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It's time to get more tax-efficient.

December 8, 2020

The outcome of the Senate races in Georgia will influence whether we see changes in tax and capital gain rates. But employing a smart tax-aware strategy can make sense either way.

One way to make a big difference to a portfolio's total return is to have a tax-aware investment strategy. And in an environment where taxes on capital gains and income may head higher, it's even more important to figure out how to minimize the impact on portfolios. In general, taxes can be minimized by three broad approaches: vehicle selection, asset allocation and manager selection. But without the tools to implement all three approaches, constructing a tax-aware strategy for clients can be challenging — and may underdeliver on clients' needs and goals. Model portfolios with an intentionally tax-efficient approach may be a solution.

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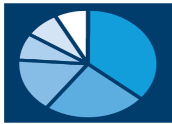
Components of a tax-aware investment strategy

VEHICLE SELECTION
Relative to mutual funds, advisors might be able to harvest losses with tax-friendly vehicles like Separately Managed Accounts (SMAs) and Exchange-Traded Funds (ETFs) when opportunities present themselves. This can give advisors greater control over a portfolio and even provide more ways to personalize it.



ASSET ALLOCATION
Some asset classes are inherently more tax-efficient. Using assets like municipal bonds can provide tax-exempt income for clients in higher tax brackets.

MANAGER SELECTION
Low turnover means fewer taxable events. For example, a manager can make meaningful shifts to a portfolio when it makes sense strategically and only when it's truly warranted.

Some asset classes are inherently more beneficial for investors concerned about taxes. Municipal bonds can provide tax-exempt income for investors in high tax brackets. And investing in muni separately managed accounts can provide customization, which may be important for clients living in high-taxation states.

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ETFs often have fewer and smaller capital gain distributions than mutual funds because ETFs redeem shares with in-kind distributions of securities, while mutual funds generally sell securities to meet larger redemptions, which triggers more capital gains and losses.

Perhaps the most complicated aspect of managing tax efficiency is analyzing the trading patterns of the asset managers in a given portfolio. Are they thoughtful about capital gains and losses? Are they seeking to control the overall number of taxable transactions? “Managing turnover is a simple but powerful way of managing the tax experience for an investor,” explains Joshua Kutin, Head of Asset Allocation, North America, at Columbia Threadneedle. “The fewer times that you trade, the fewer taxable events you create. It’s important to only trade when it’s a high-conviction idea.”

Implementing an integrated tax-efficient approach can be complex. But a model portfolio constructed with explicit tax awareness can be a comprehensive solution to delivering tax efficiency — or a complement to a broader tax-efficient asset allocation strategy.

Bottom line:

Managing portfolios for tax efficiency is almost always beneficial for investors, but implementing a holistic approach can be complicated. For investors and advisors, model portfolios may be a way to implement a sophisticated and tactically integrated tax-efficient approach.

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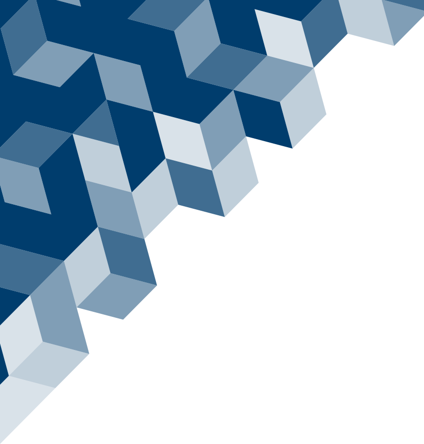

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