TAX MANAGEMENT

Taxing Situations

Diversifying the risks of concentrated stock portfolios

Overlay management provides asset managers a renewed ability to address the needs of HNW clients with concentrated stock portfolios.

Key Implications

- Traditionally, to tax-efficiently diversify the risks associated with holding concentrated stock portfolios, advisors and their HNW clients have relied on hedging solutions including equity collars, variable prepaid forward contracts, and exchange funds. However, these strategies have potential drawbacks including illiquidity, high fees, and recent IRS crackdowns.
- In addition to hedging strategies, some HNW clients and advisors have turned to separate accounts to implement a diversified investment strategy for concentrated portfolios. A tax-efficient transfer to separate accounts, however, is rarely implemented, as it is seen as competing with the manager's ability to perform their area of expertise—the generation of alpha through security selection.
- The ongoing development of the UMA and model portfolio delivery has highlighted the role of the overlay manager in providing investors with tax-efficient investment strategies. Overlay providers have begun using their capabilities to offer HNW investors alternative methods for hedging concentrated stock positions and a more tax-efficient option to the transition to traditional separate accounts.

Numerous studies have posited that protecting assets against taxes is a common goal and a prevalent concern for high-net-worth (HNW) investors. In 2007, the Phoenix Marketing Group, a Cerulli Associates data partner, surveyed more than 6,600 affluent households with investable assets in excess of $250,000 and/or an annual income in excess of $150,000 to better understand consumer financial trends. Among investors with more than $1 million in investable assets, more than 45% of respondents ranked the minimization of taxes as their most pressing issue related to savings and investments during the previous year.

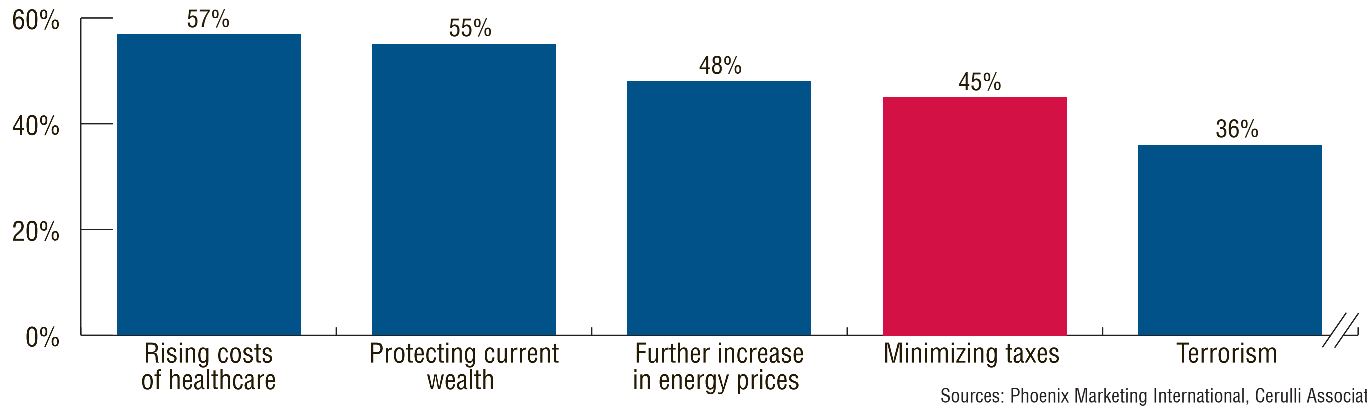
The ability to tax-efficiently diversify large portfolios of concentrated securities is one of the most complicated issues facing the HNW.

When it comes to asset management, one of the most complicated issues facing HNW investors is the ability to tax-efficiently diversify large portfolios of concentrated securities. Indeed, many HNW individuals and families have amassed great wealth by owning a large quantity of highly appreciated stock. They may have acquired the security as a result of a successful initial public offering (IPO), a family transfer, or as part of a buyout or an executive compensation package heavily weighted in employee stock options. Regardless of how they obtained the securities, a portfolio of concentrated stocks with deeply embedded gains poses a dilemma for advisors who must weigh the risks associated with holding a concentrated portfolio versus the tax impact of attempting to diversify those assets. Even when a client wishes to diversify, the tax consequences often make it difficult for an advisor to effectively implement an appropriate solution.

