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WHITE PAPER NO. 65

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OCTOBER 2020

Investment implications of a Biden win for ultra-high-net worth investors

"Don't tax me...don't tax thee...tax that fellow behind the tree!"[1]

President elect Joe Biden has floated several tax policy proposals designed to increase tax rates on wealthy individuals. The purpose of this paper is to examine the *investment* implications likely to ensue should these proposed changes become the law of the land in 2021.

SUMMARY OF SELECTED BIDEN TAX PROPOSALS

It is unclear at the time of this writing who will win the upcoming presidential election. It is equally unclear which party will control the Senate. With that said, Joe Biden appears to be leading in most polls and therefore an examination of the investment implications of his proposed tax policy changes seems warranted. Below is a brief outline highlighting several of Biden's proposed tax law changes that would most meaningfully impact UHNW taxable investors.

Tax Issue	Current Policy	Biden Proposal
INDIVIDUAL INCOME TAX	- 37% maximum rate through 2025, reverts to 39.6%	- 39.6% maximum rate
INVESTMENT INCOME	- 20% maximum long-term capital gains tax rate - 3.8% net investment income tax	- No preferential rate for capital gains or dividends for taxpayers earning over $1M in income
ESTATE & GIFT TAX	- Top rate of 40% with exemption of $11.6M through 2025	- Return to historical norm ($3.5M exemption?) - Eliminate step up basis

[1] *Quote attributed to Senator Russell B. Long D-Louisiana - late chairman of the Senate Finance Committee*

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IMPACT ON FUTURE PRE-TAX CAPITAL MARKETS RETURNS

Most investable capital in the world arises from entities not subject to US taxation such as endowments, foundations, pension plans, defined contribution plans and sovereign wealth funds. In the US alone for example, only 25% of US equity assets are owned by taxable individuals. As a result, changes in individual US income tax policies should have only a moderate impact on aggregate investor behavior and by extension prospective returns. We note that since 1969 US capital gains rates have been raised four times and there has been no predictable reaction by the US stock market to those tax increases.

Although most asset classes may not be meaningfully affected by individual tax rate changes, municipal bonds almost certainly will since they are predominantly funded by wealthy US individuals. For this asset class, an increase in individual marginal income tax rates would boost their relative attractiveness, although given today's exceptionally low current yields any increase in tax rates should only exert a minimal positive impact.

One component of the Biden proposed tax plan that could meaningfully impact pre-tax returns is a proposed hike in the corporate income tax to 28% from its current 21% level. The table below compiled by S&P Capital IQ Compustat and reported by Ned Davis Research suggests that 2021 EPS could fall by as much as 12.7% due to the proposed increase in the corporate tax rate. We expect that US equity returns would fall commensurately with any decrease in after-tax earnings similar to how equity markets increased as after-tax earnings rose following the 2017 Tax Cuts and Jobs Act. We note, however, that the stock market's reaction to changing tax rates is fleeting.

28% corp tax rate could lower SPX EPS 4-13%

Biden's Proposed Corporate Tax Hike Impact on S&P 500 After-tax Income

	Tax Rate		
Line Item	**17.7% Effective (As of 12/31/2019)**	**28% Stated (Biden)**	**21.0% Effective (halfway of 2017 and 2019)**
Pretax Income per Share ($)	174.73	174.73	174.73
Income Taxes per Share ($)	30.67	48.92	36.69
Effective Tax Rate (%)	17.7	28.0	21.0
Change in Taxes per Share ($)	0.00	18.25	6.02
After-tax Income per Share ($)	144.06	125.81	138.04
Change in After-tax Income (%)	0.0	-12.7	-4.2

Source: S&P Capital IQ Compustat.

Ned David Research T_SSF20_24.1

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IMPACT ON AFTER-TAX CAPITAL RETURNS EXPECTATIONS

All thoughtful UHNW advisors use projected after-tax returns to design portfolio architecture, determine sustainable spending levels and evaluate the attractiveness of individual managers and strategies. The changes in income and capital gains taxes proposed by Biden will reduce returns for almost all asset classes and, as a result, will negatively impact portfolio growth and/or sustainable spending levels. Using Greycourt's Cassandra tax-conversion model, we examined prospective changes in after-tax returns for ten asset classes. For all scenarios examined we assumed a 10-year time horizon, maximum federal tax rates (but no state taxes), and the 3.8% PPACA ("Obamacare") tax.

