assessing potential taxes from strategy realignment

Before implementing decisions to reposition a portfolio, it's important to assess the tax implications. Consider the case of an advisor taking over an active equity portfolio, where there is little conviction in the inherited strategy. Perhaps the client built the portfolio, or it was put together by a former advisor. Moreover, consider that the client is seeking S&P 500® Index-like performance with a priority placed on tax efficiency. Exhibit 1 illustrates this situation where the hypothetical portfolio consists of 40 securities, with a total portfolio value of $999,952 and cost basis of $732,363. Most of its securities are classified as long-term holdings from a capital gains tax perspective; however, 18% of the portfolio by market cap[1] represents short-term holdings. Exhibit 1 illustrates the embedded gains and losses of each security in the portfolio.

Exhibit 1: Hypothetical portfolio with embedded gain and losses



Hypothetical portfolio for illustrative purposes only.

Since the client's goal is S&P 500 like performance, we need to examine how closely the portfolio tracks the S&P 500 Index. Tracking error[2] is a useful measure to assess potential performance deviation. The portfolio in Exhibit 1 has a tracking error of 5%, which is quite high given the objective of S&P 500 like performance. It needs to be repositioned to a lower tracking error target, while considering potential tax consequences.

[1] Or alternatively, 8 of 40 names (20%).

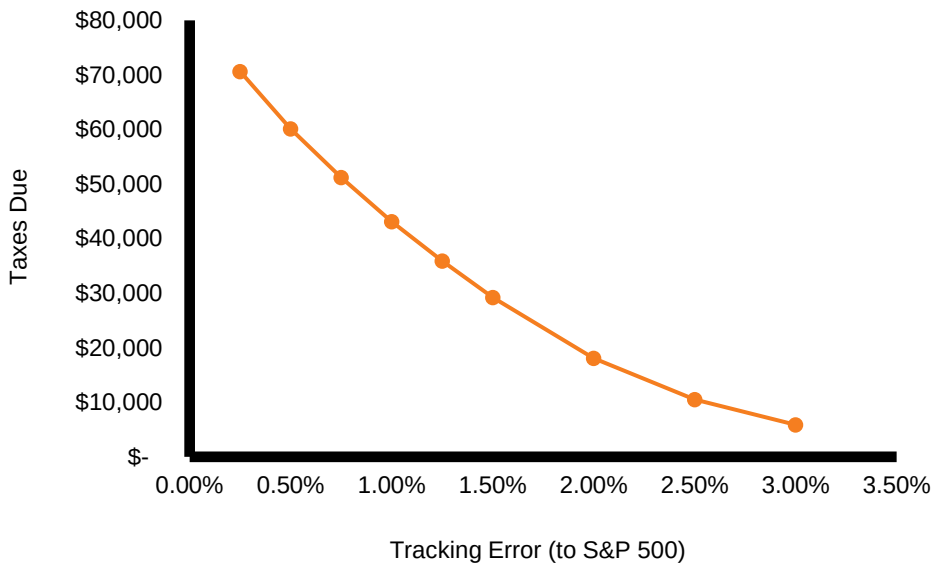
[2] As an example, a tracking error of 1% means that there is a 95% chance that the return of the current portfolio will be within +/- 2% of the target or benchmark portfolio. The tracking error of the current portfolio is 5%, which means that there is a 95% chance that the portfolio will have a return within +/- 10% of the S&P 500 Index (the target or benchmark portfolio). This level of tracking error implies that the target portfolio will perform quite differently from the S&P 500 Index.

A naïve option is to fully liquidate the portfolio and buy an exchange-traded fund (ETF) or index fund that will track the S&P 500 with little tracking error. However, pursuing this option would generate a $96,443 tax bill[3], which is almost 10% of the portfolio's value. While this transition approach would accomplish the performance target, it would fall short of the tax management goal.

