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Even if totally dispassionate, any observer of our industry will have noted that the focus placed on tax-efficiency by investment managers has sharpened dramatically over the last five years. This is excellent news, to the extent that it should provide more suitable alternatives for investors who must worry about the impact of taxes on the management of their assets, very large or simply modest. At the same time, it is also fair to say that the term "tax-efficiency," or any of its variants, seems to be used in a variety of ways, with little formal effort to define it. Thus, tax-efficiency can mean many things to many people.

The Institute of Private Investors has, commendably, proposed to create certain standards and their first emphasis has been applied to the calculation of the tax-efficiency of a portfolio. It is defining it as the ratio of after- to pre-tax return. Similar efforts are badly needed with respect to investment processes. For instance, one can indeed identify at least seven potential different approaches to the management of a large capitalization equity portfolio:

Tax-oblivious: a process where taxes are not taken into consideration at all when making investment decisions.

Tax-managed traditional process: a process where portfolio construction rules provide for some focus on tax-loss harvesting around year-end and where lot accounting is based on the High Cost First Out approach (with or without a further focus on short- versus long-term gains/losses). Security selection and portfolio risk management processes would however still be tax-oblivious.

Goal-based tax-efficiency: a process where security selection is driven by the goal of seeking stocks in companies with demonstrably superior long-term prospects (a longer expected holding period means that the realization of taxable capital gains in the interim will be limited). Portfolio construction and risk management rules, however, do not explicitly focus on taxes, such that there is no explicit effort to harvest losses, for instance.

Screen-based tax-efficiency: a process where security selection and portfolio construction rules incorporate an explicit focus on taxes. The security selection process starts with a series of contemporaneous or sequential screens designed to identify stocks which are more likely than not to be held for the long-term or to offer exceptional

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current value. Once that new, smaller universe is created, security selection and portfolio construction rules are usually non-quantitative, but still involve loss harvesting and HIFO lot accounting. Usually, risk management does not incorporate a tax dimension, so that portfolios may, for instance, still have exposure to tax-inefficient sectors.

Systematic tax-efficiency: a process in which security selection, portfolio construction and risk management are built into an expert system which drives the portfolio management process. The expert system continuously scans the portfolio, a target portfolio (representing the manager's best current ideas) and a universe of alternative stocks. It then recommends transactions which will simultaneously minimize the tracking error between the portfolio and its target, between the portfolio and its benchmark and net realized capital gains. The major weaknesses of this approach are that the target portfolio construction process is often tax-oblivious and that it still considers a pre-tax benchmark (a market index, for instance) as relevant. Thus, portfolios managed through this approach often incorporate stock or sector exposures which can be significantly tax-inefficient and, which in the context of a broader balanced or diversified portfolio, are not really needed.

Passive structured process: totally different in nature, this process eschews security selection as a means of providing value added, but rather focuses on active tax management. In effect, using a sampling approach to mimic the behavior of a chosen index, the manager systematically and continuously scans the portfolio for opportunities to harvest tax-losses while remaining within a set tracking error relative to that underlying index. In short, rather than incurring tracking error to generate security selection alpha, the manager incurs tracking error to yield tax-efficiency. These systematic losses are used either within the portfolio to raise the tax basis of each holding (and thus eventually reduce any capital gain tax cost associated with a liquidation of the portfolio) or outside of the portfolio to help enhance the tax-efficiency of the investor's total asset base (as it may involve other portfolios explicitly managed in a tax-oblivious manner).

Integrated tax-efficiency: arguably still somewhat of a pipe dream, one could envision a process combining the best of all the approaches discussed earlier. The process would probably be based on an expert system which would scan a universe of securities scored for

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their long-term after-tax return potential and otherwise function in the same manner as the passive structured approach, with a benchmark selected with long-term after-tax wealth building in mind. With securities thus effectively prioritized in terms of their potential, the system would seek to produce value added both from systematic loss harvesting and by picking as "good" as set of stocks as possible given all other considerations.

Beyond seeking clarification in terms of each individual investment process, one should probably further focus on issues such as the construction of an overall balanced portfolio. This is, however, a different topic which deserves its own focus and will thus be covered in another issue.

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This Winter issue of the *Journal of Private Portfolio Management* really contains two main themes: strategic asset allocation and location on the one hand, and investment policy, on the other. Our first article, however, does not fall into either of these categories and yet is particularly interesting. Hayes highlights the major forces at work that are shaping how Baby Boomers are responding to retirement planning and articulates a new paradigm that is faced by many professionals in the financial planning industry.

The article by Reichenstein is the first in a series of four articles in which he will cover the main aspects of the issue of asset location. In this first article, the author introduces the whole study and focuses more sharply on the question of which saving vehicle one should select for the retirement portion of one's assets. Bortnick, Cohen, and Jacob retain the focus on asset location, or vehicle selection, as they discuss private placement variable life insurance and annuities, and how they can be used as part of an overall long term investment strategy. Blazzard and Stone also look into the same topic, though their focus is placed on a potential structure which would allow asset managers to wrap all or at least many of their investment products in a vehicle designed to enhance their tax-efficiency.

The second group of articles discusses three important issues associated with the formulation of one's investment policy. Welch presents an alternative to the well-known short-against-the-box

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approach, illustrating the imperfections associated with that strategy and showing why an investor who entered into such a transaction prior to June of 1997 on a stock that has continued to appreciate is better off unwinding it and re-hedging using a different hedging strategy. Cunningham and Fender revisit the issue of active versus passive investing and show that the odds of beating the S&P 500 on an after-tax basis over the last twenty years were seemingly not particularly attractive. Finally, Garland looks into a different topic, updating previous findings on spending rules, or the way on which trustees of endowments and foundations decide how much they can prudently spend given the size of their funds and the return on these assets.

In closing, I would like to welcome four new members to our Advisory Board: Steven Albrecht, Terence E. Burns, Sidney Dickstein, and Sandra L. Manzke who have all either already contributed to our Journal or have provided many critical insights over time. I look forward to benefit even more from their support, as authors, reviewers, or simply sources of great ideas.

**Jean L.P. Brunel**
**Editor**