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# Tax-Aware Investment Management

**C**onsciously designing and managing equity portfolios around each individual investor's risk profile and tax situation is what separates Advisor Partners from typical money managers. As a separate account manager, the firm builds and manages custom tax-managed, index-based equity portfolios, exclusively for the benefit of the clients of other advisors.

**Q:** *What is the investment philosophy of the firm?*

**A:** We are a separate account manager that builds and manages custom tax-managed index-based portfolios, exclusively for the clients of other advisors. We do not work directly with retail clients. We are often hired as a sub-advisor by wealth managers and independent financial advisors. We focus on customizing portfolios for each individual client situation. We are very aggressive about managing around a particular person's tax situation, and this is something that separates us from other money managers. We have close to \$200 million dollars of assets under management. Our minimum account size is \$500,000 and our average account size is about \$1.5 million.

**Q:** *An ideal client would be a partner in an accounting firm or law firm or an executive at Fortune 1000 company?*

**A:** We have one team of advisors as clients who were formerly with a "big five" accounting firm. They had an interest in our managing a tax-managed equity portfolio, but they wanted it designed so that it had as little as possible to do with their corporate executive client's industry. The executive's company is publicly traded, so we built a portfolio that would exclude their stock but also exclude their industry, Information Technology. Our job is to manage the portfolio's return to be close to this customized benchmark. At the same time, we seek to earn an even higher after-tax return through the ongoing harvesting of tax losses. The realized losses can be used to reduce the client's overall tax bill, which to them is as good as portfolio performance. So, the work that we're doing is customized to the advisory firm which designs the client's overall portfolio, but the customization of the benchmark and when and how we

trade the portfolio is specific to this individual client.

**Q:** *Does that mean that you end up customizing each and every portfolio for each and every client of an intermediary?*

**A:** Yes. We are built for what's known as mass customization, more like one client at a time. You'll find that 85 plus percent of all SMA portfolios are not managed on a custom basis. We're building portfolios designed to replicate a standard or customized index. We're not promising out-performance due to either sector rotation, fundamental stock research or market timing. The reasons advisors hire us are the same reasons they might invest in an ETF or an index fund. The advantage we offer is that the portfolios can be customized and not just be tax-efficient, but actively tax-managed. Unlike a fund, we can pass through realized tax losses to each client.

**Q:** *Why don't more SMA managers follow this approach?*

**A:** A lot of the SMAs are being sold to help brokers move from a commission to a fee-based model. It's very efficient for an active manager to run large model portfolios, and there's a natural inclination for an active manager to avoid customization. If an active manager's investment committee or portfolio manager believed that a particular stock, for example, Intel, is going to wildly outperform and that their track record is dependent upon a heavy concentration in that particular stock, they're not going to be very interested in excluding that stock because the client already works for Intel or some other company who's stock is highly correlated to Intel. They're not going to be very interested in harvesting Intel at a loss because the active manager believes Intel is about to go up any minute. Not holding the stock in the portfolio would adversely affect the portfolio manager's track record which in turn hurts their ability to garner more assets.

As an index-based manager, we're agnostic about individual security selection and therefore have no tension in running a custom portfolio. We don't have a track record of out-performance that we're trying to deliver that gets in the way of giving the client what they want in terms of customization and tax management. Active managers do.

**Q:** *So investment goal or client goal-driven portfolios are what you are trying to design?*

**A:** We can replicate a multi-disciplinary account if that's what

somebody wants done. Let's say you as an advisor have a heavy bias towards mid-cap growth which is what you'd want to achieve by design and you'd want to under-weight large-cap growth. In a multi-disciplinary account you're picking managers for each of those asset classes and giving them a specific portion of money to manage so that overall you end up with a portfolio that's biased towards growth in mid-cap and away from large-cap. We take the indices that underlie all of those styles and the weight that you want and that creates a custom benchmark for the client. So you've got the style management without the higher active management fees, and with much more thought about what the client might need from portfolio or benchmark customization or tax management.

**Q:** *Are the investment vehicles that you use to invest in mostly index funds or ETFs, or do you do actual stock picking?*

**A:** We build index portfolios using individual stocks, but we're not stock pickers. Everything is done with stocks because that allows you to replicate the benchmark that you're trying to achieve and at the same time it gives you the best opportunity to do tax-management. Tax-management means detecting and realizing a loss in a stock for the client, and replacing that stock sold at a loss with another "similar stock" to achieve similar tracking to the client's standard or customized benchmark.