A more tax-efficient approach involves making security-level purchases and sales to reduce the portfolio's tracking error to the S&P 500. Mechanically, this involves buying and selling securities that align the factor, industry, and sector exposures to the S&P 500, while at the same time, weighing the tax implications of each decision. This can be a challenging task, one that can significantly benefit from quantitative tools such as a tax minimization algorithm.

Exhibit 2 shows the results of running such a tax minimization algorithm to reposition the hypothetical portfolio to perform more like the S&P 500. Each point on the curve shows the lowest tax cost solution for each tracking error level.

Exhibit 2: Tax cost to reach different levels of tracking error to the S&P 500



For illustrative purposes only.

The pattern in Exhibit 2 is typical of an appreciated portfolio: The cost to move the portfolio closer to the target (in this case, the S&P 500 Index) increases inversely with tracking error. Without tax considerations, we might strive for a tracking error of around 25bps, which means there is a 95% chance the portfolio will have a return that is within +/- 50 bps of the S&P 500. However, the tax cost to achieve this level of performance is $70,000.

Given the tax implications shown above, a natural question is: How should taxes and tracking error be selected? Our view is that a tracking error of 50bps to 100bps strikes a reasonable balance between consistent S&P 500 performance and taxes. However, we can see that moving to this range immediately generates a tax bill for the client in the range of $40,000 to $60,000. While more tolerable than the full liquidation cost of $96,443, it's still a rather large tax bill to pay in a single year.

To mitigate this large upfront tax bill, clients can consider a transition plan that spreads the tax bill out, with the potential to decrease it. We consider two transition approaches below to accomplish this. Each approach can be automated.

> *To mitigate a large upfront tax bill, clients may want to consider a transition plan that spreads the tax bill out.*

[3] Using a long-term capital gain tax rate of 23.8% and short-term capital gain tax rate of 43.4%.

Personalizing the transition: The Timeline transition versus the Tax-Budget transition

The first approach, the Timeline transition allows an investor to control the length of time over which the transition occurs, while the second approach, the Tax-Budget transition allows the investor to control the amount of taxes paid each year.

In the Timeline approach, the tax-sensitivity of the transition will be dictated by the number of years allotted for the transition. A transition that occurs all on day 1 is likely the most tax-insensitive transition for a portfolio with embedded gains. Tax efficiency can meaningfully improve as the number of years allotted for the transition is increased. Here we will explore transition horizons that span immediate transition to a period of five years.

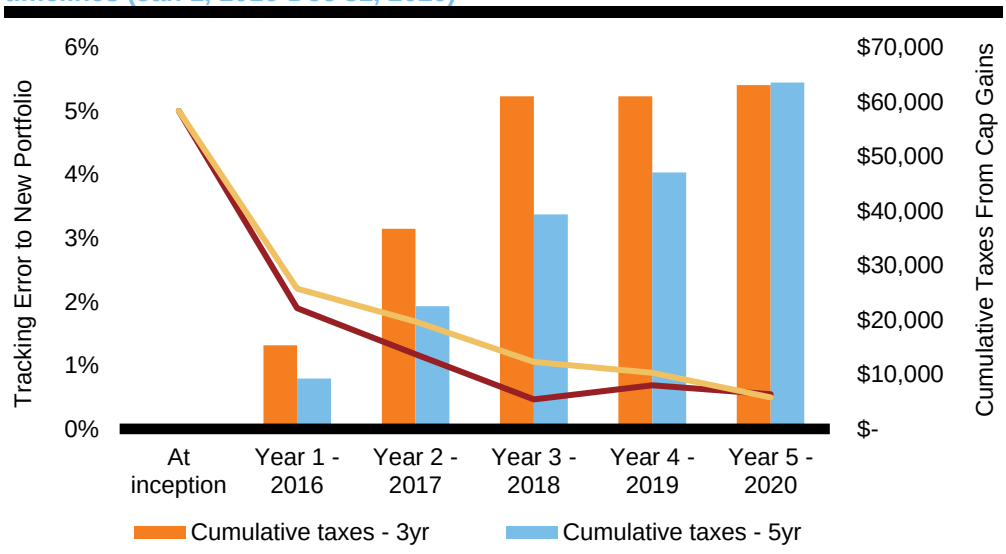
The second approach, the Tax-Budget transition, allows an investor to provide an annual tax budget for capital gains tax that must not be exceeded. With this approach, the timeline is not specified. Instead, the timeline of the transition will depend on the size of the tax budget and the embedded gains in the portfolio. Lower embedded gain amounts with larger tax budgets will have shorter transition horizons. Portfolios with higher embedded gains and low annual tax budgets typically require longer horizons.

