

## TAX ALPHA: THE IMPORTANCE OF ACTIVE TAX MANAGEMENT

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It is a popular sentiment that investors should not let the “tax tail” wag the “investment dog.” While it is true that tax considerations should not dominate investment decisions, tax considerations significantly influence investment returns. Taxes represent a very large drag on performance – often larger than transaction costs, management fees, or inflation.<sup>1</sup> Failing to consider the impact of taxes on investment decisions can be expensive, especially over the long term.

### THE COST OF TAXATION

To put this in perspective, even a very tax-efficient index-based portfolio will realize a difference between pre-tax and after-tax returns of close to 2% annually according to a 1998 study.<sup>2</sup> The same study showed that, for most active strategies, this performance difference is in excess of 3% annually.

A recent Canadian study<sup>3</sup> conducted in 2003 arrived at a similar conclusion by showing that an average of 1.35% was lost to taxes annually, over a ten year period, on mutual fund distributions alone, on funds managed by Canadian portfolio managers. Another 1% was lost to taxes upon liquidation of the mutual funds at the end of the ten-year period. The actual returns lost to taxes ranged from nil, for tax-efficient funds, to 7.13% annually for the most tax-inefficient fund.

Many investors have become more sensitive to the various costs that reduce their rate of

return, including commissions and management expense ratios. Increasing attention, however, is being placed on the cost of income taxes. It is clear that the cost of taxes is no small matter.

### ACTIVE TAX MANAGEMENT

To ensure that a proper Active Tax Management (ATM) program is in place, consideration should be given to appointing a Tax Overlay Manager who understands the critical issues involved in ATM.

ATM can be executed at different times, and at different levels. The times during which ATM can be executed are as follows: (1) at portfolio inception, (2) during ongoing management, and (3) at portfolio disposition. Further, this ATM can take place at three different levels: (1) the money manager level, (2) the structural level, and (3) the investor level. Consider the matrix on the next page.

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ACTIVE TAX MANAGEMENT MATRIX			
LEVEL → TIMING ↓	Money Manager Level	Structural Level	Investor Level
Portfolio Inception	Tax Overlay Strategies	Tax Overlay Strategies	Tax Overlay Strategies
Ongoing Management	Tax Overlay Strategies	Tax Overlay Strategies	Tax Overlay Strategies
Portfolio Disposition	Tax Overlay Strategies	Tax Overlay Strategies	Tax Overlay Strategies

ATM takes place at three levels, so who has the greatest responsibility to ensure taxes are minimized? Further, how can an ATM program work properly given that communication is critical between the three levels? In most cases, a Tax Overlay Manager is ideally suited to ensuring that there is proper communication and coordination among the levels to achieve maximum tax alpha (that is, *value added* from tax overlay strategies).

A word about each level in the ATM matrix is warranted. First, it should be said that responsibility for tax-efficiency falls in the hands of parties at all three levels. Money managers alone are not responsible for tax minimization. On the contrary, the architect of the investment program has responsibility, when establishing the structure of the program, to consider taxation. Certainly, investors and their advisors must not mitigate the efforts of the other parties by being careless in their own tax management.

### ***Money Manger Level***

Care must be taken by managers to ensure tax efficiency. Not all managers are trained to think this way. Many money mangers have grown up in the non-taxable world of pensions, foundations, and endowments. To be sure, some managers may openly admit that they don't concern themselves with taxes. Should these managers be set aside or by-passed when selecting managers for taxable accounts? Not necessarily. If the manager has proven that he can add alpha when it comes to performance, perhaps he should still be considered.

Studies have shown that a very effective approach to portfolio construction is to build a tax-efficient core, with satellite managers, on the perimeter, focused strictly on pre-tax alpha. This brings us to the issue of investment program structure.

### **Structural Level**

The architect of an investment program is responsible for the structure of the program. The structure of a program involves decisions around:

- Pools versus separately managed accounts;
- Corporate versus trust structure;
- Active management versus passive management;
- Selection of managers based on ability to add pre-tax alpha, and/or tax alpha;
- Distinct programs for taxable investors versus one program for all investors;
- The manner in which fees are charged (directly tax deductible, or indirectly deductible)

There will be other decisions that must be made by the sponsor of any investment program. Some of these decisions may impact the level of taxation ultimately experienced by investors in the program, and proper ATM will require consideration of taxes before a final decision is made on these issues.

### **Investor Level**

Finally, investors and those who advise them have some responsibility to ensure tax-efficiency is achieved. All of the good work that is achieved by a Tax Overlay Manager during his or her overseeing of the program's ATM can be mitigated by the investor if he or she fails to consider tax issues. Fortunately, tax alpha directly benefits the investor, and so investors are more often than not quite motivated to minimize tax. Under the guidance of a qualified advisor, taxes can be minimized at the investor level. When combined with a properly designed and executed ATM program at the other levels, investors can

rest assured that their after-tax returns will be maximized.

