



Using Discretionary Overlay in Anticipation of Higher Capital Gains

By John Phoenix

John Phoenix is CEO of Metamorphosis Money Management, a Registered Investment Advisor that delivers an institutional tax transition and active overlay solution to the high net worth investor market that aims to improve absolute returns.

Perhaps the most frustrating thing for investors in this environment is that no one can really predict the impact of the steps the government is taking to fix the economy. However, one thing is for certain—they will need a way to pay for it, and that means an increase in taxes.

We are currently enjoying a bit of a lull before the storm. The president is reluctant to move too quickly to raise capital gains taxes out of a very rational concern that doing so could further hinder economic growth. But a storm is approaching—perhaps an imperfect storm at best—for high net worth and ultra high net worth investors.

Be certain: Long-term capital gains tax rates will increase. So far, the president has proposed to allow the Bush tax cuts to sunset, increasing the long-term capital gains rate from 15 percent to 20 percent starting in 2011. On the campaign trail, the president talked about even higher rates for the affluent.

The trouble is this storm is closer than most investors realize. To properly maximize the gains in a multi-million dollar portfolio, tax managers need to harvest losses gradually to create a stockpile of losses that can offset capital gains in the future.

"Perpetual tax loss harvesting accomplishes several strategic investment goals for my clients," said Lou Moore, of Lincoln Financial Advisors. "Tax management offers one of the few opportunities to add value independent of investment performance. Also, in times like this, it creates a great stockpile of losses that can be redeployed opportunistically once things turn around."

A specific tax management strategy applies to all investors, but it is particularly critical for investors with concentrated equity positions or low-basis stock, such as business owners and high-level corporate executives.

Losses Are a Gift Forever

With limited chances to realize gains in this environment, many investors and advisers don't see a need for harvesting losses, *but the losses can be carried forward forever*. That means just what it sounds like: Losses taken today can be used in 2010, 2011 or 2020. So whether investors plan to realize gains in six months or six years, now is the time to stockpile losses to provide an ability to keep more of future gains when investments begin the move back into positive territory. But what's the best way to do it?

Discretionary Overlay

Most advisers and savvy investors should be familiar with tax overlay, but the term has become overused and doesn't always accurately describe the latest techniques in the space.

"Many managers claim to manage for tax, but few can deliver a truly tax efficient and customized portfolio like a discretionary overlay can provide," according to Moore.

Discretionary overlay is tailor-made for investors with low-basis stock portfolios, exchange funds or other concentrated holdings. It can be a great solution for frustrated CPAs or investors dealing with multiple accounts spread across different advisers. The discretionary overlay manager consolidates all of the reporting to reduce the administrative burden and provides all of the cost basis and tax lot information CPAs need. The overlay manager will also guard for wash sales and overlap among the holdings.

Discretionary overlay managers have discretion to trade the entire equity portion of an investor's account and make investment decisions based on the specific needs of the investor. If the portfolio has pre-existing low-basis positions, the discretionary overlay manager will factor in this data when trade recommendations are made by the managers to avoid overweighting industry sectors that could increase the investor's risk. By taking into consideration correlation among stocks in different asset classes and the risk characteristics of each stock in the model and existing portfolios, the discretionary overlay manager can execute a trade based on a wide range of data points that ensure the security purchased is the best fit for the investor's portfolio.

Year-Round Tax Loss Harvesting

Possibly the greatest advantage of discretionary overlay is the ability to add value by proactively tax loss harvesting year round.

In traditional overlay, tax loss harvesting is a passive strategy done in December only at the adviser's request. If there are losses in December, which is not always a guarantee, the manager will sell the securities and either hold the cash or typically redeploy the proceeds in an exchange-traded fund. While this is better than doing nothing, the manager is missing opportunities throughout the entire year to use volatility to the investor's advantage and can potentially create a tax problem if the ETF purchased as a proxy increases in value during the 31-day holding period.

With discretionary overlay management, tax loss harvesting is a systematic, active tax management strategy that is executed, potentially every day, in accordance with the

investor's Investment Policy Statement. The manager seizes upon the daily volatility in the stock market to lower the investor's tax bill while potentially increasing absolute returns by earning on money that would have traditionally gone to the government. This is especially important in a market like the one we are currently experiencing with dramatic swings in either direction. The discretionary overlay manager may use this volatility to offset gains realized earlier in the year, or stock pile losses to be used to offset future gains months, or even years later. The discretionary manager uses quantitative trading tools to execute this perpetual harvest and only buys securities from the manager's suggested buy list instead of using ETFs.

Savvy advisers and investors are already positioning portfolios for the future. With the introduction of discretionary overlay, advisers have a new, powerful tool to take advantage of the approaching imperfect storm of higher capital gains tax rates.