Traditionally, in order to tax-efficiently diversify the risks associated with holding concentrated stock portfolios, advisors and

TOP 5 OF 16 WEALTH MARKET CONCERNS REGARDING SAVINGS AND INVESTMENTS, 2007

Minimizing taxes ranks as the 4th out of 16 concerns for investors with more than $1M in investable assets.



Sources: Phoenix Marketing International, Cerulli Associates

their HNW clients have relied on hedging solutions, including equity collars, variable prepaid forward (VPF) contracts, and exchange funds. These strategies, however, are not always ideal solutions for clients. VPF contracts, in which the investor agrees to deliver some or all of the underlying shares of their concentrated position at a future date in exchange for an up-front cash advance, have been the source of a recent crackdown by the Internal Revenue Service (IRS). Exchange funds allow holders of concentrated blocks of low tax-basis securities to exchange these securities for shares in a limited partnership that invests in the concentrated blocks of different stocks of similar investors. But, they have been criticized for their illiquidity, high fees, and the fact that after a lock-up period (typically a minimum of seven years) the investor still has tax issues as the basket of securities they receive has the same cost basis as their original contribution.

In addition to hedging strategies, some HNW clients and advisors have turned to separate accounts in order to implement a diversified investment strategy. Indeed, sponsors indicate that more than a quarter (27%) of new assets into separate account consultant programs are conversions from individual securities. Separate accounts, the most prevalent investment vehicles in HNW and ultra-high-net-worth (UHNW) client portfolios at 21.8% (see exhibit on page 9), offer several advantages over packaged investment vehicles. These include greater transparency, more flexibility, and the opportunity to harvest tax losses. However, the extent to which these tax management benefits are actually realized is questionable. Of the 65% of subadvisory separate account assets in taxable accounts, only 15% actively requested custom tax treatment from asset management firms in 2007.

In traditional separate account programs, the tax-efficient transition of existing portfolios is mainly the responsibility of the advisor and the asset manager. Typically, the client's holdings are mapped against an asset manager's portfolio and overlapping securities are retained at the target model weights while all other positions are liquidated (with little regard for cost or tax implications). On an ongoing basis, tax management is largely confined to year-end tax-loss harvesting at the advisor's request. So, for all their troubles of diversifying into separate accounts, clients with low-basis positions who were promised a tax-efficient portfolio transition receive only a major tax bill.

Asset managers can be largely forgiven for not wanting to undertake the customization and tax-management responsibilities for a client, as it is often seen as a detraction from what they do best—man-

HNW CLIENT ASSETS BY INVESTMENT VEHICLE, 2008
Separate accounts had the highest concentration in HNW and UHNW clients' portfolios, accounting for almost 22% of client assets.

Vehicle	% Client Assets
Separate accounts	**21.8%**
Mutual funds	17.7
Individual securities: equities	13.1
Individual securities: fixed income	11.0
Hedge funds or funds of funds	10.7
Exchange-traded funds	6.9
Private equity	5.2
Money markets, deposit accounts, cash, etc.	5.1
Direct real estate (*i.e.*, physical property)	3.3
Other	2.4
REITs or other real estate securities	1.3
Limited partnerships	1.1
Variable annuities	0.4
Managed futures funds	0.2

Source: Cerulli Associates

aging client portfolios—and can create large amounts of dispersion between accounts. Since asset managers are typically evaluated on the consistency of their returns, they endeavor for low dispersion to gain access to, and maintain their positions on, B/D platforms. Additionally, dispersion caused by the facilitation of customization and tax management prevents many asset managers from achieving operational scale. Significant differences in accounts being managed for the same investment strategy, due to customization and tax harvesting, have meant that some accounts could not be traded in bulk. Thus, some asset managers have been reluctant to take on clients who have large, concentrated positions or who need active tax management.

