BNY MELLON
WEALTH MANAGEMENT

Tax Efficiency: Effective Strategies for the Short Term

At BNY Mellon Wealth Management, our approach to wealth management is to utilize the best practices of institutional investors (pension plans, endowments, foundations, etc.) for individuals and families. Drawing from our years of experience, we have developed five practices to promote long-term financial success: investing to maximize compounding; borrowing strategically; spending dynamically; managing taxes; and protecting legacy. We call this framework Active Wealth, and it's designed to build and sustain wealth across generations.

An important part of maximizing wealth in the coming decade will be managing and mitigating the cost of taxes. Federal, state and local taxes on income, estates, capital gains and property can have a detrimental effect on a portfolio. Tax efficiency seeks to reduce tax drag, unlocking value in both the short term (annually) and long term (generational).

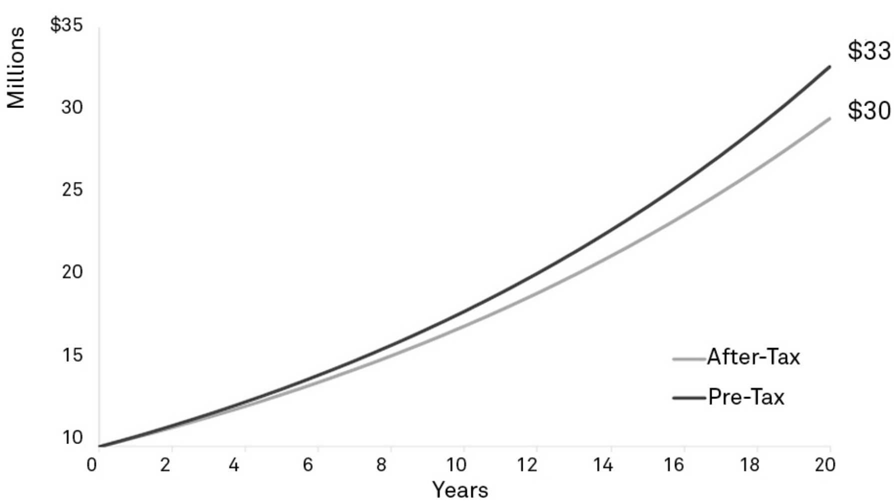
But tax efficiency is not simply an asset allocation or investment product selection decision; it is a comprehensive strategy rooted in our Active Wealth philosophy.

Let's explore some of the key tenets of our approach that can bear fruit in the short term.

Tax-Loss Harvesting

Tax-loss harvesting is an investment technique that looks to sell positions with losses while redeploying proceeds into a security with similar market exposure. Doing so captures tax benefits while allowing the investor to maintain desired market exposure. Exhibit 1 below demonstrates the benefits of tax-loss harvesting.

Exhibit 1: How Does Tax-Loss Harvesting Work?



"Harvesting" tax losses involves selling an investment at a loss to offset other taxable gains, thus lowering your taxes. Typically, an investment is sold at a loss with the proceeds being used to purchase a similar, but not substantially identical, investment in order to maintain market exposure.

Source: BNY Mellon Wealth Management. The chart is for illustrative purposes only. Based on federal income tax rate of 37%, long-term capital gains and dividend tax rate of 20%, and net investment income tax of 3.8%. Using BNY Mellon's capital market assumption of 6.1% for U.S. Large Cap stocks, with a turnover rate of 5%.

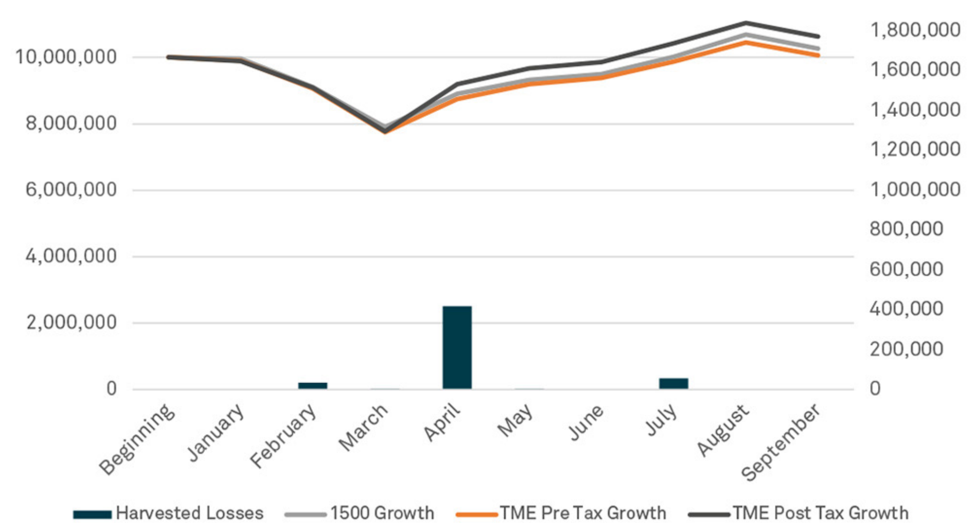
A successful tax-loss harvesting approach will look to add value on two fronts: proactive loss harvesting when markets present opportunities to do so, and also during scheduled portfolio rebalances. Investors who rebalance infrequently, or only consider capital gain/loss recognition at year-end, often miss out on significant opportunities to improve their tax efficiency.

