BROOKLYN INVESTMENT GROUP

How Can Tax Loss Harvesting and Custom Direct Indexing Enhance Portfolios?

Conversation with Brooklyn's Chief Investment Officer
Erkko Etula and Head of Equities Antti Petajisto | Q1 2023

Investment world is abuzz with tax loss harvesting and custom direct indexing as new ways of adding value to client portfolios. But when are these techniques effective? What investor challenges do they solve? And are there cautions to consider? In order to find out, we had a quick 2023 kickoff conversation with our CIO Erkko Etula, PhD, and Head of Equities Antti Petajisto, PhD. In his research, Antti has written extensively on the hidden costs of pooled investment vehicles, such as exchange traded funds.

What kind of clients benefit the most from tax loss harvesting and custom direct indexing in equities?

Erkko: These two tools are meant for two distinct purposes. Tax loss harvesting can help boost after-tax returns by reducing year-end tax burden, effectively adding alpha. It tends to be most effective if done on an individual stock level and systematically throughout the year, which means that the benefits of tax loss harvesting may be best captured in a direct indexing portfolio – i.e., a portfolio that invests directly in individual stocks rather than in ETFs or mutual funds. For example, our US large cap representative client account, which evaluates opportunities to harvest losses in individual stocks on a daily basis, generated nearly 6% of tax alpha in just the second half of 2022 when the broad equity market was volatile but roughly flat.[1] Of course, past performance is no guarantee of future results and any portfolio's tax loss harvesting power will diminish over time as the cost basis of the portfolio declines – but the potential to meaningfully boost returns in such a challenging market environment is notable.

Custom indexing, on the other hand, is a way to invest in the market in a personalized yet inexpensive way. Customization can range from simple exclusions of single stocks or sectors to a fully bespoke portfolio that incorporates the client's investment interests, their advisor's tactical views, or other preferences. Many clients complement their core equity allocations with thematic satellite portfolios or integrate their values in the whole portfolio by overweighting companies that do better along dimensions such as gender equality or environmental impact.

Taxable clients of any kind can potentially benefit from tax loss harvesting, provided that they are okay with some tracking error to the underlying index. All clients can potentially benefit from custom indexing. Combining custom indexing with tax loss harvesting in a separately managed account (SMA) can be an effective way to engage your clients while creating more value after taxes – today, it is possible to do this for clients of nearly any size and with lower fees than investing through ETFs or mutual funds.

Antti: Talking about costs, most people don't realize it, but there are actually some hidden costs associated with ETFs and mutual funds

[1] June 24 - Dec 31, 2022. Tax alpha is defined as the difference between the after-tax excess return and the pre-tax excess return relative to the benchmark and therefore inherently fee agnostic. Assuming a California taxpayer in the highest tax bracket with 51.1% income tax rate, 38.1% long-term capital gains rate, and 20% rate on qualified dividends. Detailed results available on request.

that track popular indices like the S&P 500 or Russell 2000. One of such costs is what I call the "index turnover cost" – it is expensive when everyone buys index additions and sells index deletions at exactly the same time as the official index is updated. In my research, I've shown that the average index turnover cost for the S&P 500 index was at least 0.21-0.28% per annum in the 1990s and 2000s. Given the subsequent further growth in indexing, I do not expect it to be lower today.[2] Custom indexing in SMAs allows us to design a potentially more efficient strategy that remains highly correlated with the index but avoids the index turnover costs.

Another hidden cost stems from the fact that ETF prices can deviate from the market values of their underlying portfolios, particularly during volatile periods when investors often feel the greatest need to rebalance, so an investor selling a falling ETF may end up selling it at a deep discount to the underlying portfolio value. History suggests that in severe market downturns, these temporary discounts may even reach several percentage points, and again it is a hidden cost to an investor. In SMAs, there is no intermediate layer and thus no hidden costs of this kind.

With firms using equity as a compensation tool, many entrepreneurs and professionals have accumulated sizable positions in a single stock. It often comes with significant single-company risk and a large tax liability given the appreciation of the stock. Can any of these techniques be used to mitigate some of the tax burden and at the same time diversify the exposure?

