What characteristics make for a successful tax-advantaged portfolio manager (tax manager)? While tax-advantaged management has been offered for more than a decade, many of these characteristics are still being defined.

Clearly, for taxable investors, the primary goal of investing is to maximize their after-tax wealth. We also know that a key attribute of successful tax management is the ability to pass through losses to the underlying investor in a customized way.

Furthermore, there are many products, such as mutual funds and exchange-traded funds (ETFs) that claim to be “tax managed,” “tax sensitive,” or “tax efficient.” However, mutual funds and ETFs cannot pass through losses to the investors; they only can stockpile losses and carry them forward to be used to offset future gains. This dilutes the overall impact of tax management. The result can be a significant amount of wealth left on the table. As a result, a tax manager using a separate account structure is more likely to maximize the after-tax wealth for any given investor.

This paper outlines the specific characteristics that are necessary for a tax manager to be successful in maximizing investors’ wealth and creating a foundation for what investors should expect from their tax manager.

**NO TWO INVESTORS ARE EXACTLY ALIKE**

A fundamental principle of taxable portfolio management is that portfolios and investor circumstances are unique and dynamic. For instance, two portfolios with identical holdings purchased five years apart are significantly different because of the specific underlying tax lots associated with the securities held in each portfolio. If a specific security has had volatility over the five-year time horizon, then one portfolio may own a security at a gain and one may own the same security at a loss.

In order to manage a portfolio effectively, the tax manager needs to know not only what securities are held in the portfolio but also what the underlying tax lots are for those securities. Furthermore, there could be two similar sets of portfolios and tax lots and yet the optimal portfolio management solution may be different because the investors’ circumstances and objectives differ. For example, one investor may have a significant capital loss carry-forward and the other may have a net gain for the year. Therefore, the application of a single “standard” strategy cannot effectively meet all investors’ needs.

A successful tax manager must recognize not only that taxable investors have different goals and objectives, but also that these goals and objectives will change over time. It is therefore preferable to have a customized product structure that allows a tax manager the flexibility to regularly modify the portfolio’s strategy.
CUSTOMIZED PORTFOLIO MANAGEMENT APPROACH

**Systems**

The foundation of a customized product structure is a flexible portfolio management system that provides the portfolio manager with the tools necessary to analyze the portfolio. The system needs to be able to provide separate consideration of short- and long-term gains and losses, and objective functions designed to maximize losses and minimize gains while monitoring active risk. Although this may seem basic or standard, not all portfolio management tools are able to perform at this level of customization. When, in fact, a tax manager’s portfolio management tool does not allow for such a level of customization, the actual after-tax value may be significantly reduced. Two examples may help illustrate this point. First, if the portfolio management tool only allows the tax manager to generate a net loss, then the tax manager may be generating unwanted gains. The parameter of a net loss means that the system can generate both gains and losses as long as the net loss equals the desired amount. In essence, this reduces the manager’s after-tax returns by the amount of gains generated due to the inadequate tool. Figure 1 illustrates this point.

**FIGURE 1**

<table>
<thead>
<tr>
<th></th>
<th>SCENARIO 1</th>
<th>SCENARIO 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Unrealized Gains</td>
<td>$500,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Initial Unrealized Losses</td>
<td>$(200,000)</td>
<td>$(200,000)</td>
</tr>
<tr>
<td>Gross Realized Gains</td>
<td>$100,000</td>
<td>$</td>
</tr>
<tr>
<td>Gross Realized Losses</td>
<td>$(200,000)</td>
<td>$(100,000)</td>
</tr>
<tr>
<td>Net Realized Loss</td>
<td>$(100,000)</td>
<td>$(100,000)</td>
</tr>
<tr>
<td>Final Unrealized Gains</td>
<td>$400,000</td>
<td>$500,000</td>
</tr>
<tr>
<td>Final Unrealized Losses</td>
<td>$</td>
<td>$(100,000)</td>
</tr>
</tbody>
</table>