When should an investor lean towards controlling the timeline versus controlling the annual taxes generated during a transition? Consider an investor who hypothetically holds a large position in Amazon stock. If the stock value makes up a significant percentage of the investor's wealth, with the investor also perhaps working at Amazon, concentration risk would be a primary concern. In this case, an investor might prefer to control the length of time they are exposed to such significant concentration risk using the Timeline transition. If the client's initial portfolio is an active separately managed account (SMA) strategy with 40 or more securities, such as the portfolio in Exhibit 1, where there is a reasonable level of diversification, then the investor might place greater importance on controlling taxes with the Tax-Budget transition.

To illustrate the tax implications of each approach, we start with the baseline portfolio presented in Exhibit 1 and then vary assumptions. Exhibit 3 shows the hypothetical tax costs and tracking error to the S&P 500 through time for 4 different Timeline transitions over the 5-year period ending December 31, 2020.

> *The choice between using a Timeline transition or Tax-Budget transition should depend on the client's preference.*

Exhibit 3: Cumulative taxes and tracking error associated with different timelines (Jan 1, 2016-Dec 31, 2020)



For illustrative purposes only.

In looking at Exhibit 3, we can see that lengthening the timeline reduces the taxes paid per year, and cumulatively across all five years. Both the three-year and the five-year Timeline transitions have reduced the tracking error to 60bps by year 5. In comparing the cumulative amount of taxes paid, we can see that the three- and five-year transitions result in similar amounts of taxes paid, but the five-year transition spreads out this tax bill over more years. Both approaches would have generated significantly lower cumulative tax than an immediate liquidation, which results in $96,443. Although Exhibit 3 reveals attractive benefits, it's possible that a Timeline transition can lead to a larger tax bill than immediate transition if markets substantially increase.

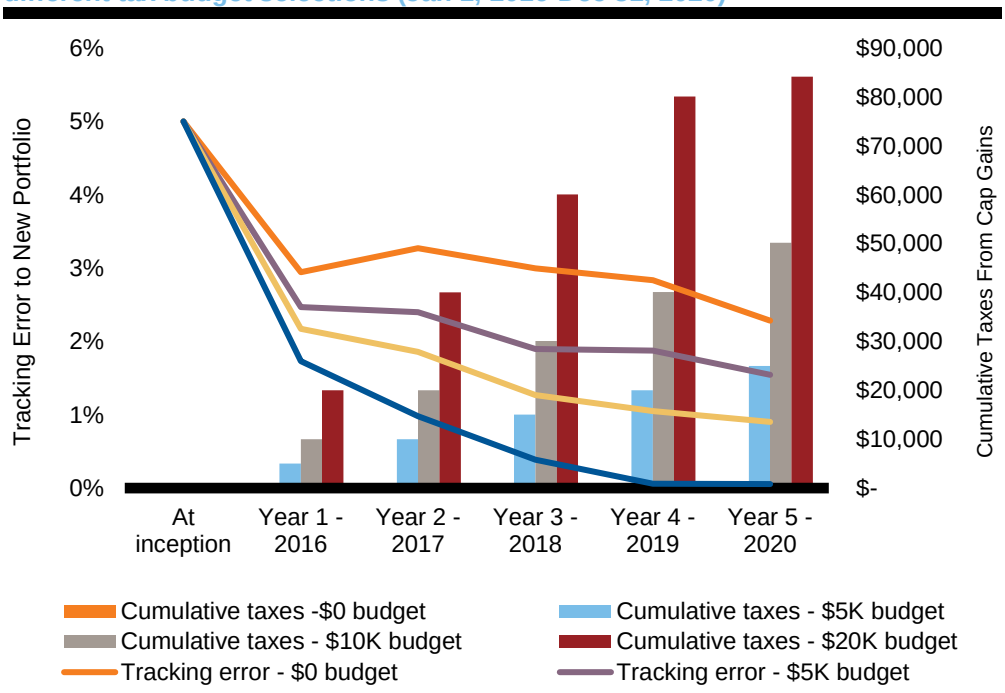
When comparing Timeline options in Exhibit 3, we can see that a longer transition (5 years) horizon means higher portfolio tracking error in the initial years compared to the 3-year transition. The higher tracking error can lead to more extreme performance—in both directions—relative to the benchmark. Investors who prioritize performance that is close to the target (the S&P 500 Index, in this case) should choose shorter timelines. If the investor can accept performance deviation from the target portfolio, spreading taxes out over more years might be attractive.