The table below summarizes the impact of Biden's major proposed changes. The columns entitled "Current" reflect the after-tax returns using today's income and short-term capital gains tax rate of 37%, long-term capital gains tax rate of 20% and the PPACA ("Obamacare") tax rate of 3.8%. The "Biden" columns increase the maximum federal income tax rate (including the rate on qualified dividends) and both long-term and short-term capital gains tax rates to 39.6%. We also include the PPACA tax rate of 3.8%. We show results under a "Pre-Liquidation" scenario which means that the investments are not sold over the next 10 years. The "Post-Liquidation" scenario models a full liquidation of the investments at the 10-year mark and thus, indicates a larger tax drag overall as tax rates increase.

		After-Tax Return Analysis						
			After-Tax Return Comparison					
		Pre-Tax Net-of-Fee Returns	**Current:** Pre Liquidation	**Biden:** Pre Liquidation	Difference (bps)	**Current:** Post Liquidation	**Biden:** Post Liquidation	Difference (bps)
Equities	US LARGE CAP	6.76%	6.05%	5.46%	-59.0	5.33%	4.08%	-125.0
	US SMALL CAP	7.73%	6.47%	5.50%	-97.0	6.01%	4.64%	-137.0
	INTERNATIONAL EQUITY	7.46%	6.58%	5.86%	-72.0	5.88%	4.50%	-138.0
	EMERGING MARKETS	8.77%	7.61%	6.66%	-95.0	6.90%	5.29%	-161.0
	PRIVATE EQUITY	10.60%	9.14%	8.02%	-112.0	8.09%	6.03%	-206.0
	PRIVATE REAL ESTATE	9.50%	7.01%	6.13%	-88.0	6.47%	5.13%	-134.0
Diversifying	DIVERSIFYING HEDGE	4.60%	2.54%	1.87%	-67.0	2.49%	1.78%	-71.0
Bonds/Cash	MUNICIPAL BONDS	2.40%	2.40%	2.40%	0.0	2.40%	2.40%	0.0
	GLOBAL HIGH YIELD	4.70%	2.62%	2.49%	-13.0	2.62%	2.49%	-13.0
	CASH	0.65%	0.32%	0.30%	-2.0	0.32%	0.30%	-2.0

As illustrated above, short of a portfolio entirely invested in municipal bonds, it will be difficult for investors to avoid incurring an increased tax drag on their investments under the Biden plan. Certain investments (e.g., high yield bonds, hedge funds, and certain real estate) will, however, be less adversely impacted by an increase in tax rates. For example, the after-tax post-liquidation return differential between US large cap and high yield narrows by 112 basis points

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under the Biden plan. As a result, high yield bonds and other credit-related strategies might play a more prominent role in taxable portfolios in the future. Below we comment on how broad asset categories and strategies would be impacted by the Biden tax plan.

Public and private equity

Equities, both public and private, have long offered the highest returns to investors, especially in the decade following the Great Financial Crisis. In addition, the after-tax equity returns for passive strategies, low turnover active managers, private opportunistic real assets and private equity have been very attractive because of the preferential tax treatment of dividends and long-term capital gains as well as the ability to defer realization of gains. With tax rate harmonization under the Biden plan, we expect after-tax returns for public equities to decline by anywhere from 60 basis points to 200 basis points – that's a lot!

Many UHNW investors also employ tax aware equity strategies designed to actively harvest tax losses and defer capital gains and thus, improve after-tax returns. Under the Biden plan, these strategies are still projected to add so-called "tax alpha", but for most, this value will get cut in half from roughly 100 basis points to 50 basis points. [2]

For private equity and private real assets investments, potential changes in the taxation of carried interest could change management compensation structures in both existing and future private funds. Some old funds have partnership agreement language that allows the general partners (GPs) to gross up carry to prior post-tax levels. Undoubtedly terms for new funds from access-constrained GPs will be renegotiated.

