Investment planning

Loss harvesting: reap alpha year-round | 24 February 2016

CIO WM Research
Jeff LeForge, Analyst, jeff.leforge@ubs.com

• One of the most impactful strategies for generating after-tax alpha is also one of the most overlooked: loss harvesting.
• Loss harvesting (LH) is a tax deferral strategy that can generate a median alpha of approximately 50bps annually after liquidation taxes.
• Losses, not gains, drive effective loss harvesting.
• Over time, the compounding effect of loss harvesting can have a material impact on after-tax wealth.
• The benefit of loss harvesting is even higher for investments that receive a step-up in cost basis at death.

Introduction

Loss harvesting (LH) is valuable because it enables a taxable investor to earn investment return on deferred tax payments. Realized capital gains are taxable and must be reported on an investor's tax return, but investors can use realized losses to offset gains dollar-for-dollar, deferring the tax expense to a later date. Loss harvesting is the act of proactively realizing losses to offset gains. This enables the investor to keep those assets invested for a longer period of time – leading to roughly 0.5% in after-tax alpha on an annualized basis. The compound growth generated on the deferral is what makes loss harvesting valuable.

Important note: Tax strategies can be complex. In addition to federal taxes imposed on ordinary income and capital gains, there may be state and local taxes that must be considered before implementing a tax loss harvesting strategy. Also, transaction costs that may apply from buying and selling securities need to be carefully considered. Each investor should consult his or her own tax advisor concerning the tax consequences of any investment strategy they make or are contemplating. UBS does not offer tax advice.
A single security illustration of loss harvesting

Figure 1 illustrates loss harvesting from a single security perspective. In this example, shares of hypothetical stock ABC have declined, creating an opportunity to loss harvest. Selling the shares will generate both cash and tax credits to offset current or future realized capital gains. This is an important part of loss harvesting: losses should be taken whenever the benefit of the loss carry-forward outweighs the costs associated with the transaction. We cover the rationale behind this in the next section.

Because shares are sold explicitly to generate tax credits, the investor’s portfolio will deviate from its target allocation. Post sale, the investor has a larger exposure to cash (generated by the sale) and a reduced exposure to Stock ABC.

However, the wash sale tax rule prohibits investors from using the loss to offset a gain if they purchase a substantially identical asset within 30 days of the sale (before or after). Losses will be disallowed regardless of custodian or account type. Therefore appropriate monitoring should be in place. Based on the wash sale rule, it will be at least thirty-one days until the portfolio returns to the original composition.

In some situations, it may be appropriate for some investors to hold the cash for thirty days and then repurchase the original security, but there are significant risks to this approach. For instance, volatile markets can create many loss harvesting opportunities, but sitting in cash can result in missing a recovery. In general we advise against this approach.

A common solution is to closely replicate the original portfolio by purchasing a similar asset that the investor is comfortable owning instead of the position that was used for loss harvesting (see Fig. 1, Stock XYZ). After 30 days the position can be swapped back to the original security if desired. Swapping securities after 30 days may lead to taxable short-term gains. This should be considered when weighing the costs and benefits of loss harvesting.

Multi security portfolios

Of course, a portfolio constructed of only one security severely constrains loss harvesting because the benefit is attained by sharing losses. In effect, losses are transferred from one security to another. Foregoing a loss harvest opportunity essentially limits deferrals to the respective security.

---

In the article *Tax Management, Loss Harvesting, and HIFO Accounting*, Andrew L. Berkin and Jia Ye illustrate the benefit of loss harvesting over time using Monte Carlo simulations. They find that a portfolio of single securities produces a median annualized alpha, after-liquidation tax return of 0.5% (see Fig. 2). Liquidating after 25 years, the median cumulative value added is 58%.

No free lunch

One important aspect of loss harvesting is that it does not avoid or eliminate the tax liability – it is simply postponed it to a later date. The process of harvesting a loss resets the cost basis on the harvested security to a lower level. This increases the future tax liability on that security, relative to not harvesting the loss. Assuming tax rates don’t change, the future tax liability is the same amount that was avoided when using it to offset a realized gain. The tax liability was simply transferred from one security to another. A larger future tax liability is the result of growth on the deferral (see Fig. 3).

In situations where the investor does not already have a realized gain to use the loss against, one strategy is to realize gains where available and immediately repurchase the same security. This takes advantage of the harvested loss and also reduces the future tax liability for those securities by resetting the cost basis at a higher level. Of course, due to loss carry-forward rules, investors don’t have to take gains to match against losses in the same tax year. Waiting to take gains likely lowers transaction costs somewhat (ultimately the portfolio will have fewer transactions) but also subjects the value of those loss carry-forwards to future tax law changes.

Who should loss harvest?

Although all taxable investors can likely benefit from loss harvesting, some investors will find it more valuable than others.