In this example, both scenarios generate a net loss of $100,000. However, Scenario 1 generates gross losses of $200,000 and gross gains of $100,000 for a net loss of $100,000, while Scenario 2 simply generates gross losses of $100,000. Understanding how a net loss is achieved within an account is important because Scenario 2 will have lower turnover and lower transaction costs. Furthermore, the final portfolio in Scenario 2 retains $100,000 of unrealized losses that can be realized eventually and used to offset gains outside of this portfolio. Second, this lack of functionality often means that the system also is not able to differentiate between short-term and long-term holding periods. This could mean that the tool is generating a short-term gain and a long-term loss, which creates a potential mismatch in taxes. Again, this lack of customization will cost the tax manager from an after-tax performance standpoint.
Ideally, the goal of a tax manager is to realize short-term and long-term losses when they become available. At times a manager may need to generate long-term gains, but at least the investor is benefiting from the significant reduction in maximum tax rates (35 percent for short-term and 15 percent for long-term). One of the worst things a tax manager can do for investors is to generate an unnecessary short-term gain. A superior tax management tool directly allows the tax manager to minimize these inefficiencies.

**Tracking and Tax Trade-off**

Typically, there is a trade-off between an active tax management strategy and one that aims to closely track the benchmark returns. This trade-off occurs because in order to perfectly match a benchmark return, a portfolio must look exactly like the benchmark. In order to realize a loss, the portfolio manager must sell one or several securities that have declined in value. These securities then cannot be repurchased for at least 31 days to avoid the Wash Sale Rule. During this time period, optimization techniques are utilized to mitigate the risk created by the underweight of the securities sold relative to the benchmark. Figure 2 details the trade-offs between realizing more losses in a hypothetical portfolio and the corresponding increase in active risk. For example, the figure illustrates that realizing $500,000 in losses will increase the portfolio’s active risk to 50 basis points.

**FIGURE 2**

*Trade-off between Active Risk Management and Passive Index Management*

Another way to view this trade-off is shown in Figure 3. At one extreme, the manager will aggressively harvest losses and allow the portfolio to drift away from its benchmark if necessary (upper right bubble). At the other extreme (lower left bubble), loss harvesting opportunities may be forgone in order to minimize risk vis-à-vis the benchmark. In many cases though, the investor may want to strike a balance between directly tracking the index and maximizing losses (middle bubble).
Once the investor’s objectives are understood, the manager will use the tax management system to meet the tax objectives within a pre-defined tracking error. The use of terms like “active risk,” “estimated tracking error” or “estimated deviation from the benchmark” all basically represent how closely a portfolio manager believes the portfolio will perform on a pre-tax basis relative to the underlying benchmark. An important aspect of this trade-off is that the tax manager must allow investors to dynamically change their preferences throughout the year. This is extremely important because, for instance, the investor’s tax situation may change due to gains realized in other portfolios or gains realized in reducing a single stock concentration. A flexible tax management system and tax manager should be able to respond to an investor’s changing needs.

The system also must be able to analyze the impact of other strategies including charitable gifting, which focuses on maximizing the amount of unrealized gains removed from the portfolio while monitoring the resulting effect on portfolio risk. In addition, basic analytical tools used to describe a portfolio such as tax lot analysis and industry/sector analysis are necessary to understand the underlying portfolio characteristics. The primary benefit of a flexible system is that the tax manager can spend more time on analysis and strategy development for the investor. The aggregation and sharing of this information allows the investor, the consultant and the tax advisor to make more informed decisions for the investor’s entire portfolio.

**Timely Information**

Finally, the tax manager must be able to provide timely information on performance (pre-tax and after-tax) and the portfolio’s tax situation (realized and unrealized gains and losses). Information regarding performance is important, as it allows the investor to develop an understanding of the appropriate level of tolerance for tracking error. If the realized volatility of returns is wider than the investor would like, then the portfolio manager may reduce the active risk in the portfolio as directed. The after-tax return provides the investor with a gauge as to how well the portfolio is performing given the investor’s specific circumstances. For example, if the investor is looking to maximize loss realization, does the after-tax return reflect that strategy given the specific portfolio characteristics regarding available unrealized losses?
Information on the timing of gains and losses is critical for an investor’s tax advisor. For example, if a mutual fund is going to make a gains distribution (remember mutual funds cannot distribute capital losses), the amount of gain generally is not known until it is made and typically occurs in November or December. This allows the tax advisor very little or no time to develop a strategy to offset these gains before year end. In contrast, a good tax manager not only provides an investor’s tax advisor with updates throughout the year on expected gains and losses, but also because the portfolio is managed in a separate account, can better control the realization of gains late in the tax year.