While the Timeline transition controls the amount of time the transition takes, it is not as precise as the Tax-Budget transition approach in controlling taxes, which allows the client to target an annual maximum budget for tax. The budget can be specified either in terms of capital gains to be realized (for example, $10,000 in capital gains per year) or an estimated tax from capital gains (for example, $2,500 in taxes from capital gains per year).

Exhibit 4 shows cumulative taxes and tracking error through time for different tax budgets using the Tax-Budget transition approach.

If the client prefers to control the time it takes to reach the target strategy, then the Timeline transition approach should be used.

Exhibit 4: Cumulative taxes and tracking error over time associated with different tax budget selections (Jan 1, 2016-Dec 31, 2020)



For illustrative purposes only.

We can see in Exhibit 4 that the taxes paid each year align with the client's target budgets, barring a few modest discrepancies. Similar to the Timeline transition approach, all the tax budgets lead to a decrease in tracking error over time. Indeed, larger tax budgets lead to faster decreases in tracking error. For example, the $20,000 tax budget, equivalent to approximately 2% of the portfolio's starting value, led to an effective transition over the course of three years. However, the total tax cost is relatively high. The 0% tax budget lowers tracking error from 5% to 2.3% over five years without generating any capital gains tax.

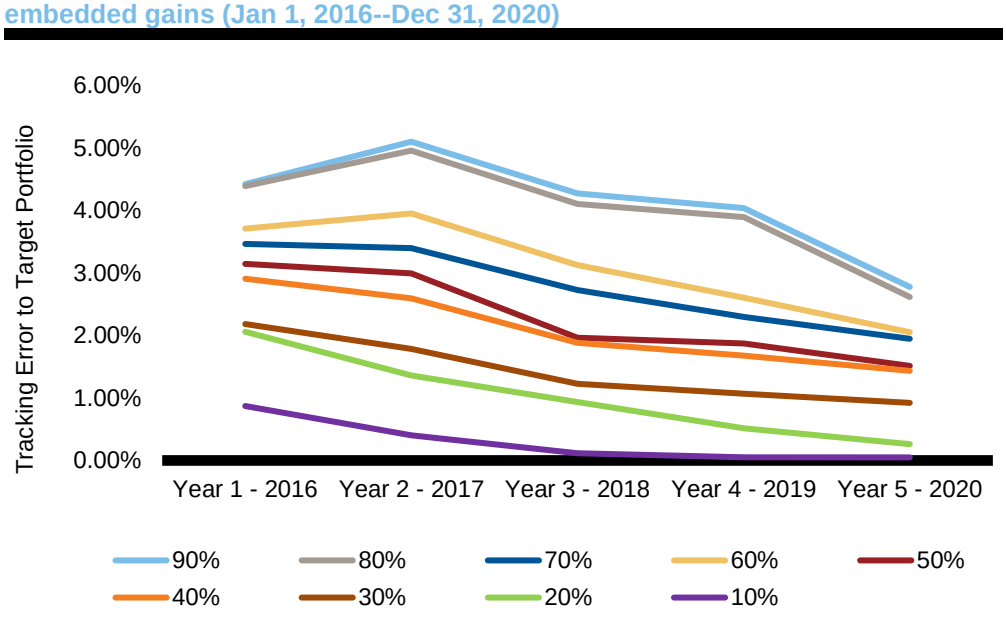
For the example portfolio in Exhibit 1, both the Timeline and Tax-Budget transitions effectively transition the portfolio towards the target. Under both methods, more tax is paid when the transition happens over a shorter time horizon. The choice between using a Timeline transition or Tax-Budget transition should depend on the client's preference: If the client has a stronger preference for controlling the amount of taxes generated each year, then they should consider a Tax-Budget transition; If the client prefers to control the time it takes to reach the target strategy, then the Timeline transition approach should be used.

