BNY MELLON
WEALTH MANAGEMENT

***Your* Active Wealth**
Podcast

Boosting Future Returns with Tax-Managed Equity

October 2022

Want to keep more of what you make when markets rebound? In our latest episode, Rajesh Nakadi, head of investments for BNY Mellon Wealth Management's global family office division, explains how you can put tax-loss harvesting on steroids with a Tax-Managed Equity program to boost net returns in better years.

Featuring:

Ben McGloin, *Head of Advice, Planning & Fiduciary Services, BNY Mellon Wealth Management*
Rajesh Nakadi, *Head of Investments, Global Family Office, BNY Mellon Wealth Management*

VO [00:00:01] Is your wealth strategy supporting your long-term goals? Welcome to *Your Active Wealth* with BNY Mellon Wealth Management, where we offer insights that can help you move closer to your goals. We'll tackle timely topics through the lens of the five pillars that comprise our Active Wealth framework: Invest, Spend, Manage, Borrow and Protect, and provide guidance on navigating the unpredictable, to help you build and sustain wealth.

Ben [00:00:31] Hi. I'm your host, Ben McGloin, head of advice, planning and fiduciary Services at BNY Mellon Wealth Management, and welcome back to *Your Active Wealth*. October is considered tax month by many who file their taxes on extension, so we thought it would be the perfect time to ask Rajesh Nakadi to be our guest. As head of investments for BNY Mellon Wealth Management's global family office group, Rajesh is involved with some of our largest investors and ensuring their various taxable investments are tax efficient. Hi Rajesh. Thanks for joining.

Rajesh [00:00:58] Thanks for having me, Ben. It's my pleasure.

Ben [00:01:01] So, Rajesh, let's dive right in. From your perspective, what are the biggest tax trends that you're seeing among wealthy investors today when it comes to investing?

Rajesh [00:01:08] Well, in terms of a consistent tax trend, let's start off with saying that wealthy investors want to minimize their taxes any chance they can. I think that would be a pretty safe assumption. But we're seeing a couple of things in addition, Ben. One is we've had massive tax revenues this year at the federal and state level, really a record year for tax revenues by a wide margin. And it's helped reduce the deficit and even put some state governments in surplus. But what's good for the government has not been good for clients as they've paid big taxes on their gains in 2021. And so while there was no tax rate increase, taxes went up significantly nonetheless. Adding to this are the losses in the market this year as well, which has brought this issue front and center. Also, the prospects for tax cuts in the next year or two are pretty low. And so more than ever, investors are really keen to maximize their after-tax returns and keep more of what they make.

Ben [00:02:22] So Rajesh, before we get into the why, let's tell our listeners what tax managed equity or TME is.

Rajesh [00:02:28] Sure, we'll refer to the acronym TME quite a bit on our talk today, Ben, but it's really short for tax managed equity. Think of TME as an ETF that gives you exposure to an index like the S&P 500, but also at the same time, actively creating tax losses by buying and selling stocks in a systematic way.

Ben [00:02:53] So essentially the goal, the strategy is to maximize the number of tax losses while also earning a benchmark return, kind of like an ETF with even greater benefits, you might say an ETF on steroids.

Rajesh [00:03:06] Yeah, well, it's really tax loss harvesting on steroids. It's the fourth quarter Ben and like every year we are seeing the usual increase in tax loss harvesting activity as most wealth managers go to their client portfolios looking to realize losses and match gains to minimize taxes.

The TME process, however, is a year-round process that actively buys and sells stocks to build a cachet of tax losses that can be used to offset gains elsewhere in the portfolio or even carry over in the future because the tax losses never expire. And so this pool of realized losses gives investors the flexibility to offset the gains elsewhere in the portfolio at any time during the year, rather than having to wait through the end of the year.
By the way, investors can also use the tax managed program for fixed income as well. We have seen one of the worst years in the fixed income market in a while, with significant losses in bond portfolios that investors can actively manage through the tax managed fixed income program.

Ben [00:04:23] So I know we've been running tax managed equity portfolios for our clients for a number of decades now. What do you think is behind the recent proliferation in their popularity across the wealth management industry?