Active equity and diversifying strategies

Perhaps counterintuitively, historically tax-inefficient strategies like high yield bonds, diversifying hedge funds and long/short equity strategies would be less affected by the new tax policy. This is because these tax-inefficient asset classes are already being taxed heavily at today's maximum federal income and short-term capital gains rate of 37% whereas tax-efficient asset classes will suffer disproportionately as current favorable long-term capital gains and dividends taxes increase significantly under a Biden plan.

[2] *Blog post: "Impact of Biden's Capital Gains Proposal on the Performance of Loss-Harvesting Strategies" by Ben Schneider and Pete Hand, Aperio Group, August 19, 2020*

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Core fixed income

After-tax returns for tax-exempt and taxable bonds alike would be largely insulated from a tax policy change. The bad news: with interest rates near historic lows, prospective bond returns remain unattractive and will struggle to keep pace with inflation under either tax plan.

As mentioned earlier, if the Biden plan is passed, municipal bonds would almost certainly become more attractive to UHNW investors relative to other forms of fixed income. Growing demand for these bonds by taxable investors might drive prices up to the point that the historical tax-equivalent yield advantage they have held over more traditional bonds ultimately disappears.

MAINTAINING PORTFOLIO PURCHASING POWER

For a traditional balanced portfolio (i.e., a 60% equity/40% bond allocation), we expect the incremental tax drag on returns under a Biden tax regime to fall between 40 and 70 basis points per year. This means that if an UHNW investor were to hold spending constant as a percentage of their portfolio, that investor's probability of maintaining portfolio purchasing power will decline (see table below).

Probability of Growing Purchasing Power In 10 Years

Portfolio Composition	Tax Plan	Annual Spending Rate		
		1%	2%	3%
60% Stocks/40% Bonds*	Current	68%	55%	48%
	Proposed	63%	49%	35%

**60% Global Stocks, 40% Municipal Bonds*

We tested a variety of other portfolios each having varying allocations to stocks and bonds and observed similar declines in the probability that those portfolios maintain purchasing power.

SHOULD INVESTORS MOVE FURTHER OUT ON THE RISK/RETURN CURVE?

Perhaps, although there are limits to what can be reasonably achieved through asset allocation strategies. For example, if a family owns a traditional 60/40 portfolio today, it might expect a net-of-fees, after-tax return in the range of 4.5-5.0% per year (again, based on reasonable long-term asset class return forecasts). Assuming inflation averages 2.0% and spending averages 2.0% annually, the family can achieve anywhere from 0.5-1.0% in annual purchasing power

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growth. To generate that same level of purchasing power growth under the Biden tax plan, the family would need to shift nearly one third of its portfolio from public equities and bonds into higher returning illiquid private market investments.

Absent the ability or willingness to materially increase illiquid investments, the family would not be able to achieve the same probability of purchasing power growth even if it shifted the portfolio to 100% equity investments (see table below).

Probability of Growing Purchasing Power In 10 Years

		Annual Spending Rate		
Tax Plan	Stock Allocation	1%	2%	3%
Current	60%	68%	55%	48%
Proposed	60%	63%	49%	35%
	70%	63%	51%	39%
	80%	63%	52%	42%
	90%	62%	53%	44%
	100%	62%	54%	46%

Fortunately, unlike most institutions, families often have greater flexibility in how much they spend and thus can better accommodate lower after-tax returns on invested capital. Ultimately, we expect families would mitigate the effects of higher taxes through highly customized solutions combining return enhancements, spending adjustments, and expected reductions in purchasing power.

EFFECTS ON ACTIVE VERSUS PASSIVE EQUITY STRATEGIES

"The amount of global alpha equals precisely zero" is a mantra we frequently repeat at Greycourt. As a result, identifying managers who are consistently successful at active investing remains a Sisyphean task. Empirical evidence suggests that less than 25% of active equity managers outperform passively managed index funds on a pre-tax, before-fee basis, let alone after fees and taxes.[3]

While no prospective change in tax laws is going to alter this dynamic, high turnover managers who are able to consistently outperform on a pre-tax basis will have a somewhat easier time preserving that outperformance on an after-tax basis under the Biden plan.