If the client has a stronger preference for controlling the amount of taxes generated each year, then they should consider a Tax-Budget transition.

Understanding the impact of embedded gains and different market environments

The initial portfolio in Exhibit 1 had about 30% embedded gains, measured as a percent of the market value. Next, we vary the ratio of net embedded gains to market value of the initial portfolio to see how the level of embedded gains affects the transition using the Tax-Budget approach with a $10,000 tax budget. Recall the initial portfolio has 5% tracking error to the S&P 500 Index.

Exhibit 5: Tracking error reduction through time for different levels of embedded gains (Jan 1, 2016--Dec 31, 2020)

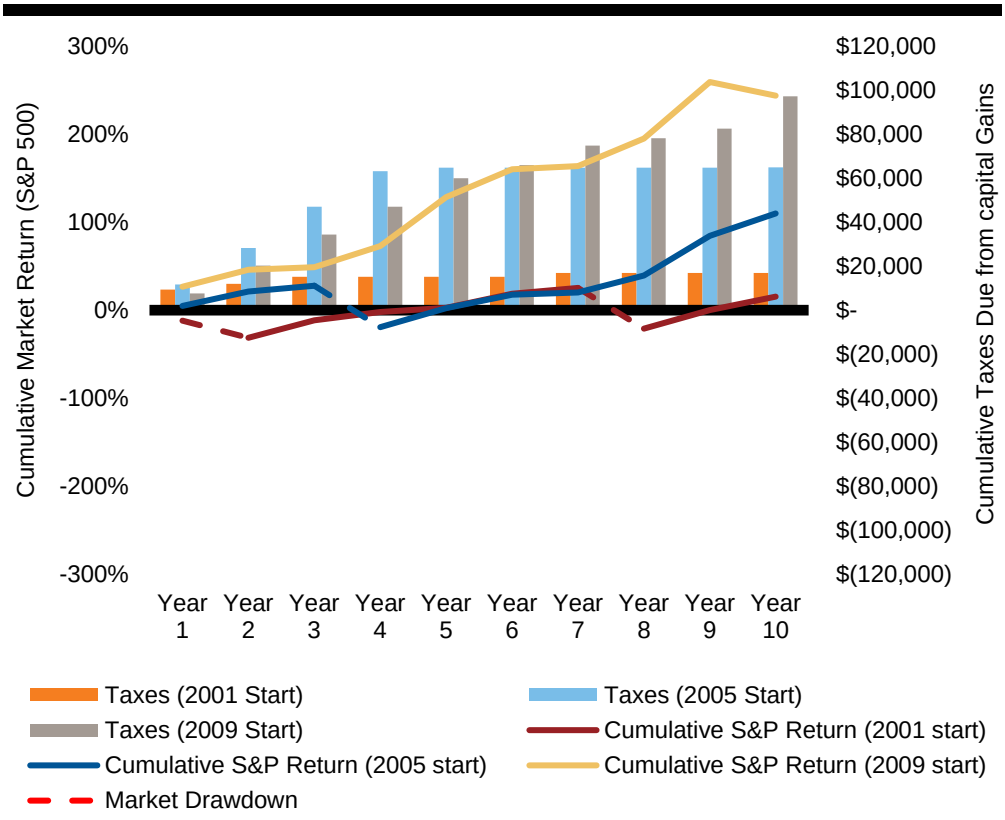


For illustrative purposes only.

