The Journal *of* Wealth Management

VOLUME 15, NUMBER 1 SUMMER 2012

Downloaded from https://jwm.pm-research.com by guest on September 26, 2021. Copyright 2012 Pageant Media Ltd.

JEAN L.P. BRUNEL Editor

HARRY KATZ Production and Technology Director
DEBORAH BROUWER Production/Design

FRANCES DAVIS Associate Marketing Director
SHARON CHIEN Marketing Manager

ERIN SCANLON Global Digital Sales Manager

PETER JUNCAJ Head of Subscription Sales
SARAH ABDELAAL Account Manager
SOPHIA SAAFIR Account Manager

DEWEY PALMIERI Reprints Manager

KELVIN LOUIE Senior Fulfillment Manager
EMPERATRIZ MIGNONE Fulfillment Manager

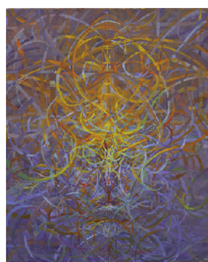
STEVE KURTZ Director, Finance & Operations
ALINA LEONOVA Business Manager

DAVE BLIDE Associate Publisher
SABRINA GLOVER Art Consultant

JANE WILKINSON President & CEO
ALLISON ADAMS Group Publisher

Cover design: Loewy Design

ON THE COVER



Sharon's Potion's Breathe
Oil on Panel, 2010
15 × 12 inches; 38.1 × 30.5 cm

***Susanna Coffey** (b. 1955, American) is a painter known for her diverse range of styles from abstract, such as the work featured, to her other works of figurative and realistic images where she balances the appearance of light and dark. In 2000 Coffey represented the US in the Korean Biennial. Her work is included in the collections of the Minneapolis Museum, the Art Institute of Chicago where she has taught painting since 1982, and the American Academy of Art and Design. Visit www.valeriecarberry.com to view more works by this artist.*

The last few years have seen articles and discussions related to tax efficiency somewhat fade into the background. While this might be understandable and may, in fact, have not had serious or adverse consequences, now might be the right time to revisit this issue.

Traditionally, tax efficiency has been defined as avoiding unnecessary taxes and deferring those that are unavoidable. Avoiding unnecessary taxes requires sophisticated planning, particularly in terms of estate and philanthropy, or involves recognizing the difference between long- and short-term capital realizations or between implicit and explicit taxes (think of the implicit tax rate built into the yield of a tax-exempt bond, for instance). Deferring taxes that are unavoidable involves eschewing activities that lead to taxable income being recognized for as long as possible. That this effectively involves selling "losers" and holding on to "gainers" is the "cost" one pays, in that the ratio of portfolio market value to its tax basis keeps rising, exposing the portfolio to a sort of a "freeze" that occurs when the portfolio has become unmanageable without serious tax consequences. This is where knowing how to use realized losses to offset gains, be they related to income or capital issues, becomes so valuable. Indeed, an unrealized capital loss can be viewed, for instance, as a free option to take an unrealized capital gain of the same magnitude without having to pay taxes. There are many other important elements to the science and the art of being tax aware, but our point here is not to revisit these, but rather to discuss why tax awareness may seem to have receded into the background and why it might have to be brought back into focus.

The main reason mentioned by most observers as to why tax awareness may not have seemed a top priority in the last few years simply is that many investors suffered losses in the 2008 financial crisis. They have had plenty of opportunities, therefore, to offset any gain registered in the rebound with these carry-forward losses. Yet, lower aggregate return levels may have, in fact, played an equally important role.

Before expanding on this latter thought, however, it may be necessary to return to tax-awareness insights for a short while. A fundamental insight into tax awareness is that tax inefficiency often arises from the fact that taxes are paid on both beta (market returns) and alpha (managers' value added). Thus, the long-held rationale has been that some form of passivity—at least passivity with respect to security

Downloaded from https://jwm.pm-research.com by guest on September 26, 2021. Copyright 2012 Pageant Media Ltd.

selection alpha—is desirable, as portfolio activity quickly depresses tax efficiency. Yet, digging a bit deeper into this essential insight, which was in the seminal work by Arnott and Jeffrey (*The Journal of Portfolio Management*, 1993), one comes to the conclusion that the source of inefficiency relates directly to the fact that taxes are paid on both alpha and beta. Thus, with high enough levels of market return and tax rates, it follows that alpha would have to be disproportionately high to be able to absorb both its own taxes and those on the return of the underlying market. For instance, imagine a 10% market return, a 2% manager alpha, both pretax, and a 30% tax rate. Selling a position that has registered the full 12% return requires the payment of 3.6% in taxes, of which 3% relates to the market return and 0.6% to the security selection value added; the tax on the market return alone is higher than the alpha! It should, therefore, not be a surprise that one would typically suggest that a better strategy is a "market buy and hold" that allows one to record the full 10% return and thus defer the tax on that market return. In this mindset, security selection is viewed as unable to produce after-tax value added. Even those strategies that involve systematic capital loss realization appear as unnecessarily complex and costly relative to the obvious alternatives.