First, investors in the highest tax bracket may find loss harvesting an effective strategy due to the sizable tax deferral. The compound growth from deferring tax liabilities may be so substantial that the threshold to loss harvest is easily achieved – particularly if executed in an account with low transaction costs.

Second, investors with a long-term investment horizon benefit more as well. Investing the cumulative deferrals in appreciating assets will continue to benefit from compound growth. At the extreme, loss harvesting from a Legacy portfolio that is expected to be transferred and receive a step up in cost basis at death would result in the greatest benefit.

Additionally, investors that expect their tax rate to be lower in the future will benefit from deferring taxes. Although federal capital gains taxes are uniform across the country, states differ. Investors planning to change residence to a state with lower capital gains taxes will benefit from deferring taxes until after they have moved.
Fourth, investors currently accumulating savings or hold income-producing portfolios will find that reinvestment of income creates additional loss harvesting opportunities over time. Loss harvesting opportunities and portfolio turnover diminish over time as asset prices appreciate above the original cost basis (see Fig. 4). However, new asset purchases replenish this declining opportunity set due to the addition of new, high cost basis positions to the portfolio on an ongoing basis.

Finally, loss harvesting may be more appealing to investors that prefer passive, index-like equity exposure, and have less of an appeal to investors that have a high belief in alpha-generation through security selection. Loss harvesting requires the willingness to buy and sell securities based mainly on deferring taxes. Such a strategy will likely conflict with high-conviction security selection as the expected outperformance of specific securities increases the hurdle for loss harvesting significantly. Although the benefit may be reduced, active strategies should incorporate loss harvesting as a way to defer tax burdens.

What are the best periods for loss harvesting?

Two specific market conditions drive opportunities for loss harvesting: acute market declines, and periods of high dispersion among individual equities.

Figure 5 illustrates the aggregate sum of potential loss harvest opportunities for SPY, an ETF that tracks the S&P 500. This assumes a 5% threshold; harvesting does not begin until 360 days after the first purchase; and shares are repurchased 1-month after harvesting. For example, one share of SPY first purchased on 2 January 1998 would lose harvest five times. A share purchased the following day, on 3 January 1998 has a similar harvest opportunity trail.

The aggregate sum in Figure 5 illustrates the total loss harvest opportunities for mutually exclusive portfolios, of a single share first purchased each day between 2 January 1998 and 29 January 2016. More harvest opportunities exist during acute declines because previously purchased shares are more likely to reach the threshold. Substantial declines exceeding thresholds provide consecutive loss harvest opportunities.

During periods of low dispersion among individual equities, investors may find limited meaningful opportunities to harvest losses. During extended periods of low dispersion, the harvest (tax credits) may accumulate, waiting for gains to be offset. The benefit of loss harvesting increases when there is high dispersion among individual equities. This allows the losses (harvest) to be swiftly paired with gains to complete the cycle.
Portfolio management considerations

From the portfolio management perspective, losses, not realized gains, will drive systematic loss harvesting. Limiting loss harvesting to the end of a tax year foregoes valuable opportunities presented throughout the year, particularly because losses may be carried forward and are not limited to a fiscal year. Investors can maximize tax savings by disposing of losses whenever a loss harvesting opportunity is large enough to justify the trading costs.3

Harvesting losses whenever the potential tax benefit exceeds the costs is a low and somewhat ambiguous hurdle. Almost half of daily returns of the S&P 500 companies are negative, so should investors be loss harvesting a large part of the portfolio on a daily basis? One option is to opt into a quantitative tax-overlay manager that will execute loss harvesting on an ongoing basis. Alternatively, less-quantitative managers can review portfolios for loss harvesting opportunities on a monthly basis along with ad hoc reviews during periods of decline.

Portfolios comprised of a high number of positions instead of a low number of positions will also likely be more fertile ground for loss harvesting opportunities. For example, a portfolio comprised of a single, multi-asset class exchange traded fund (ETF) will have far fewer loss harvesting opportunities relative to a portfolio that is comprised of multiple ETFs, equity positions, and municipal bonds.

Over the last decade the number of ETFs available has expanded rapidly (see Fig. 6), making it possible to construct a portfolio that holds funds that focus on narrow styles and sub sectors, while increasing loss harvest opportunities. Additionally, there are various highly correlated ETFs, so finding a replacement security to emulate the appropriate exposure is typically fairly straightforward.

Conclusion

Loss harvesting is a strategy that should be considered by taxable investors. The benefit of the strategy is limited when losses are sold solely to offset gains at year-end. Allowing losses to drive the buy and sell decisions maximize the benefit of loss harvesting. Investors should not wait for realized gains to loss harvest. Unused losses can be carried forward indefinitely and do not expire until death, making them more flexible, relative to gains. Scanning for loss harvest opportunities each month, or in periods of market volatility, helps to prevent missed opportunities to harvest losses.