Rajesh [00:04:35] We're definitely seeing a much bigger interest level and activity this year, Ben. If you look at the last 12 years, we've seen one of the biggest bull markets, the longest bull markets in history, except for maybe the 2020 period of volatility. And in a period of steadily rising markets, low volatility, low interest rates, it can be more challenging for a TME strategy to continually generate losses and outperform the index.

But we're in a very different market environment now, one with slowing growth, with higher inflation, with the Fed in an aggressive hiking cycle, shrinking its balance sheet, etc. And the Fed is certainly not pumping liquidity in the markets like it did over the past 12 years. It's really led to a tightening in the financial conditions, and that means continued volatility going forward and potentially more muted returns in the public markets as well, which makes it all the more important for clients to focus on after tax, after fee returns to really keep more of what they make. And that's why we've seen a jump in the interest level and use lately and certainly expect that to continue going forward as well.

Ben [00:06:03] And so some might say another reason is investors are incentivized to make some lemonade out of this year's lemons, right Rajesh?

Rajesh [00:06:09] Yes, absolutely. Look, markets have been challenging all year with not too many places to hide. But volatile markets are tailor-made for TME, you know, because you have more individual stock dispersion. You have some stocks with far greater losses. That means more opportunities for harvesting losses when markets are down. TME is a great way to maximize your tax savings.

Ben [00:06:40] So who could benefit or who could use a tax managed strategy, be it a tax managed equity or tax managed fixed income strategy in their portfolio?

Rajesh [00:06:48] Well, if you take a step back, as a general rule of thumb everybody should be actively looking to harvest losses in accounts and minimize their taxes where possible, while keeping their goals in mind. Many investors rely on their wealth managers and other tax advisors to help them uncover potential losses to offset the gains, or sometimes go with the direct indexing solution, which has been gaining popularity in the market – and essentially is a tax sensitive product offered by many firms where you are able to customize your index.

However, our experience has been that if you're an ultra-high net worth investor, and by that we mean if you have a portfolio of, say, more than $10 million or in particular if you're a family office, you're definitely better off with a systematic tax managed equity program that is tailored to your portfolio, to your risk parameters and to your loss budget. And the loss budget essentially is how much would you like in realized losses by the portfolio manager.

Ben [00:08:05] So it sounds like you're comparing maybe a non-customized strategy, like a direct indexing, with customized strategy. Could you explain when someone would need more of a customized approach?

Rajesh [00:08:19] When you have a sizeable portfolio with multiple accounts and many moving pieces. So, for example, if you and your wife had a sizeable but separate investment accounts and you declare a joint tax filing, and certainly in the family office space, we see this quite often where clients have multiple accounts with different entities and different goals. And so it's all the more important to put all the information together in order to maximize losses. Of course, anyone can harvest a tax loss in their portfolio by selling a stock less than less than what they bought it. But it's almost impossible for an individual or family with multiple accounts to do it successfully by themselves, or more to the point, it's nearly impossible to do it and keep your portfolio closely tracking to its benchmark at the same time.

Ben [00:9:17] Why is that so difficult?

Rajesh [00:9:19] Well, the key issue, Ben, is the wash sale rule. The basic rule prohibits selling an investment for a loss and then replacing it with the same or a substantially identical investment either 30 days before or after the sale. If you do have a wash sale, the IRS will not allow you to write off that investment loss.

Ben [00:9:40] This sounds very compelling, but could you share what the pitfalls of an individual investor trying to do it themselves are?

Rajesh [00:9:47] Well, the wash sale rule also applies to stocks in any of your investment accounts, including your spouse, if you're filing jointly. So if you're like many wealthy individuals and have multiple investment accounts, all separately managed accounts with individual stock holdings, then those positions would all need to be coordinated to make a stock sale tax deductible.

Ben [00:10:13] And so how is BNY Mellon Wealth Management able to do it?

Rajesh [00:10:16] Well, as a major custodian in the industry, BNY Mellon Wealth Management can view activities across all of our client's multiple portfolios. And so being a custodian makes it ideal for our TME team to view activity across multiple portfolios and take that into consideration while harvesting losses. If you're not a master custodian or if you don't manage every portfolio for your client, you can imagine how difficult it can be to consistently harvest losses when the opportunities arise.

