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Quite a few years ago, I started to work on the question of the role of derivatives in enhancing the tax efficiency of an investment program. Honesty forces me to admit that little progress has been made on that front, as the "big D word" is still perceived by most people as something that should not be mentioned in polite company. Yet the original idea and, more important, the fundamental insight behind it still seem both intellectually valid and practically reasonable.

The main insight underpinning the proposal is that traditional management conducted solely through physical securities is fundamentally tax inefficient. Indeed, the sequence of events describing a typical investment process, when implemented in a traditional manner through physical securities, requires the investor to realize a capital gain *and* pay tax on it *before* knowing whether the investment idea that led to the trade was among those that works out. This is relevant as investors typically find that their ideas are wrong a significant percentage of the time. Thus, investors who carry out trades as we envisage them here will frequently pay taxes for the privilege of making a poor decision. And the process does not even stop there!

Indeed, having recognized that he or she made a poor decision and thus desirous to unwind the trade, our investor may still have to pay additional taxes. This is so because a poor trade does not necessarily mean a trade where one loses money. A trade that underperforms some benchmark fits the definition of being a "bad" idea and yet it can lead to some unrealized capital gain accumulation. Thus, our investor is caught both coming and going and may have to pay taxes a second time to get back to square. It is not surprising then for us and many others to note that traditional active management may be doomed to failure or that if it is not, it has to be a really difficult endeavor.

My original solution to this quandary effectively involved suggesting that one should differentiate between two distinct decision axes: security selection and asset allocation. In a traditional setup, these two axes are subsumed into one, as any asset allocation decision is implemented through the purchase or sale of individual securities. In this new design, these dimensions are handled individually. A critical premise is indeed that security selection, whether managed with a view to add security selection alpha or to perform active

THE JOURNAL OF
WEALTH MANAGEMENT

tax management, should not be endangered by asset allocation shifts. Thus, asset allocation shifts might be executed through some form of derivative contract, say an index future or a total return swap. This allows one to change the order of the four steps of the investment process, which, in a physical transaction, are as follows:

1. having an investment idea
2. executing the security purchases and sales required to implement the idea—noting that assuming the slope of the capital market line is positive (or, in plain English, that returns are positive over time), such a trade probably means realizing some hitherto unrealized capital gain
3. paying the capital gains tax associated with the trade
4. praying . . . because one does not know at that time whether the trade will be successful

A derivative-implemented asset allocation trade allows one to invert the order of the last two steps. Indeed, the sale required in step 2 can be executed through an opening trade involving shorting an index futures contract, while the purchase simultaneously required can be executed through the establishment of a long index future position. Note that these can be combined into one through the creation of a total return swap. This means that in either case one does not need to realize a capital gain at the time the trade is put on and thus that paying any capital gains tax is deferred until one has had the opportunity to see whether the trade was successful. Arguably better yet, an unsuccessful trade therefore does not involve some initial tax implication and might result in some capital loss if it is not successful and its execution was carried out through a total return swap.

The main issues associated with the use of derivatives have always been the fact that these trades are typically "lumpy" and that it is difficult for many who are not investment specialists to understand the transaction, its implications, the new risks it involves, and the administrative tasks required both to book the trade and to account for it and its associated cash flows on a continuing basis. Add to this the psychological issues associated with "derivatives" and the need to manage the nature of the indexes chosen to avoid being caught in the net of constructive sales, and one understands why this approach has not had any significant success.

Over the past several years, however, the creation and proliferation of exchange-traded funds—ETFs for short—has changed the landscape. ETFs should allow investors to follow the principle underpinning our suggestion without needing to resort to the use of derivatives. Indeed, these funds, usually designed to mimic the behavior of some underlying index, make it possible for investors to begin to think along the differentiated axes we believe are crucial. Consider, for instance, the investor who wants to shift 10% of his or her portfolio away from U.S. equities and toward Japanese equities. It is possible first to execute the trade without being required to pay capital gains taxes until after that trade is unwound. The sequence of events would look as follows:

1. identify a U.S. equity index that is both sufficiently close to the current portfolio to minimize basis risk and yet is sufficiently different such that selling that index short would not be construed as a constructive sale
2. sell short the appropriate dollar amount of the ETF designed to mimic that index's behavior
3. use margin to buy the appropriate amount of the ETF designed to mimic the behavior of the chosen Japanese equity index

In such a trade, the overall portfolio's asset allocation will thus be in line with the investor's new desires without there having been any need for our investor to upset the management of that U.S. equity portfolio or to realize capital gains within the U.S. equity portfolio as he or she reduces the portfolio's exposure to that asset class.

At the time our investor decides that it is no longer a good idea to have that additional Japanese equity exposure, he or she can simply unwind the trade, covering the U.S. equity ETF short sale and selling the long position in the

THE JOURNAL OF
WEALTH
MANAGEMENT

Japanese equity ETF. At that time, and at that time only, will there be any need to consider paying taxes on any capital gain realized on the trade. Note that it is even possible to begin to think of strategies that would allow that capital gain to be deferred in exchange for some further basis risk.

This kind of strategy can be developed into a myriad more complex alternatives to deal with a number of potential investment situations. I am currently conducting research on the topic with a particular focus on the diversification of low basis positions and would like to invite practitioners as well as members of academe to consider this broader topic of the use of ETFs and derivatives in tax-efficient portfolio management and also to submit research papers on it. Indeed, the more we all focus on this topic, consider the pros and cons, and evaluate the implications, the more likely we are, as an industry, to find ways to help our clients, those wealthy individual investors who need us to keep helping them, to keep more of what they make.

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This spring 2006 issue of *The Journal of Wealth Management* focuses in particular on broad investment policy issues, although we also consider a few asset management strategies. Steve Braverman discusses the impact of the Uniform Prudent Investor Act (UPIA) and the Revised Uniform Principal and Income Act (UPAIA) on the duties and responsibilities of trustees. Then, Cris Lewis and Frank Caliendo revisit the important question of tax-deferred retirement saving, by measuring the pure gains from intertemporal shifting of taxable income. We conclude this first section on theoretical issues related to investment policy formulation with an article by Brian Jacobsen, who considers the use of downside risk measures in tax-efficient portfolio construction and evaluation.

The next three articles are dedicated to portfolio construction and management methods. First, Paul Kaplan considers the issue of using annuities to execute asset allocation for retirement income management. Then, Donald Mulvihill offers the second part of his article on core and satellite portfolio construction, focusing this time on implementation issues. Finally, Bill Martin discusses an important new development in the industry: the use of overlay management techniques in the context of both mutual funds and traditionally managed assets.

Our final three articles delve into more specific investment management issues. First, Paolo Sassetti and Massimiliano Tani discuss dynamic asset allocation using systematic sector rotation. Then, Greg Gregoriou looks at commodity trading advisers, investigating whether the size of funds affects performance. Finally, Mark Schaub evaluates the short-term investor wealth effects associated with NASDAQ-traded American depository receipts, with a particular focus on emerging, developed, and regional market issues.

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