Enter a period of lower returns and the need for tax-awareness may appear to be weaker. Indeed, the foregoing analysis changes, arguably quite materially, if one assumes considerably lower market returns. For example, assume an equity market return of zero! Trading into or out of individual stocks for security selection purposes is no longer penalized by having to offset taxes on market-related capital gains against security selection alpha. Ostensibly, one is still paying taxes on that alpha, but with tax rates by definition below 100%, some after-tax alpha remains. Pure tax efficiency would argue that even these taxes are unnecessary, as deferring taxes is like receiving an interest-free loan from the government. Yet, if one has to choose between returns of zero or something, even if some tax has been paid, it is hard to refute the suggestion that something must be better than nothing.

This may be the tax-aware equivalent of Adam Smith's invisible hand argument: Taxable investors may have been correct in ignoring taxes for the last few years, not only because they had losses that could offset gains, but because tax efficiency might not have been so urgently needed.

Looking ahead, however, the situation may change. Although quite a few observers suggest that investors should expect relatively low returns for a while, many are also suggesting that this might be a transition period, following which, inflation might be somewhat rekindled and nominal returns might eventually rise. These forecasts are based on a variety of views, ranging from the very loose monetary policies followed by all developed central banks and a few in the developing world to a feeling that inflation might reduce the otherwise unsustainable government debt burdens of many countries without triggering a long, drawn-out recession or worse.

The potential for inflation to pick up over some time horizon, combined with historically low interest rates might create both the need for and the means to apply tax-aware principles. Indeed, inflation would at some point pad upwards the returns from assets that provide some measure of inflation hedging. Rising prices for these would create unrealized capital gains, which might need to be offset, all the more so as a fair part of these gains would not be real—they would not correspond to rising purchasing power, rather they would simply reflect the increase in price levels. Being able to handle these assets, among which equities might at some point count, in a tax-aware manner would certainly be important.

Simultaneously, an increase in inflation would be bound to be reflected in rising interest rates, at both the short and the long end of the yield curve. Rising bond rates would have to result in falling bond prices; this would generate some capital losses that could be used to offset a few of the gains registered in other areas of capital market.

In short, it may be a good idea to brush up on tax-aware principles as they may become useful sooner than many people expect.

The Summer 2012 issue of *The Journal of Wealth Management* starts with three broad articles. The first article, by Paul Hokemeyer, is unusual in the sense that it looks at the issues faced by many wealthy families from a therapeutic standpoint, arguing that wealthy patients and their families often struggle to find culturally competent and sensitive psychotherapeutic treatment. Therapists bring their own issues around money into the psychotherapeutic relationship, con-

The Journal *of*
Wealth Management

sidering the most common issues that impact therapists' ability to work with people of wealth and providing practical tools to assist them in working through these issues.

The second article, by William Reichenstein and William Meyer, looks at the implications of the currently lower return environment. Reichenstein and Meyer point to the impact of lower returns by arguing that the present value of Social Security benefits are about the same if you assume a 3% real rate and life expectancy of 84; however, changing the real return assumption to 0%, for the present value of the benefits to be the same, a single individual would need to live to 80! The third article in this section, by Tom Arnold and Bonnie Buchanan, employs techniques from real options analysis to determine an actual value that can be gained or lost due to government policy.

The next five articles focus on separate aspects of the investment scene or the investment process. The first of these, by Robert Mileff, Nathan Sonnenberg, and Scott Welch, focuses on alternative investments. Mileff, Sonnenberg, and Welch review some history, revisit the argument for including alternatives within diversified portfolios, and discuss how alternatives dictate a different conversation with investors about their purpose, acceptable and unacceptable trade-offs, and appropriate ways to incorporate alternatives in well-diversified portfolios. The next article is by Lee Dunham and Geoffrey Friesen, who revisit a classical concept, presenting a simple, intuitive investment strategy that improves upon the popular dollar-cost-averaging (DCA) approach that retains most of the attributes of traditional DCA that are appealing to most investors yet adjusts to new information, which traditional DCA does not. In their article, Peng Wang and Larry Kochard propose a new variant on tactical asset allocation, creating a combined model using a Z-score approach that takes advantage of both short-term momentum effects and long-term mean-reversion in valuation to achieve superior overall portfolio performance. Next, Brian Boscaljon focuses on individual portfolio insurance premia and offers a model that is based on individuals' unique preferences with respect to consumption and leisure time. Finally, Thomas Kilgallen proposes a study to test the risk-adjusted returns from a commonly used technical trading strategy, showing that applying this strategy has provided before-tax returns comparable to or better than a buy-and-hold strategy, but with much less downside volatility.

Our final three articles cover a very wide spectrum of issues. The first, by Olivier Mesly and François-Éric Racicot, discusses a new framework for analyzing past financial crises by building on the concept of predatory marketing and proposes possible solutions to limit financial fraud. Next, Daniel Konku, Vivek Bhargava, and D.K. Malhotra examine short- and long-run performance of one special class of penny stocks: initial public offerings (IPOs) filed for and issued as penny stocks, as defined by the amended SEC Act of 1990. They conclude that penny stocks show high performance in the first year of issue but the returns decline sharply after a 13-month period. Finally, Greg Gregoriou offers a review of a book by Colin Read in the Great Minds in Finance Series, which encapsulates the work of a series of great minds in finance and establishes the history rarely addressed and discussed in finance.

Jean L.P. Brunel
Editor

Downloaded from https://jwm.pm-research.com by guest on September 26, 2021. Copyright 2012 Pageant Media Ltd.