ABR Dynamic Funds' Portfolio Construction Series: Part 10

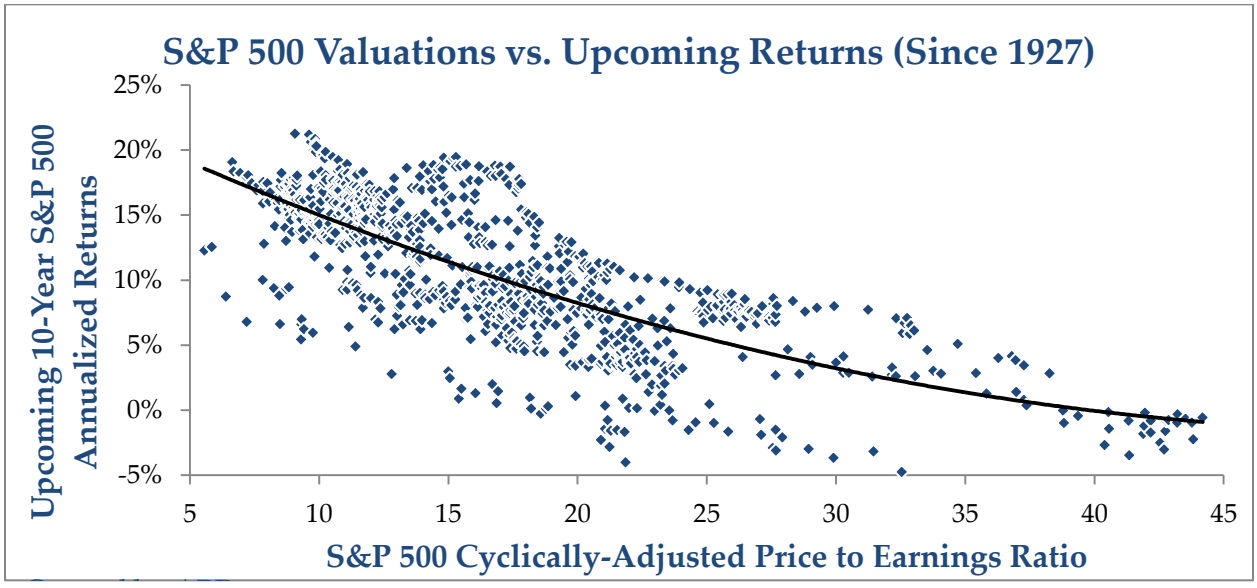
Timing capital gains taxes is the same as timing the market

With nothing but respect for Tax Professionals, we must admit that it isn't easy to make this topic interesting, so we did the next best thing and kept this installment short. It may still be worth a read for those who have considered tax loss "harvesting" or who aren't invested in what they consider to be an ideal portfolio in order to avoid realizing gains and paying taxes. There is one quick caveat before continuing: this installment deals only with investment timing decisions, given a fixed tax rate, not with the potential consequences of anything that might alter the effective tax rate.

Some investors make investment timing decisions based on tax consequences related to the decisions. That includes investment decisions on the overall portfolio level and, especially, investment decisions made when looking through the portfolio to "harvest" tax losses. This effort is misguided and often detrimental. First, it's worth explicitly noting that paying taxes does not change an investor's NET worth at all. Net worth is net of all liabilities, including tax liabilities. Investors who simply look at the value of their portfolio have, on occasion, overlooked this fact. Furthermore, the effort to minimize capital gains tax consequences (again, just through investment timing) is misguided. The government claims a percentage of capital gains. The government takes more when investors make more. From that perspective, **the *highest* possible capital gains taxes over time would indicate the best net results for investors.**

Minimizing taxes through the timing of investments isn't just misguided; it may actually be detrimental to investors. Because the government claims a percentage of the gains, timing taxes is timing the market, and minimizing tax bills is minimizing gains. **In other words, avoiding tax bills when tax liabilities are higher means not de-risking when the market is higher, and realizing tax bills when they are lower means selling when the market is lower. Of special importance is that the same logic often applies when investors go through a portfolio component by component looking for tax losses to "harvest." Many individual investments exhibit mean reversion too.**

The following graph is one illustration of the mean reversion in the S&P 500. It shows the S&P 500 valuation (cyclically-adjusted price to earnings ratio – CAPE) on the X-axis versus the annualized S&P 500 return over the next 10 years on the Y-axis for each month* going back to 1927. The key feature is the downward slope. Higher decade-long returns have tended to follow periods when the S&P 500 was valued lower, and lower decade-long returns have tended to follow periods when the S&P 500 was valued higher. In other words, the S&P 500 has been mean reverting, and so have a number of other investment strategies.



Data Source: http://www.multpl.com/

Thus far, we have argued that incurring tax bills does not affect net worth and that minimizing tax bills through the timing of investments may be detrimental to long-term results. We will wrap up this installment by quickly noting that, in fact, it may make sense to incur a tax bill in order to rebalance into a better portfolio. Given that it has no effect on net worth, the main objection posed to this assertion is that there is a compounding effect from growing a larger pool of capital. However, this objection makes no meaningful difference in most cases:

As a hypothetical example, consider a portfolio which is half principle and half gains, and assume the gains are subject to a 20% tax liability. In other words, the government claims 10% of the total portfolio. Liquidating fully 20% of the portfolio in order to facilitate a sizable rebalance would incur only a 2% tax bill, leaving 18% of the portfolio available for a rebalance. **So long as an investment can be found for that 18% of the portfolio which increases the overall portfolio's expected return by just 0.011% per month (a mere 13 basis points per year), paying the 2% tax bill results in a greater expected net worth for the investor after just the first month.**** The better expected return immediately overcomes the larger pool of capital.

*It is worth noting that the independent sample size is considerably smaller than 12 months * 80 years = 960 data points. Because the returns are 10-year returns, each successive monthly data point carries a great deal of overlap with the previous data point (9 years and 11 months of overlap).

**Using typical long-term core returns of 6-7% for the portfolio.

Next Week's Preview: Typical option "collar" overlays are worse than just selling the holdings they overlay.