Ben [00:10:53] For sure. Can you take us through an example of a typical client, of a wealthy individual?

Rajesh [00:11:01] Well, there's no such thing as a typical client, Ben, as we all know. But in general, they tend to be diversified across multiple portfolios, often with varying investment goals. Clients with more substantial assets also have a broader canvas of investments, including alternative investments such as hedge funds and private equity. And so really the first step in the process is to evaluate the goals of the client. And explore if the TME portfolio aligns with those goals. Clients can also express investment preferences such as growth or value or quality tilts, or even include ESG considerations. And those can all be included within the TME framework. The next step involves choosing how much of their portfolio they want to put in the TME approach. It's usually a sizeable portion of the private equity exposure, but we've seen some family offices use TME for nearly all of the reallocation.

Ben [00:12:12] So Rajesh from your experience, when would it make sense to have almost all of your public equity in a tax managed equity portfolio?

Rajesh [00:12:19] It's not for everyone. It's for a small segment. And we see this in many of our family office clients who want to manage their public equity exposure in a passive way through ETFs or TME, and then want to spend their active alpha effort in the non-traditional areas such as private equity or hedge funds or real estate where they believe they can get more persistent outperformance and alpha. In this type of a barbell scenario where the public equity exposure is mostly passive and the alternative exposure is active, TME is especially effective in extracting the losses on the public side and in order to offset the gains in the rest of the portfolio.

Ben [00:13:09] So you've made reference to benchmarks and indexing. So maybe kind of elaborate, what type of an index could a client use?

Rajesh [00:13:18] Well, we could use any index, but the reality is many of them go with the S&P 500 Large Cap Index or the S&P 1500 All Cap Index, as those tend to be popular benchmarks in most portfolios. You also see the Russell Value and the Russell Growth indexes are also very popular with investors who want to have a style preference or style tilt in their portfolios.

Ben [00:13:50] So Rajesh, I suspect many clients that are looking to transition to a tax managed equity or tax managed fixed income portfolio already have existing portfolios. Could you share what some of those difficult transition scenarios would look like?

Rajesh [00:14:04] Yes. So a significant number of opportunities that come to TME involve pre-existing portfolios that no longer mimic the composition of the benchmark and contain active stock specific embedded risk in those portfolios. And these usually involve gains where the stocks have been held for a long time that have significant appreciation and the TME team works with the client on a transition plan to get the portfolio in line with the benchmark while minimizing the tax impact. The hardest situations are when there is significant concentration within the portfolio where there's a few stocks that have appreciated a lot over a long period of time and there are large unrealized capital gains in those portfolios. So those transitions tend to be a little longer.

Ben [00:15:03] So that's when we'll work together with the clients and work through those situations?

Rajesh [00:15:08] Exactly. If there's a single stock concentration or if there are a few stocks with large capital gains, they may be better off with other solutions in order to hedge or diversify away from the concentration risk. The BNY Mellon wealth strategists and the capital markets teams work with the client on the best solutions to mitigate that risk, either through wealth transfer solutions or through hedging solutions. Circling back to what works best, of course, the easiest solutions and the easiest situations are where investors start with cash and the TME team is able to start tax loss harvesting right off the bat.

Ben [00:15:52] Wow. Well, Rajesh, this has been very, very interesting. And we thank you so much for having the conversation today.

Rajesh [00:15:58] Of course, any time. Thank you.

Ben [00:16:00] So the key concept here is that it's not what you make, it's what you get to keep after tax. And that is likely going to be even more critical going forward, now that we are in a new investing cycle where volatility and muted returns may be more the norm than the exception. If you are interested in learning more about the future of passive investing and the strong merits of tax managed investing, both within equity and fixed income investment strategies, I would encourage you to reach out to a BNY Mellon wealth manager. I'm Ben McGloin, thanks for joining us and we'll see you on our next episode of *Your Active Wealth*.

VO [00:16:32] Thank you for listening to this episode of *Your Active Wealth*. Be sure to subscribe to this podcast on Apple Podcasts, Spotify, Google Podcasts or Stitcher and visit bnymellonwealth.com to view the latest insights on the subjects that matter most to you.