### **Reliability of Tax Alpha**

An argument can be made that the alpha (the value added) attainable from ATM can often be much larger than the alpha that can be achieved from active portfolio management through security selection. Consider a very good portfolio manager that is able to outperform a given benchmark by 150 to 200 basis points annually. This accomplishment is no easy task, and most experts would acknowledge that this type of manager is the exception, not the rule. Yet, it's possible to reliably and consistently add 200 to 300 basis points annually through attention to taxes. Further, quantifying tax alpha can be done through comparing actual portfolio values to values that would have been attained had specific tax overlay strategies not been implemented.

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Adding tax alpha is not an uncertain activity. When the proper tax overlay strategies are executed, the achievement of tax alpha is very reliable. Not many active managers can say the same thing about pre-tax alpha, which is dependent not solely upon the skill of the manager, but upon the sentiments of capital markets as well, at least in the short term.

## BENCHMARKING AFTER-TAX PERFORMANCE

The world of pre-tax returns is an easy world in which to work in that benchmarks are readily available. Unlike the pre-tax world, there are no “one size fits all” after-tax benchmarks. Each starting date creates a unique adjusted cost base (ACB) and, as a result, each starting date creates a unique after-tax return series. Further, each taxpayer has his or her own marginal tax rate, and so after-tax returns will be different for each investor. Assumptions have to be made about which tax rates to use. Fortunately, we have found that these assumptions are entirely adequate for the purpose of comparing one money manager to the next.

Despite any challenges in arriving at after-tax returns, it’s critical to establish some benchmarks to gain assurance that the tax overlay strategies implemented are adding tax alpha.

For a portfolio that starts from a pre-existing set of appreciated securities, we have found that a useful benchmark is the initial unchanged portfolio, held into the future. A good manager must provide additional after-tax value to this base case.

For a portfolio that starts with cash, an ideal benchmark would be an indexed portfolio with cash flows identical to those of the actual portfolio. Investment flows affect both portfolio performance and benchmark performance since taxes depend on the ACB at which the securities were acquired.

## TAX OVERLAY STRATEGIES

There are many strategies that can be implemented by a Tax Overlay Manager to ensure that tax alpha is maximized. Some strategies must be executed at a specific level (money manager, structural, or

investor level), while others can and should be implemented at more than one level. Professional judgment is required to know how and when to execute a specific overlay strategy. The specific tax overlay strategies utilized should enable the following to be accomplished:

- **Determination of the most appropriate investment owner.** In certain situations it will make sense for a portfolio or specific security to be held in the name of a particular investor. This can permit a splitting of income, avoidance of the superficial loss rules, utilization of capital losses or available deductions, or other accomplishments.
- **Determination of the most appropriate asset location.** Asset location refers to whether an asset is held in a non-taxable account, or a taxable account. The construction of portfolios in each of these accounts cannot be undertaken in a vacuum. Consideration must be given to all assets, regardless of location, when constructing a tax-efficient portfolio, with a decision to use registered, non-taxable accounts for certain assets in certain situations.
- **Meeting the investor’s cash flow needs tax-efficiently.** Investors will have different needs, and some will require cash flow from their investments. Cash flow can be taxable, or non-taxable, depending on the approach adopted. Proper ATM requires considering these needs when constructing a portfolio.
- **Deferral of tax at portfolio inception.** Too often, portfolio managers are hired to manage an investor’s assets and immediately cause accrued capital gains to be realized by liquidating everything, forcing the payment of taxes and creating a hurdle rate of return that must be exceeded to recover the taxes

paid. A good Tax Overlay Manager will create a deferral of tax while still enabling the portfolio manager to create the desired portfolio.

- **Deferral of ongoing accrued capital gains and income.** Portfolio managers are able to control the timing of taxable capital gains and income in a number of ways. Management style has much to do with this, and so controlling this deferral is often a function of manager selection, among other things.
- **Offsetting of realized taxable capital gains.** Proper ATM will allow capital gains to be realized when appropriate, but create offsetting losses or use other available measures to mitigate the impact of those taxable capital gains. There are a number of ways to accomplish this.
- **Minimization of highly taxed interest income.** Certain strategies are available to minimize the tax cost of interest income, even when large cash positions must be dealt with and no securities are immediately attractive.
- **Proper assessment of securities transactions.** A tax-sensitive manager will evaluate the tax cost “hurdle” of selling a specific security, recognizing that any new security chosen as a replacement must perform well enough to recover the taxes paid on the disposition, and then outperform the original security, for that transaction to add value. This will typically require that the new security outperform the original security by 2% to 4% annually.
- **Minimization of portfolio lock-up.** Where portfolio turnover is kept to a minimum as a means to defer tax, the adjusted cost base of securities in the portfolio can end up substantially lower than the fair market value, ensuring a significant tax liability when an eventual disposition of the securities takes place. This can result in portfolio “lock-up” where a manager feels handcuffed into holding a security longer than he or she should. Methods to minimize lock-up while minimizing taxes should be employed.
- **Tax-effective portfolio rebalancing.** Rebalancing a portfolio where a tactical asset allocation strategy has been adopted can be done in different ways, including the use of a futures overlay to defer tax. Further, the rebalancing trigger point may very well be different for a taxable portfolio than a non-taxable one. Any measures that reduce the tax cost of rebalancing are welcome.
- **Tax-effective portfolio diversification.** A common dilemma is the concentrated portfolio. The decision to liquidate all or part of a concentrated position in a security can be difficult, with the decision impacted by the volatility of the concentrated asset, investment time horizon, expected rate of return of the concentrated asset, and the adjusted cost base of the security. In addition, the use of derivatives strategies can help to accomplish diversification while deferring tax.
- **Avoidance of the superficial loss rules.** When multi-managers are used in certain environments, the problem of the superficial loss rules, or wash sales, can arise when one manager disposes of a security at a loss while another takes a long position in the same security at about the same time. The Tax Overlay Manager must ensure that these problems are avoided through the use of appropriate strategies.

