Why embrace tax-loss harvesting as a valuable investment strategy?

Behavioral finance teaches us that investors feel the pain of loss three times more than they feel the euphoria of a gain. In fact, behaviorists believe people are much more loss-averse than they are risk-averse. Study after study has shown that faced with a strong probability of a loss, investors will invariably take on additional risk, just to have a chance at avoiding that loss.

Given this predisposition, it's hardly surprising that most investors express a healthy skepticism at the idea that losses can positively contribute to portfolio returns. But for taxable investors who can set aside the contradictory nature of this concept, tax-loss harvesting should be just as welcomed a technique as buy low and sell high.

In this paper we'll explore five unique approaches to tax-loss harvesting.

Five ways to reap the benefits of tax-loss harvesting

1

Integrate your tax-loss harvesting efforts with those of your clients and their tax advisors.

Too often clients and advisors compartmentalize tax-harvesting activity. Your clients may have their own brokerage account, use different advisors or have spousal assets and activities that could impair desired tax results. For example, joint filers combine gain and loss results on a single filing. It's often recommended that financial advisors engage the entire family and their tax representatives to look holistically to forecast potential for taxable gains and develop mitigation strategies if necessary.

2

Consider harvesting losses throughout the year.

For most investors, tax-loss harvesting has traditionally meant trying to find a loss within their portfolio at the end of the year to offset a capital gain, thereby reducing capital gain taxes they would have to pay for the calendar year. However, this simple method has been largely hit or miss over the past 30 years, as shown in the tables on the next page. And in fact, going back to World War II, nearly 80% of the time the market (whether defined by the Russell 3000 or the S&P 500) has experienced positive returns in December.

One approach to deriving more tax alpha is to harvest losses throughout the year, because harvesting opportunities can be fleeting. For example, in 2009 the Russell 3000 Index was down nearly 19% in the first two months of the year, yet it finished the year up more than 28%. If you waited until the end of the year to harvest losses, options were more limited, as 86% of the index constituents were up.

Don't wait until December to harvest losses.

Exhibit 1: Russell 3000 distribution of monthly returns (01/01/80–08/31/22)

	%+	%-
January	58	42
February	58	42
March	65	35
April	70	30
May	70	30
June	60	40
July	51	49
August	60	40
September	50	50
October	64	36
November	74	26
December	74	26

Source: Russell Investments as of 08/31/22.
Updated annually.

Exhibit 2: S&P 500 distribution of monthly returns (01/01/80–08/31/22)

	%+	%-
January	58	42
February	60	40
March	63	37
April	72	28
May	70	30
June	60	40
July	53	47
August	58	42
September	48	52
October	64	36
November	71	29
December	74	26

Source: S&P 500 as of 08/31/22.
Updated annually.

3 Be mindful of wash sale rules and activity that could work against your tax-efficient goals.

Wash sales occur when shares are purchased within a 61-day window of shares being sold at a loss. The sale date is the middle day and the other 60 days are divided into the 30 days prior and the 30 days after the sale. The sale and purchase of substantially identical shares in this 61-day window will trigger a wash sale.

For example, if shares are sold at a loss on May 31, the time frame for a potential wash sale to occur is from May 1 to June 30. When a wash sale occurs, the loss from the shares sold is disallowed.[1]

Any combination of purchase and redemption type transactions can cause a wash sale:

- **Purchases** include direct purchase via check or bank account, automatic investment plans, reinvested earnings (capital gains and/or dividends) and incoming exchanges.
- **Redemptions** include direct redemptions via check or to a bank, systematic withdrawal plans, outgoing exchanges and possibly payment of some fees or tax withholding.

Events that don't cause a wash sale include incoming or outgoing transfers, account re-registrations and fund mergers.

[1] The loss amount is then added to the basis of the shares purchased (replacement shares). The loss will not be realized until these replacement shares are sold. Wash sales cannot occur on a full liquidation of shares unless the shares are repurchased within the time horizon for the wash sale, or the same shares are purchased in a different account within that time horizon. The IRS expects shareholders to make their own wash sale adjustments if the same security is held in different accounts and a wash sale is triggered based on activity in those accounts.

4 Be thoughtful about how proceeds from loss-harvesting transactions will be managed during wash sale periods.

Program sponsors may offer different practices or options when tax-loss harvesting in separately managed accounts (SMAs). Most sponsor platforms will facilitate trading to generate losses at their discretion, to reach a requested target loss dollar amount, and will systematically avoid purchasing back into those securities within 30 days so wash sales are not triggered. Advisors and clients should be aware of and thoughtful about this 30-day window. The investment approach will be altered for this short period of time and the impact will vary depending on the size of tax-loss harvesting transactions.

Sponsor platforms have recognized the potential investment impact during the wash sale period, and it's common to offer a choice of keeping proceeds in cash or investing in an exchange-traded fund (ETF) to maintain market exposure. Additionally, most sponsor platforms have a process to automatically rotate back into the SMA's holdings on the 31st day after the sale to restore the account.

Each platform has different processes and procedures around tax-loss harvesting, so it's best to consult with your firm's operations or managed account specialist team for assistance.

5 Take a multiyear approach and monitor the impact of harvesting routines.

Participating in your client's tax planning can lead to long-term client satisfaction that translates to referrals and introductions to potential new clients. A financial advisor's ability to add value is a multiyear proposition. Different levels of loss harvesting exist in different market environments and even in similar market return environments.

Obviously, down markets create ample opportunity to harvest losses, but not all up or down markets are the same. There are times when markets become narrowly driven. For example, consider the scenario in which a handful of large stocks in the index move up while many other stocks in the same index move down. This can create more opportunities to harvest losses than otherwise possible in a broader market, where most stocks are going up with similar returns.

Finally, when it comes to managing for tax impact, market timing is not essential for success. A correct fundamental call about the market direction is not needed to benefit from loss harvesting. Each loss harvesting path may be different, but different tax-loss harvesting experiences may lead to a beneficial end:

- **If loss harvesting meets or exceeds expectations**, then in most cases excess capital losses can be carried forward by the individual to future tax years — first offsetting capital gains of the same tax character, then capital gains of a different character, then offsetting up to $3,000 per year of ordinary income, and any remaining losses carry forward again.
- **If loss harvesting fails to meet expectations**, then the portfolio's market value will have increased meaningfully.

Bottom line

Tax-loss harvesting is a tool that can help many investors relieve the impact of taxes and help them keep more of their wealth. For financial advisors, it can help validate your value proposition and drive client satisfaction, retention and referrals.

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*Source: Columbia Threadneedle Investments as of June 30, 2022. Updated annually. Contact us for more current information.

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