TRANSACTION COSTS MATTER
Due to the potential for turnover associated with tax-managed strategies, the successful tax manager also must focus on minimizing transaction costs. These include both explicit costs (commissions, custody charges, etc.) that are directly visible to the investor and implicit costs (bid/ask spread, market impact, etc.) that cannot easily be seen by the investor. Portfolio turnover increases the transaction costs borne by the investor as shown in Figure 4. This illustrates the impact of commissions depending on fund turnover and actual commission rate.

<table>
<thead>
<tr>
<th>TURNOVER</th>
<th>TOTAL COST AT 1 CENT/SHPRE</th>
<th>TOTAL COST AT 3 CENT/SHPRE</th>
<th>TOTAL COST AT 5 CENT/SHPRE</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>1.3 bps</td>
<td>3.8 bps</td>
<td>6.3 bps</td>
</tr>
<tr>
<td>30%</td>
<td>1.9 bps</td>
<td>5.6 bps</td>
<td>9.4 bps</td>
</tr>
<tr>
<td>40%</td>
<td>2.5 bps</td>
<td>7.5 bps</td>
<td>12.4 bps</td>
</tr>
<tr>
<td>50%</td>
<td>3.1 bps</td>
<td>9.4 bps</td>
<td>15.6 bps</td>
</tr>
</tbody>
</table>

Turnover will increase as a consequence of two main factors: benchmark generated turnover (securities being added or deleted from the index due to bankruptcy, mergers and acquisitions, and lack of representation) and tax strategies (loss harvesting). The tax manager must pay attention to the rebalancing rules and reconstitution schedules dictated by the selected benchmark in order to ensure proper tracking error. The actual commission rates, shown above, should not be ignored. For instance, given a strategy with a 40 percent annual turnover rate, the difference between executing trades with a 1 cent/share versus 5 cents/share commission will result in 10 basis points (bps) of difference in return to the portfolio. This drag on performance is substantial (especially when compared to investment management fees) and a conscientious manager will strive to obtain the best possible commission rate. A manager who is part of a larger organization can more easily leverage the overall relationship with the broker community and usually obtain lower commission rates.

Incidentally, some investment managers pay higher commission rates than others. As a result, investors must consider both investment management fees and commission costs when comparing two tax managers.

Even before a trade list is created, estimates of both explicit and implicit costs need to be incorporated into the portfolio optimization process so that if all else is equal, given the choice between transacting in one of two securities, the security with the lower expected cost would be traded. Once a trade list is created, the trading desk can utilize certain algorithms in an attempt to exploit short-term trends in security price movements and find liquidity across markets. For example, if a security is traded in multiple locations (New York Stock Exchange, American Stock...
Exchange or Electronic Communications Networks) and is offered at 1 cent lower in one of the locations, then you want to purchase the security at the lower price. While 1 cent may seem insignificant, Figure 4 shows that with 40 percent turnover this type of strategy can increase the investor’s return by 2.5 bps.

These algorithms, as well as recognizing that different types of trades require different types of execution strategies, help the tax manager and trader minimize transaction costs. If applied consistently, the compounding effect of these strategies over time can significantly reduce the total transaction costs in a portfolio, which directly increases the investor’s after-tax wealth.

MAINTAINING OPEN COMMUNICATIONS

To most efficiently make use of the potential benefits of a flexible system and account structure, there needs to be regular communication between the portfolio manager, the investor and the investor’s tax advisor and consultant. This open line of communication is critical to the success of the strategy. If there is a change in the investor’s tax situation outside of the tax advantaged account that might necessitate a change in the overall portfolio strategy, the investor needs to convey this information to the tax manager. For example, if an investor unexpectedly had a large realized capital gain in another account in the month of October, it would benefit the investor to more aggressively harvest losses in his or her tax advantaged account for the remainder of that year. Taking this one step further, in January (the start of the new tax year), that same investor may again want to readjust the balance between active risk and loss harvesting by decreasing estimated tracking error, which may require realizing some capital gains. Although not all investors follow the same schedule, it is not unusual to have this communication on a quarterly basis, as different events throughout the year can provide opportunities to discuss the current strategy.

