► **Greycourt White Paper**

White Paper No. 9 – *Managing Investment-Related Taxes: Increasing Net Wealth through Astute Management of the Tax Consequences of Investment Activity*

Background

An important part of Greycourt's value proposition to its family clients[1] is our ability to add substantially to their net after-tax wealth through careful management of investment-related taxes throughout the portfolio management process. Because taxes represent such an important aspect of portfolio management for families, two families can experience the same gross returns but experience profoundly different results in terms of their net wealth. For wealthy families these differences can amount to millions of dollars per year. This white paper describes the main steps Greycourt takes to minimize taxes throughout the investment process.[2]

Discussion

Greycourt engages in four specific techniques in the course of managing taxes in family portfolios. Each of those techniques is described below.

After-tax asset allocation

Although the role of asset allocation as the core of successful portfolio design has been understood since the early 1950s,[3] it wasn't until the early 1970s that investment consultants (and, much later, other financial advisors) began to use optimization techniques to design portfolios. Almost all investment firms conduct asset allocation analyses for their clients by applying mean variance optimization algorithms to gross expected returns, risks and correlations among asset classes. This approach works well for pension plans and most endowments, but it is profoundly flawed when applied to families. This is because working with gross

---

[1] Taxes are not relevant to pension plans or charitable endowments and are of only marginal importance to private foundations, which pay a 1% or 2% excise tax on investment earnings.

[2] It is important to emphasize that only a family's tax advisor can make final decisions about the taxability of investment activities.

[3] Harry Markowitz first described the advantages of a modern portfolio theory approach to asset allocation in his seminal article published in the Journal of Finance in March, 1952. For a further discussion of the modern understanding of asset allocation see *Asset Allocation*, by Gregory Curtis, in *Expert Financial Planning: Investment Strategies from Industry Leaders*, edited by Robert C. Arffa (John Wiley & Sons, Inc., 2001), p. 327 ff.

returns ignores the widely varying impact of taxes on the investment results produced by different asset classes. To take a simple example, private equity investments tend to be extremely tax-efficient since most of the returns come in the form of deferred long-term capital gains. On the other hand, non-directional hedged strategies are almost always very tax-*inefficient* since most of the returns are generated through short-term gains and ordinary income.

By contrast, Greycourt conducts its asset allocation studies on an *after-tax* basis. We take each asset class and estimate the realistic after-tax return it can be expected to generate. We then use those net numbers in our optimization algorithms. (We also deduct anticipated investment expenses, another important item typically ignored by other firms.) The results, as expected, show that a taxable family must accept more risk to obtain the same returns as a tax-exempt investor. In other words, an efficient frontier line for a taxable investor will fall below and to the right of an efficient frontier line for a tax-exempt investor with similar objectives, as shown in Exhibit A. A family using a portfolio strategy developed using gross return expectations will find that their actual net returns are far lower than they expected.

Asset location

Families, unlike pension plans and endowment funds, typically have an enormously complex series of entities through which capital must be invested. These entities often exist as part of the family's tax and estate planning strategies, but may exist for other reasons as well. The most obvious of these entities are private trusts, charitable trusts, partnerships, foundations, closely held businesses and the individual portfolios of different family units and generations. The tax consequences of investing in these different entities can be quite different, and hence it should be obvious that the location of an asset in a family's portfolio will have important implications for the growth of net wealth. A simple example is that sensible investors would not ordinarily put the same kinds of investments in a generation-skipping trust as they would put in a defective grantor trust. Similarly, managers appropriate for the patriarch's personal portfolio may be wholly inappropriate for the family foundation. Yet it is quite rare for a financial advisor to understand these implications and act accordingly.

At Greycourt we spend a great deal of time understanding the structure of a family, the various entities that control capital and the tax consequences of each. We then insure that the investments we have identified as playing a role in the overall family investment strategy are allocated to each entity in the most tax-efficient manner.

Using tax-aware managers

Once the asset allocation strategy has been developed on a an after-tax basis and investments have been allocated efficiently among a family's various investment entities, the next step is to identify money managers who are tax-aware in their investment disciplines. For many years managers – including banks and brokerage firms whose primary clients were families – paid no attention at all to the tax consequences of their money management activities. More recently, managers have begun to pay lip service to the concept of tax-efficiency, but managers who are truly tax-aware in their disciplines remain extremely rare. Some of the characteristics of a truly tax-aware manager would include:

- Managers whose styles include low turnover.[4]
- Managers who are conscious of holding periods and avoid incurring short-term capital gains whenever possible.
- Managers who aggressively offset gains against losses in an attempt to zero-out the tax liabilities of their buying and selling.[5]

Of course, some desirable managers are engaged in strategies that are inherently tax-inefficient – non-directional hedged strategies, for example. It would be counter-productive to insist that these managers somehow develop tax-efficient disciplines, since it is the very nature of the strategy to produce short-term gains and ordinary income. Even here, however, techniques can be used to mitigate the tax impact. For example, non-directional hedged strategies can be located in the family foundation. Alternatively, hedged accounts can be placed inside an insurance wrapper (onshore or offshore) to shelter the returns. Finally, it should be kept in mind that a manager's annual turnover is not always a reliable guide to its tax efficiency. A manager that is aggressively offsetting losses against gains will inevitably increase its turnover but will still be highly tax-efficient.

Harvesting tax losses across the portfolio

While tax-aware managers can harvest losses that occur in their own portfolios, they will have no idea of the gain and loss positions held elsewhere in a client's account. The client, however, or an overall advisor like Greycourt, can carefully monitor activity across the portfolio and coordinate among managers to net out gains and losses, or at least minimize net gains. For example, if Manager A has losses that can be realized and Manager B has gains he cannot offset, Greycourt

---

[4] Portfolio turnover measures who often a manager buys and sells securities. For example, a manager with average turnover of 200% will, on average, sell every security in the portfolio in six months. (In other words, the manager is generating mainly short-term capital gains.) A manager with a turnover of 20% will, on average, sell every security in five years – in other words, generating mainly long-term capital gains.

[5] Note that this does not necessarily require the manager to sell a security it wishes to keep. The manager can repurchase the security in 31 days; it can double the loss position and sell the original position in 31 days; it can double the loss position and buy a put and sell a call on the new shares; it can sell the security with a gain and buy a similar security.

can work with the two managers to net out the tax consequences across the two portfolios.[6]

Summary: tax management substantially increases net wealth
Astute management of the tax consequences of investment activity in family portfolios can very substantially increase net wealth. Careful research has shown that loss harvesting alone can add 80 basis points to the value of a portfolio every year.[7] For a $100 million family, that means nearly $1 million per year in increased net worth from only one of the four major tax-aware techniques. At Greycourt we believe that our tax-focused approach to families will add many times more value than we subtract via our fees. And, of course, tax management is only one of many services we bring to our relationships with substantial families. We will be happy to discuss these issue with you.

GREYCOURT & CO., INC.
September 2001

(This paper was written by Gregory Curtis, Greycourt's Chairman.)

---

[6] The importance of a qualified master custodian of the family's assets cannot be over-emphasized in allowing Greycourt to manage gains and losses across different managers and accounts.

[7] See, e.g., Arnett, Berkin and Ye, *The Management and Mismanagement of Taxable Assets*, the Journal of Investing (Spring 2001); Gordon and Rosen, *The Benefits and Methods of Harvesting Your Losses, and Not Just at Year-end*, The Journal of Wealth Management (Fall 2001).