Tax-Managed Equities

Tax-managed equities (TME) reflect an investment process that is specifically designed to minimize the taxes incurred within a separately managed equity portfolio, while closely tracking an equity index (e.g., S&P 500). When properly executed, the goal is to minimize taxable events by minimizing the realization of gains, shifting short-term gains to long-term gains when possible, and seeking opportunities to offset taxable income with losses.

In a volatile market environment, generating attractive portfolio returns can prove difficult and ignoring tax implications can add unnecessary cost. On the other hand, capturing losses presented by volatile markets generates tax-loss carry forwards that can be used to improve after-tax returns in current and subsequent years. Tax-managed equity provides the opportunity to pair portfolio-level gains with security-level losses — a powerful approach to long-term compounding. Exhibit 2 below offers an example of the potential benefits using a $10 million separately managed equity portfolio.

Exhibit 2: S&P 1500 vs TME, Pre- and Post-Tax



Source: Morningstar Direct and BNY Mellon Wealth Management

While tax-managed equity offers a one-stop shop for tax efficiency, it should not be the sole tactic within the equity portfolio. The ability to generate cash flows from other equity assets, particularly during the rebalancing process, will provide added flexibility for tax-managed equity portfolios and lead to better after-tax returns.

Asset Location

Many high net worth families have multiple tax-sheltered accounts in addition to their traditional taxable investment accounts. The blend of tax-sheltered and traditional accounts presents an opportunity to lessen the overall tax burden by locating tax-inefficient securities in accounts that offer tax shelter, while placing efficient strategies in non-sheltered accounts.

After determining the tax status of an investor's accounts, we must consider their relative size. The size of each account will influence the extent to which we can maximize tax efficiency while maintaining the desired asset allocation. Appropriate asset location allows us to minimize tax drag on after-tax returns by placing investment strategies with high turnover or taxable income in tax-sheltered accounts, and strategies with fewer taxable events in non-qualified accounts. While we don't avoid paying taxes entirely, we minimize what is paid today and delay receiving high-tax proceeds, increasing the ability of assets to compound.

Asset location should be a component of any long-term investment strategy. However, individual decisions involved in rebalancing or raising funds to meet cash flow needs, particularly as people near certain goals (such as retirement), often require annual adjustments to the asset location strategy. Exhibit 3 below illustrates a few basic asset location considerations.

Exhibit 3: Asset Location Considerations

Best to IRAs		Best to Taxable Accounts
Taxable Fixed Income (e.g., corporate bonds, high yield bonds, short-term bonds)	**Tax-inefficient Equities** (e.g., REITs, actively traded equities, small cap, emerging markets)	**Tax-efficient Equities** (e.g., large cap tax-managed equities, low turnover/ passively traded equities) **Tax-exempt Fixed Income** (e.g., municipal bonds)

Taxable vs. Tax-Exempt Bonds

Investors can choose a mix of taxable and tax-exempt bonds for the fixed income portion of portfolios. Depending on the applicable tax bracket and prevailing interest rates, one may be more attractive than the other. The simplest approach is to purchase tax-exempt bonds for the taxable accounts, and taxable bonds for the tax-deferred accounts. While this approach will work, it may not be the most tax efficient. Depending on rebalancing needs, it may be beneficial to hold certain taxable assets in multiple account types.

Conclusion

Taxes play an important role in determining the total return kept and are critical to successful, long-term wealth creation. It is important to understand tax efficiency and its goal to maximize after-tax returns. We have touched on many of the portfolio-related tax-saving strategies that can accrue tangible value in the short term. While not addressed here, we also consider tax efficiency from a long-term perspective through customized estate planning and gifting strategies that reflect the current tax environment and result in significant long-term tax savings.

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