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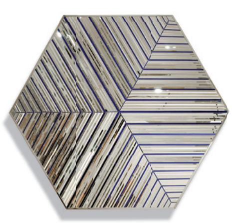
ON THE COVER



Hexagon
Mirror and Reverse Glass Painting on Plaster and Wood, 2010
34.25 × 39.5 × 1.5 inches, 86.99 × 100.33 × 3.81 centimeters

Monir Farmanfarmaian *(Qazvin, Iran, born 1925) is an Iranian artist known for her abstract geometric patterns and cut-glass mosaic technique. Having a career spanning over 50 years, with her work having a long-standing presence within the US and International art markets. Some of her solo and group exhibitions at major Galleries and Museums include the Metropolitan Museum of Art, New York, New York, Victoria and Albert Museum, London, UK, and the Iran America Society, Tehran, Iran. This piece and other works by this artist are available at Haines Gallery located in San Francisco, California.*
Visit www.hainesgallery.com to view more works by this artist.

In our Summer 2013 issue, we revisited the issue of tax awareness. Our focus was to discuss the differences between static and dynamic tax efficiency. In this issue, we would like to return to the topic of tax awareness, but in a different way; we want to consider how exchange-traded funds (ETFs) can help enhance portfolio tax efficiency.

Classically, tax efficiency can be defined as the act of avoiding all unnecessary taxes and deferring unavoidable taxes. One of the important dimensions of this effort relates to the observation that any unrealized capital loss can be viewed as an option; more specifically, it is an option to take a realized capital gain elsewhere in the portfolio, now or at some future point in time, tax free. This is the foundation of the systematic tax-loss-harvesting process that several managers made popular in the 1990s.

Yet, after having been quite popular then, systematic tax loss harvesting seems to have lost some of its shine. Ostensibly, as clearly explained by David Stein in several of his writings, the efficacy of a systematic tax-loss-harvesting process is a direct function of the rate at which security prices rise and of the volatility around that uptrend. The higher the rate of price increase and the lower its volatility, the harder it is for systematic tax loss harvesting to be successful, after some initial time period. This is because the engine that allows systematic tax loss harvesting to operate is the ability of random volatility, around some central tendency, to generate occasional capital losses in certain securities, while others are earning unrealized capital gains. When markets rise quickly and in a semi-straight line, all securities in the portfolio soon find themselves having such significant unrealized gains that only major downward market price adjustments would produce losses, and these would not be likely to occur in a low-price-volatility environment.

Interestingly, one of the trends of the past several years—the proliferation of ETFs—may help managers who seek to manage assets in a tax-efficient manner. In fact, these ETFs are making tax-efficient asset management across most asset classes considerably more practical and potentially less expensive. ETFs can begin to offer the outline of a solution to managers because they can be used within an individual security portfolio to allow managers to benefit from underlying market volatility, without necessarily running into excessive transaction costs.

Over the past several years (with the past 18 months being a notable exception), broad market returns have been modest. In such an environment, tax efficiency is potentially less rewarding, if one believes that there must be a trade-off between security selection driven in part by a focus on tax efficiency and security selection driven by a search for value added, or alpha. Revisiting the issues fundamentally, we remember that the challenge created by taxes is that one pays taxes on both alpha and market returns; in contrast, the success of portfolio activity—and the risk of realizing thus far unrealized capital gains—is measured only by its security selection alpha. Thus, one can simply observe that whatever pretax alpha is generated by security selection must, in an after-tax context, bear the capital gains taxes associated with both general market returns and portfolio alpha.

In short, when market returns are low, one can generally argue that it is still possible to generate after-tax alpha: The tax penalty related to the returns on market performance is small enough to be virtually negligible. Over the past several quarters, market returns have climbed back into double-digit territory, thereby making it virtually impossible for all but a small cross-section of managers to be able to claim that they are able to produce after-tax alpha in a tax-oblivious manner.

Fundamentally, there are two dimensions in a tax-aware investment management process. Tax awareness can indeed be applied at the level of security, industry, strategy, or asset selection. In prior writings, I discussed the potential role of derivative securities in the execution of a tax-aware investment process, principally when one is focused on industry, strategy, or asset selection issues. These can be quite powerful in that they can avoid the pitfall of having to realize a gain when one is attempting to reduce exposure to an appreciated position: An initial futures position is indeed an opening rather than a closing trade, which therefore does not generate a taxable gain—or loss for that matter. Further, if appropriately structured to avoid straddle and other important tax rules, it may not create the need to recognize an unrealized gain in the underlying physical position. Yet, the main challenge with derivatives is twofold. First, they are complex and require a great deal of expertise. Second, they typically require substantial size, below which costs can be prohibitive, which is one of the problems that ETFs can help address.

The second dimension of a tax-aware investment management process relates to security selection issues. While systematic tax-loss harvesting has proven to be a relatively easy approach to execute, involving only minimal cost and position size requirement across many of the larger markets, it has also shown itself to be problematic in markets where transaction costs—including both commission and market impact—are high. Indeed, the key threshold before a tax-loss-harvesting trade is undertaken is that the anticipated tax benefit must exceed the round-trip transaction costs it will generate. This is the other problem that ETFs can help address.

Focusing first on security selection issues and addressing specifically markets with high transaction costs—emerging market equities in particular—one can consider building a portfolio in a somewhat different manner, to retain the ability to execute a measure of systematic tax loss harvesting. More detailed research is needed to validate this concept, and I am explicitly inviting research and article submission on this topic here.