**Q:** *Generally, in how many indexes do you end up investing?*

**A:** Our most popular mandates are the large-cap and all-cap equity indexes, like Wilshire 5000 or S&P 500 or Russell 3000, 2000 or 1000.

**Q:** *Comment on certain relationships that have worked well.*

**A:** We have a relationship with a wealth manager at a large Wall Street wire house. His focus is in serving the Fortune 100 executives here in the U.S. For some of those executives, the company that they work for has asked that the executive not sell the stock or sell the stock short or to even hedge the stock for fear that stock might get sold or shorted. In that circumstance, one of the strategies the broker has employed is using Advisor Partners to build an index portfolio that excludes the stock of the company the client works for and the several dozen other stocks in the index that might as well be that same company – in other words they're highly correlated.

**Q:** *How do you go about building strategies based on indices or indexed portfolios?*

**A:** We depend on the advisor to know their client and to come up with a strategy that reflects their firm philosophy as well as the client's circumstances.

We have one client who is in retirement. The advisor picked a value benchmark and we're being asked to not reinvest dividends while we are being asked to harvest losses. That client's tax situation is such that instead of being at the maximum federal rate, they are closer to the min-

imum. In that instance it's the advisor who has their hands on the dial in terms of how they want this done, but we're actually getting it done. So they are the strategists and we are the executors.

It is important to make the distinction between tax-efficiency and tax-management. Tax-efficiency is seeking to minimize the damage from taxes. It's a good thing to do and you'll find mutual funds and ETFs spend a lot of time focusing on it. They do it by avoiding the realization of gains, or if they must realize a gain, trying to offset it with a matching loss. If they can't find a matching loss, they try to age the gain so that it is taxed at long term rates rather than short term rates. What they're trying to do is pour as much of their pre-tax return over into their after-tax return. A fund can discourage capital gains to the clients, but it can't give the client a realized loss. So at best, a co-mingled vehicle would deliver all of its pre-tax return as after-tax return.

However, with an SMA you can get active tax-management. With tax-management, you undertake everything that you undertook in tax-efficiency – avoiding the realization of gains, matching gains with losses, or aging gains to long term – but on top of that, you can realize and pass through losses that the client can use to offset gains elsewhere in their financial life, and to a limited extent income. When you take into account the tax savings earned through the realization of net losses in the separately managed account, it's like capturing added performance.

For a tax-managed portfolio, the after-tax return can be as high as, or higher, than its pre-tax return. In

terms of quantifying how much higher, it's going to have a lot to do with each client's situation. For example, the higher the client's marginal tax rate, the more benefit these losses have.

The amount of losses realized in a given year has to do with when and

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about

Jim Blachman

**Jim Blachman, CFA** is Chief Investment Officer. Jim heads Advisor Partners' investment management team, and is responsible for all client accounts. Jim has served as head of two RIAs and has developed and managed complete investment programs including internet-based optimization/advice engines, asset allocations, security research and selection, trading, operations and reporting. His career spans over 20 years in the industry, including quantitative research, consulting, sales management, product development and investment management. Jim attended the University of California, Berkeley earning both Masters and Bachelors (with distinction) in Economics emphasizing econometrics and industrial organization.

how a portfolio is funded. Funding with cash typically gives you the most loss harvesting opportunities. Funding with existing basis tends to restrict your ability to realize future losses unless you have large unrealized losses in the portfolio at inception.

More volatile stock markets are better for loss harvesting than less volatile stock markets. Finally, loss harvesting is dependent on the chosen portfolio benchmark. Including more volatile small cap stocks, for example, will typically mean more loss harvesting opportunities than a more narrow large cap S&P 500 portfolio.

**Q:** *Do you think that minimum account size that you have is too small to provide customized services?*

**A:** We enjoy a smaller number of high quality relationships with wealth managers and family offices. With a single point of contact we may efficiently accommodate as many as 30 or 40 clients with \$1 million each, with a single relationship interface.

**Q:** *Do you generally have an overlay of a fee on top of the other fees that you charge?*

**A:** By virtue of our being a passive manager, our fee is lower than an active manager's fee. Many of our relationships hire us without the use of an investment platform or overlay manager charging their fee. The advisor or the family office can hire us directly through one of the major open custodian platforms, as opposed to working with multiple money managers at smaller dollar amounts through advisory platforms. ■

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