A couple of expected patterns emerge in Exhibit 5. First, tracking error of portfolios with higher embedded gains remains elevated relative to lower embedded gains portfolios when using a $10,000 tax budget. Second, when the embedded gains are significant, such as 90% of market value, the tracking error is reduced to only 2.8% after five years. Compare this to a reduction to 1% tracking error when the initial embedded gains are 30% of the market value. Not surprising, large embedded gains work against tax and tracking error objectives.

Thus far, we have used a consistent historical period beginning January of 2016 through December 2020 to illustrate results. To give a sense of how the results change based on different market environments, we present results for a five-year Timeline transition for three historical time periods: 2001 to 2010; 2005 to 2014; and 2009 to 2018. These time periods reflect different experiences of market drawdowns during the transition: early in the transition, late in the transition, and a transition with no market drawdowns, respectively. In addition, these markets have varied levels of growth (the annualized S&P 500 Index returns for those periods were 1.4%, 7.7%, 13.1%, respectively. After the five-year transition period, we continue to run the strategy for 5 additional years where the portfolio is managed with approximately 50 bps of tracking error to the S&P 500 Index.

Exhibit 6: Influence of market environment on taxes



For illustrative purposes only.

Comparing the cumulative taxes due from capital gains (right hand axis) we can see that different market environments lead to very different tax outcomes. The period from 2001 through 2010 generated the least amount of taxes due (about $17K after 10 years), due to low growth and two drawdown events. The period from 2009 through 2018 generated the most taxes ($97K), due to high market growth and no large drawdowns. While the results are as expected, they underscore that taxes generated using a Timeline transition are market dependent.

The target portfolio being transitioned to also has an impact on the tax cost of the transition. In this analysis, we have focused on transitioning an existing portfolio to a passive S&P 500 Index strategy. Transitioning to an active strategy carries two additional considerations. First, because active strategies typically have meaningful turnover, they are a moving target. For example, in a 40% turnover strategy we might expect that 40% of what is purchased in one year will not be in the strategy a year later. This means we need to transition the existing portfolio rather quickly (three years or less), or we may never actually converge on the active strategy. When repositioning to an active target, we recommend setting a timeline to transition

the portfolio to guarantee that the full portfolio eventually reaches the target strategy. Second, we must assess whether the potential stream of alpha looking forward will overcome the taxes generated from repositioning the portfolio. In some instances, it will be more efficient to simply defer gains rather than reposition to an active strategy. In these cases, investors might consider adopting a passive target and prioritizing gains deferral (using the tax-budget approach) while trying to capture broad market performance rather than seeking alpha.

Conclusion

We discussed two approaches to help clients tax efficiently reorient their portfolios to new strategies. The Timeline approach moves the existing portfolio to the new strategy over a set number of years. The Tax-Budget approach moves the existing portfolio to a new strategy while limiting taxes or capital gains per year. Using a hypothetical initial portfolio, we historically simulated each approach under different Timeline and Tax-Budget choices and then observed tax and tracking error consequences. Each approach successfully transitions the initial portfolio to the new strategy, but the results depend on the starting portfolio and the market environment during the transition.

Portfolios with more unrealized gains will take longer to transition or lead to more taxes during the transition. A low growth market with cyclical pullbacks is more favorable for transitioning. While this result is perhaps anticipated, the actual tax consequences and tracking error values derived can help guide investors towards a choice that aligns with their personal preferences. The journey towards the target destination should be driven by personal preferences regarding risk and tax implications. Advisors will play a valuable role in guiding investors in these decisions.

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