- **Minimization of manager replacement tax.** Just as a portfolio manager continually tries to find more attractive securities, so a manager of managers seeks to find more attractive portfolio managers. Each time a portfolio manager is replaced, the new manager will generally reconfigure his or her sub-portfolio, which may require the triggering of taxable capital gains. The Tax Overlay Manager must take various steps to minimize this tax liability.
- **Tax minimization on ultimate disposition of the portfolio.** Liquidating all or a portion of a portfolio can lead to significant tax consequences that can be minimized through the use of various strategies, including those that will split taxable capital gains between spouses, defer a tax liability, or eliminate the tax altogether.
- **Minimization of U.S. estate tax in addition to Canadian tax.** In the case of U.S. citizens, no capital gains taxes are paid at the time of death in the U.S. Yet, the ACB of the securities is stepped-up to the fair market value at the time of death. Where U.S. estate taxes can be avoided through proper planning, there may be no U.S. tax at all on the accrued capital gains in a portfolio upon death. This benefit disappears if the securities with accrued gains are disposed of during the investor's lifetime. This fact must be considered when making decisions to dispose of securities, even where other securities may appear to be more attractive at the time.
- **Balancing of Canadian and U.S. tax minimization.** For investors who are U.S. citizens or residents, a proper ATM program will recognize that specific securities sold in a transaction may have a large U.S. tax impact where the average cost base method is not used.

Proper tax lot accounting can reduce U.S. taxes without impacting the Canadian tax liability negatively.

- **Creation of a structure that provides flexibility to investors.** The sponsor of an investment platform ought to consider the needs of the majority of investors and, where possible, build flexibility into the platform that will allow investors to control certain aspects of their own tax planning, including the timing of taxable capital gains, the type of income earned, the tracking of unique adjusted cost bases, and the deductibility of fees, among other things.
- **Creation of a structure that promotes tax and pre-tax alpha.** Studies have shown that much value can be added in a multi-manager approach where a tax-efficient core is created, supplemented by satellite managers focused on performance and not necessarily tax-efficiency. Consideration should be given to this type of portfolio structure.

There are other things that a Tax Overlay Manager may seek to accomplish, but the above list represents the most common objectives. Each Tax Overlay Manager may have his or her own library of strategies to accomplish the desired objectives, and some of the strategies are closely held and guarded, almost as proprietary.

## CONCLUSION

Taxes represent a very large drag on performance – often larger than transaction costs, management fees, or inflation. Failing to consider the impact of taxes on investment decisions can be expensive, especially over the long term.

Active Tax Management can add significant tax alpha when applied at the money

manager, structural, and investor levels, at various times. It can be argued that this tax alpha is more reliable than pre-tax alpha added by money managers through security selection.

A Tax Overlay Manager should be considered to quarterback the Active Tax Management process for any investment

program. The role of this overlay manager is to design and execute the various tax overlay strategies that work best in a given situation, and ensure appropriate communication and co-ordination between money managers, investment program sponsors, and investors, with the focus on maximizing tax alpha.

## CONTACT US

At WaterStreet, we take on the responsibility of the Tax Overlay Manager for each of the families we serve. It's simply part of what we do. We have significant experience in tax-efficient portfolio architecture and seek to add value, or "tax alpha," in every case. If you would like more information about how we are adding value by being different in our approach to investment management, we would be glad to speak to you.

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<sup>1</sup> Stein and Garland, "Investment Management for Taxable Investors," *The Handbook of Portfolio Management* (1998). Also, consider an example: A security with a cost of \$10 is sold one-year later for \$12. Assume a management fee charged by the money manager of 1%, levied on the average market value of \$11. Also, assume custodian fees of 0.25% of the same \$11 amount. Commission costs are also approximately 0.25% in this example. The management fee, then, is \$0.11, custodial fees are \$0.0275 and commissions are \$0.055 (round trip) for the year. The total fees equal \$0.1925, or 1.60% of the sale proceeds. Assuming the security paid no dividends and was sold by an investor in the highest tax bracket (46%) at the end of the year, the tax on the capital gain would be \$0.46 (23% of the \$2 capital gain). This tax cost is equal to 3.83% of the sale proceeds.

<sup>2</sup> Siegel and Montgomery, *Journal of Portfolio Management*, Winter 1995.

<sup>3</sup> Milevsky, Mawani, and Panyagometh, "The Impact of Personal Income Taxes on Returns and Rankings of Canadian Equity Mutual Funds," *Canadian Tax Journal*, Fall 2003.