**FIGURE 5**
The “Four Seasons” of Tax Management

<table>
<thead>
<tr>
<th>First Quarter</th>
<th>Second Quarter</th>
<th>Third Quarter</th>
<th>Fourth Quarter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rebalance the portfolio to reduce estimated tracking error</td>
<td>Develop a Russell reconstitution strategy (if applicable)</td>
<td>Maintain client communication to identify changes to strategy</td>
<td>Review current year tax situation to avoid year-end surprises</td>
</tr>
<tr>
<td>Establish gain/loss targets for the year</td>
<td>Update tax strategy to include anticipated allocation changes.</td>
<td>Reevaluate client preferences for active risk and taxes.</td>
<td>Consider charitable gifting of low cost basis securities</td>
</tr>
<tr>
<td>Estimate cash flow projections to increase efficiency of the account</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Do any of the situations or circumstances apply to your portfolio?

Figure 5 describes some of the other special situations, such as cash flows and transitions between portfolios that may require additional communication. During this communication, the portfolio manager would provide the investor with scenarios or options that aid the investor and the investor’s consultant in making more informed decisions. For example, let us assume an investor wanted to maximize losses realized in December. Further, assume the investor’s portfolio contained $1 million
in unrealized losses and currently had an estimated tracking level of 25 bps. A tax manager could provide multiple scenarios that detail the amount of losses realized and the resulting estimated tracking level. The scenarios might look like this:

- **Scenario 1** – Realize $250,000 of losses and the estimated tracking level rises to 35 bps
- **Scenario 2** – Realize $500,000 of losses and the estimated tracking level rises to 50 bps
- **Scenario 3** – Realize $750,000 of losses and the estimated tracking level rises to 75 bps
- **Scenario 4** – Realize $1 million of losses and the estimated tracking level rises to 175 bps

Once the investor, the tax advisor and the consultant have this information, they can better understand what losses are available and how they will impact the estimated tracking level in the portfolio. This two-way flow of information can enhance the performance of the strategy by allowing the investor to tailor the account to his or her own tax and investment needs. In addition, good communication between investor and tax manager provides a better opportunity for expectations to be set properly and subsequently achieved.

**A WORKING PARTNERSHIP**

The tax advisor needs timely information regarding realized gains and losses from all of an investor’s managers to appropriately manage the overall tax situation. The tax advisor can aggregate this information and provide valuable feedback and modifications to the current tax management strategy. This circular flow of information provides for more accurate tax forecasts and therefore a more tailored tax-advantaged portfolio. The open line of communication and flow of information has an important implication for the tax manager. As we have discussed, the tax manager needs to customize each investor’s portfolio strategy, prepare and execute trades in each portfolio, provide the investor and the investor’s advisors with timely information, and be available to the investor to discuss these points. Inherently, this limits the number of portfolios that a tax manager can effectively manage for investors while still providing a high level of customization. Even with technology, it is difficult for a portfolio manager to provide this level of customization while managing a large client load.

The capabilities of a successful tax manager create a foundation for meeting investor expectations. If a tax-advantaged product is managed correctly, the investor should expect a working partnership to be formed between the investor, the consultant, the tax advisor and the tax manager. As described in Figure 5, the ongoing flow of information helps to ensure that all parties involved work together to create a coordinated and truly customized result. Furthermore, this flow of information helps the investor and the consultant make more informed decisions. With consistent communication and a robust exchange of information, the partnership is stronger and unintended adverse tax burdens are minimized.

As discussed earlier, it is extremely important for your tax manager to have a flexible system. However, simply having such a system is not good enough. It is also critical that the tax manager allows the investor and the investor’s advisors to make changes to the portfolio strategy throughout the year. A tax manager must be able to demonstrate a willingness to allow the investor to make strategic portfolio modifications on the run. If all of these pieces come together, this partnership can provide the investor with both a strong investment solution as well as a comprehensive tax solution.
IT’S NOT JUST ABOUT RETURNS
An investor or consultant cannot expect to accurately measure the tax manager based solely on pre-tax or after-tax performance. To do so would ignore the extra value a tax manager provides the investor: control and customization. How do returns alone capture the benefit of being able to gift low cost basis securities while understanding the impact to the portfolio’s characteristics? How do returns alone reveal the value of the receipt of timely tax information or a complementary tax strategy? How do you measure the value of communication or a customized portfolio structure? This does not suggest that one should completely ignore performance; it is a key piece of information in judging a tax manager. It does suggest, however, that the success of the strategy is not based solely on pre-tax and after-tax performance. A successful tax manager provides the investor with a more comprehensive array of benefits, which ultimately provides more efficiency for the investor’s overall portfolio.

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