Tax-overlay managers

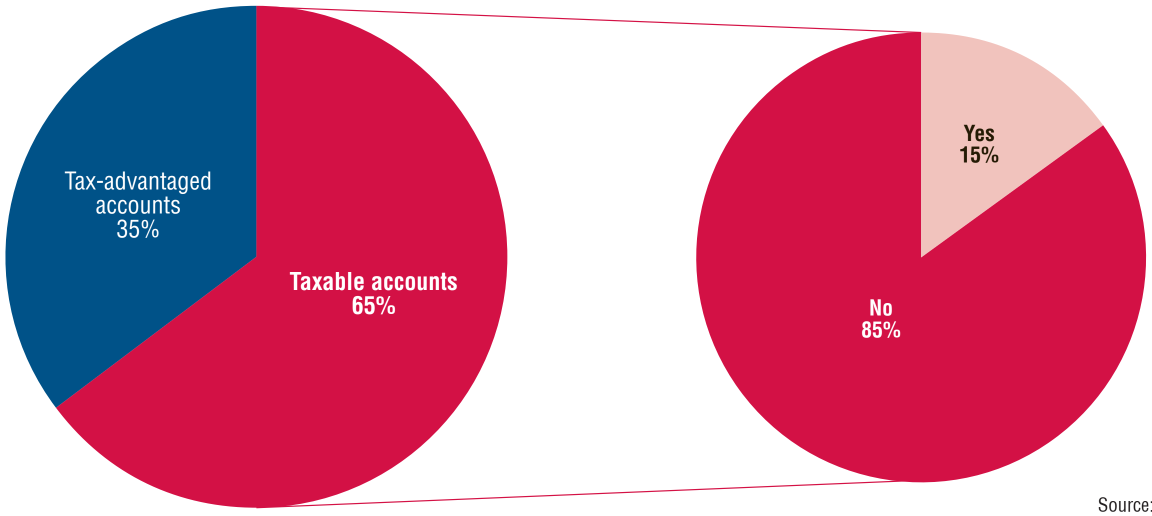
The ongoing development of the unified managed account (UMA) has highlighted the role of the overlay manager in providing investors with tax-efficient investment strategies. Recently, overlay providers,—including Metamorphosis Money Management (see case study on page 11), Placemark, Parametric, and Natixis Managed Portfolio Advisors (MPA)—have begun using their capabilities to offer HNW investors alternative methods for hedging concentrated stock positions and a more tax-efficient option to the transition to traditional separate accounts.

The facilitation of these strategies is due, in large part, to the delivery of model portfolios by asset managers. Model portfolios are a way for asset managers to be hired as research providers by periodically submitting portfolio holdings information to a program sponsor or overlay manager, rather than the asset manager traditionally managing separate account client assets. While the asset management fee received for the delivery of model portfolios is lower than in traditional separate account relationships, model delivery allows asset managers to focus on their area of expertise (the generation of alpha through security selection) while delegating the trade-execution and tax-management responsibilities to a tax-overlay manager.

In order to implement a tax-efficient separate account transition, a tax-overlay manager will work with a financial advisor to obtain and consolidate a client's investment statements to provide an analysis of a client's risk exposure and current tax scenario. Although there is some variation

SEPARATE ACCOUNT CLIENTS RECEIVING CUSTOM TAX TREATMENT, 2Q 2008

Of the 65% of separate account assets held in taxable accounts, 15% actively requested custom tax treatment from asset managers.



Source: Cerulli Associates

among the methodology of tax overlay managers, the more progressive approaches first take into consideration a client's risk profile. Then the advisor and tax manager devise a diversified target-investment portfolio (typically made up of multiple investment managers/strategies) and work with the client to establish a capital gains tax budget. Subsequently, the tax manager develops a plan to begin moving the existing concentrated securities to the target portfolio while keeping the capital gains taxes within the budget established by the investor.

Instead of simply buying all of the securities held in the targeted model portfolios, purchases are made using a quantitative model that takes into account the risk and correlation statistics of each individual security. Securities that have large embedded gains, but are closely correlated and have similar risk characteristics to securities in the target portfolio, may be maintained in order to meet the investor's capital gains budget. The use of model portfolios allows the overlay manager to create hybrid portfolios that track the selected managers' portfolios while maintaining the discretion to execute strategic investment decisions based on client-specific information and needs.