Erkko: Direct indexing with tax loss harvesting can be an effective way to manage the risk and tax burden of a concentrated position – in fact, it is one of the most common requests from high-net-worth clients. The request to manage a concentrated position tends to come in two flavors, which require different approaches: Some clients want to keep the stock as part of a larger portfolio. For them, we seek to optimize a diversified portfolio around it to best mitigate the risks of the concentrated position. Other clients want to sell down the position over time without incurring taxes. For them, we can manage the tax liability of the position by pairing it with a tax-managed direct indexing portfolio: the pace of the sell down is dictated by the amount of tax losses harvested in the direct indexing portfolio, which are used to offset gains realized from selling the concentrated position, dollar for dollar. The cash from the sell down is deployed in the direct indexing portfolio, increasing both the speed of loss harvesting and the speed of the sell down in a virtuous cycle.

Antti: It is possible to further enhance the above process by introducing small short positions in the direct index portfolio. This solution is, of course, not suitable for all clients, and the risks should be carefully considered by anyone contemplating such a strategy, but it does highlight a broader point that, in the right circumstances, the efficacy of both risk management and tax loss harvesting can be boosted by some shorting.[3]

Many retail investors learned a thing or two about capital gains distributions last year (2022). The value of their mutual fund shares went down – and yet at the end of the year they received a notice of capital gains distribution, resulting in a capital gains tax on a down year. Why did it happen and could something like this also happen in a direct indexing portfolio?

[2] See Petajisto, A. 2011. "The index premium and its hidden cost for index funds." Journal of Empirical Finance 18, 271–288.

[3] E.g., Sialm, C. and N. Sosner. 2018. "Taxes, Shorting, and Active Management. Financial Analysts Journal 74.

Erkko: Unwanted capital gains distributions driven by portfolio turnover are a well-known downside of mutual funds. And, yes, in a year like 2022 you may have ended up paying capital gains taxes even though the value of your investment was down. Another downside is that the mutual fund's transaction costs get socialized across all investors, so you will inevitably end up paying for other people's trades as they enter and exit the fund. ETFs are able to mitigate both issues thanks to the create/redeem feature but there are often other hidden costs as Antti outlined above.

Antti: A typical capital gains distribution by popular equity mutual funds in 2022 was 5-10%,[4] with several funds even showing double-digit distributions, despite these funds actually experiencing significant losses the same year. A well-managed direct indexing portfolio can avoid unwanted capital gains because each investor's portfolio is managed separately, accounting for individual tax considerations.

Erkko: So what direct indexing does is it creates optionality for the investor – you have the choice to do what is right for you. In a mutual fund, there is no optionality – you are always at the mercy of others. If you are currently in a mutual fund, this may be an opportune time to move to a directly indexed portfolio, particularly if your mutual fund position is at a loss that can be used to offset taxable gains elsewhere, or carried over. Alternatively, if your mutual fund position has gains, a direct index portfolio with tax loss harvesting can help offset those gains.

Thematic investments are getting very popular, and many investors want to express their views or beliefs through their stock portfolios. But most thematic funds and ETFs are quite expensive. Can custom direct indexing help in achieving the two objectives of low cost and choice of themes?

Erkko: This is one of the key benefits of custom direct indexing – you get to choose what themes you want to express and you'll get to do that seamlessly as part of your overall equity portfolio, without having to subscribe to outside funds. Theme selection, of course, carries the risk of poor decision making. As a result, it is important to develop such strategies thoughtfully, and to consider consulting with your trusted investment advisor in the process.

Since the themes are integrated in your own direct index portfolio, we can offer thematic investing as part of a broad equities managed account at a very competitive price point. As you might have guessed, our solution can also offer tax-loss harvesting across the whole portfolio, if that is of interest. And, as discussed above, we can avoid many of the hidden costs that lower the returns of mutual funds and ETFs. So, all told, we think you can get a better investment experience at a lower price.

For further reading on our views, please visit our website at bkln.com/research.

[4] See Morningstar's article at https://www.morningstar.com/articles/1122484/which-popular-funds-will-hit-investors-with-losses-and-capital-gains-distributions-this-year