The concept would be to construct a portfolio comprising a majority exposure to the main factor risks in the underlying index through individual securities; some minority index factor risk exposure—which research would help calibrate—could be retained through an index ETF. These typically are highly liquid and offer low transaction costs. Thus, assuming for an instant some individual security/index ETF exposure, one could benefit from random market gyrations by modifying the index position. For instance, in the case where price levels have fallen, one could realize a capital loss in the index ETF, replacing it with some combination of regional ETFs that would be significantly close to the overall index factor risk exposure and yet not give rise to tax straddle issues. Once the wash-sale rule period expires (in the United States, 30 days on either side of the trade), one can reinstate the original position, if doing so does not cause too significant of a capital gain. If not, one can maintain the regional position and potentially take advantage of uncorrelated cross-regional volatility.

A similar strategy can make sense as well, to deal with systematic tax-loss harvesting at the asset class or strategy level. Assuming one has an investor who does not believe that all assets should be indexed, one can still adopt both a tax-oblivious active security selection approach and some measure of tax efficiency by using ETFs for a part of the aggregate exposure to each asset class or strategy as and when appropriate. Then, one can leave alone security selectors and accept whatever level of tax efficiency they are assumed to have. The ratio between the two would naturally be driven by the degree to which one is willing to trade some active security selection alpha in exchange for a greater measure of tax efficiency at the total portfolio level.

Ostensibly, either of these techniques must first be thoroughly researched and vetted with one's own tax advisors. Individual circumstances are complex and varied, so it would not be prudent to deal in generalities. A specific analysis is required. The idea of using liquid, low-fee, and low-transaction-cost vehicles to enhance the overall tax efficiency of a diversified portfolio may well make sense, however, at least in all jurisdictions where capital gains are taxed.

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The Winter 2013 issue of the Journal of Wealth Management includes two articles that are substantially longer than usual. They both address issues that should be paramount for many of our readers. The first article in this issuer, by Robert Dubois, is one of the two long pieces. The article contrasts traditional portfolio optimization and its focus on minimizing the volatility of returns with an alternative method whereby risk management focuses on downside risk reduction. Most individual and family investors cherish this topic; their risk management efforts are indeed often focused on minimizing drawdown risks. Recognizing the existence of different payoff patterns and promoting a bucket approach to risk categories appears to be an original idea, making this article important. It would be interesting to take the idea a step further by combining the author's insights with behavioral finance and goal-based wealth management to see whether they can indeed lead to the next iteration of strategic asset allocation approaches in the wealth management world.

The next three articles explore various dimensions of the strategic or policy allocation process. The first, by Jacek Niklewski and Keith Redhead, examines the issue of time diversification. Postulating that time diversification is one factor that ameliorates the long-run risk of stocks, the authors conclude that equities become less risky as the investment horizon extends only for a medium-risk portfolio, such as an index fund. They also argue that it may even be the case that a balanced fund (equities and bonds) has more time diversification than a 100% equity fund. The next piece, by Steven Cosares, introduces a model for an approach to financial planning whereby investment decisions over time follow a (decreasing) glide path. One must accommodate varying objectives among investors; specifically, the model incorporates a parameter for "glide-path intensity," which allows the investor to select the level of deviation from the risk-minimizing solution, which would minimize the risk of missing a goal. The final piece in this trio, by James Chong and G. Michael Phillips, evaluates several low-volatility portfolio strategies to identify the return penalty, if any, associated with increased downside safety for total portfolio values. The authors conclude with practical suggestions for wealth managers about incorporating low-volatility methods into their practices.

The next two articles relate to investment decision implementation. The first, by Aymen Karoui, analyzes the response of the asset allocation process to fund performance and broad market conditions as well as the market determinants of fund flows for hybrid funds. He concludes that managers increase their stock allocation and reduce their bond allocation subsequent to periods of out performance; stock allocations are positively correlated with past stock returns and negatively correlated with bond returns; and fund flows react favorably to an increase in stock and bond returns, while high-stock fund flows exhibit a higher sensitivity to stock returns. The second article, by Andrei Reztsov, presents an adaptive and quantitative approach for the ranking of investment funds by fund-of-funds managers, in order to help managers allocate capital between funds when the available information/data is limited.

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The next two articles, focusing on commodities, are very topical. The first is the other lengthy article, by George Crawford, Jim Kyung-SooLiew, and Andrew Marks. It discusses the use of spot commodities as inflation protection and concludes that inflation hedging with physical commodities is difficult, risky, and ultimately unreliable. After examining 53 years of spot prices for 45 commodities and 14 commodity aggregate indexes, the authors find that owning certain things—specific commodities—rather than dollars would have been a better storehouse of value in the inflationary 1970s and in the brief period of high inflation in 1989–1990. The second piece, by Haim Mozes and Serge Cooks, is equally thought-provoking, delving into the disconnect between gold prices and the demand for gold, and concluding that increasing physical gold demand does not imply higher gold prices.

Our next article is the most recent installment in the series by Olivier Mesly and his work on financial predation, which the author extends here to analyze how blind trust can lead small family-owned businesses to be duped by dishonest predator employees. Our final piece is a review by Greg Gregoriou of *The Complete Guide to Hedge Funds & Hedge Fund Strategies* by David Capocci.

Jean L.P. Brunel
Editor