> **Model portfolios allow the overlay manager to create hybrid portfolios that track the selected managers' portfolios while maintaining the discretion to execute strategic investment decisions based on client-specific needs.**

While the tax overlay manager seeks to replicate the target portfolio (and the underlying manager's models) as closely as possible, the trade-off between the realization of gains and the adherence to the target portfolio creates dispersion between the two portfolios (measured by tracking error). Daily account monitoring enables the overlay manager to take advantage of tax losses in the hybrid portfolio to either offset the realized gains from the initial liquidation or to use the losses to further diversify out of the low-basis securities and into the target portfolio (reducing the tracking error between the hybrid and target portfolios to zero over the length of the transition).

While the use of model portfolios and the delegation of trading authority to overlay managers has raised concerns from some asset managers about the effect on performance, the majority of asset managers (67%) are currently submitting model portfolios to overlay managers. The

CASE STUDY
METAMORPHOSIS MONEY MANAGEMENT

Mapping Tax-Efficient Transitions

The Denver-based, active tax-overlay manager, Metamorphosis Money Management (M3), focuses solely on alleviating the capital gains tax burdens associated with assisting HNW investors to implement an investment strategy using separate accounts. The firm utilizes a proprietary trade-management system (Global Trading System™), based on the institutional transition business pioneered by CalPERS in the 1970s, to map the most tax-efficient transition path for clients with concentrated portfolios of low-basis securities looking to move to a more diversified portfolio of separate accounts.

Through the use of model delivery, M3 creates portfolios—at the advisor's direction—that track selected managers' portfolios while retaining complete supervision over all of the investor's holdings. As a result, M3 has the ability to make and execute strategic investment decisions specific to individual clients that have the potential to generate significant tax savings—referred to as 'tax alpha.' M3 employs a process, known as Perpetual Harvest™, that monitors a client's holdings daily to identify loss-harvesting opportunities at the individual account level that occur throughout the year. By aggressively managing a client's individual tax lots, M3 seeks to deliver the tax efficiencies that separate accounts have traditionally promised, but have failed to deliver due to operational and administrative barriers.

Unlike other overlay managers that seek to provide ongoing overlay services to entire B/D platforms, M3 specializes in tax-efficient transition strategies for clients with low-basis or concentrated stock portfolios. This means that their role in the management of a client portfolio ends once a client has been moved into their target asset allocation. M3 is custodian agnostic and completely open architecture, utilizing any separate account asset manager that is willing to provide it model. For this reason, M3 services are ideal for B/Ds that have already brought overlay management services in-house but whose role as overlay manager is largely confined to portfolio management, cash-flow management, and wash-sale prevention. Additionally, M3 works with proprietary managers and family offices that are targeting HNW and UHNW clients who may have significant tax issues.

Because they deal solely with clients who have tax issues, M3 has investment minimums of $1 million for their transition-management strategy (although their average client is transitioning more than $5 million). A meeting with a client's accountant is a mandatory requirement prior to account opening. M3 charges an asset-based fee for its services which can vary depending on the client's account size and tax situation.

hybrid portfolios may substitute similar securities and delay the execution of trades in the manager's model for tax purposes, causing the portfolio to deviate from the manager's actual performance. Because of this, many overlay providers do not show individual manager performance on client statements, but instead provide clients with consolidated performance for the hybrid portfolio until the portfolio has been transitioned and the client's portfolio mirrors the asset manager's. Additionally, because the overlay manager is using the manager's model in order to create a tax-efficient hybrid transition portfolio for a client, the asset manager is paid the full model fee, based on their initial target portfolio allocation throughout the course of the client transition, even when the majority of the client's assets may still be concentrated in a few holdings.

The majority of asset managers (67%) are currently submitting model portfolios to overlay managers.

Cerulli analysts believe that tax-overlay managers can help to provide opportunities for asset managers that participate in model portfolio delivery to better address the needs of HNW investors with concentrated or low-basis portfolios who may have previously been underserved by a traditional separate account. Model portfolio delivery frees asset managers from the operational burdens of the ongoing monitoring and implementation of client-specific information and allows them to focus solely on the management of their portfolio. Moreover, a shift in emphasis toward meeting client goals and providing solutions through diversification and tax management can potentially help to quell the large swings in asset flows that are typical of managers in the separate account space, and have been the result of a long-standing industry emphasis on performance and beating investment benchmarks. ◆