[3] *SPIVA Institutional Scorecard Year-End 2019*

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On the other hand, low to moderate turnover managers like those typically found in many private client portfolios will have a harder time outperforming after tax.

This is because the current tax regime heavily favors low turnover, tax efficient passive indexes by applying favorable tax rates to qualifying dividends and because in a low turnover index fund nearly all capital gains are taxed at the favorable long-term rate. If one harmonizes dividend, short-term and long-term tax rates as proposed under the Biden tax regime, tax rates applied to passive and active managers will be identical. Relative to their current tax burdens, passive managers and low turnover managers will suffer as higher tax rates are applied to all capital gains under the Biden plan. High turnover managers, on the other hand, are already burdened with disproportionately high short-term tax rates on their capital gains so, by contrast, the Biden plan doesn't change their tax burden by as much. As can be seen in the table below, under the Biden tax plan the excess return required for active low turnover managers to break even with a passive index fund is higher than under today's tax regime. On the other hand, the excess return for high turnover active managers is meaningfully lower.

Assumptions:	
S&P 500 Arithmetic Return	6.8%
Dividend Yield	2.0%
Passive Manager Fee	4 bps
Active Manager Fee	85 bps
Manager Volatility (active and passive)	15.3%
Time horizon (Years)	10
Assume Full Terminal Liquidation	

	Annual Portfolio Turnover				
	20%	30%	50%	75%	100%
Current Tax Regime Break Even Excess Return (bps)	113	122	146	192	270
Biden Tax Regime Break Even Excess Return (bps)	140	148	160	168	174
Difference (bps)	27	26	14	-24	-96

WHAT ACTION(S) SHOULD UHNW INVESTORS CONSIDER TAKING NOW?

There are a few actions taxable investors might reasonably consider taking before year-end in anticipation of Biden's proposed tax plan. Many of these pre-emptive strategies fall into the realm of tax and estate planning advice which while potentially powerful fall outside of our core investment advisory services. Two estate planning strategies we have frequently heard mentioned include:

1. Utilizing any remaining lifetime gift exemptions before the maximum individual limit is

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reduced to $3.5M from today's $11.6M.

2. Accelerating charitable gifts while they can be deducted today at the maximum income tax rate (currently 37%) rather than the proposed limit of 28%.

A more investment-centric strategy being contemplated by investors is whether to intentionally realize embedded long-term capital gains in 2020 at today's relatively favorable 20% capital gains tax rate (as proposed, Biden's plan would raise the long-term capital gains tax rate to 39.6%). Following the strong equity market rally that began in 2009, many investors now find themselves in the position of having large unrealized gains, especially in their low-turnover tax-efficient equity portfolios.

UHNW investors often utilize tax harvesting strategies that delay the realization of gains in order to benefit from both the time value of money and the possibility of benefitting from a stepped-up cost basis at their death. As discussed earlier, beyond 2020, these gains may be subject to nearly double today's capital gains tax rate and the step-up at death may be eliminated. Given these possibilities, should an investor preemptively incur some tax pain today to avoid more tax pain later?

To illustrate, let's consider the dilemma faced by a hypothetical client, Donna Taxme. Donna is 75 years old and has a simple $100M portfolio comprised of a 60% US stock index fund and 40% municipal bonds. She began investing in January 2009 immediately following the sale of her highly successful construction company. Given strong equity markets since then, the cost basis on her equity portfolio is now quite low at 50% of its current market value. She lives comfortably on the income generated by her municipal bonds and, as a result, needs no distributions from her equity portfolio. Donna has always sought to minimize taxes, believing that upon her death her daughter would receive a stepped-up basis on her appreciated assets, thereby avoiding capital gains taxes entirely. However, in light of the proposed Biden tax plan where stepped-up basis is eliminated, Donna wonders what she should do. The table below explores two possible scenarios she might consider.

- **Option #1:** Leave her equity portfolio untouched leaving her daughter to pay the higher capital gains tax rate upon Donna's death.
- **Option #2:** Sell her equity portfolio in 2020, pay the lower current long-term capital gains tax rate and immediately reinvest the remaining proceeds into a 60% stock; 40% bond portfolio. Of course, following Donna's death, her daughter will still have to pay

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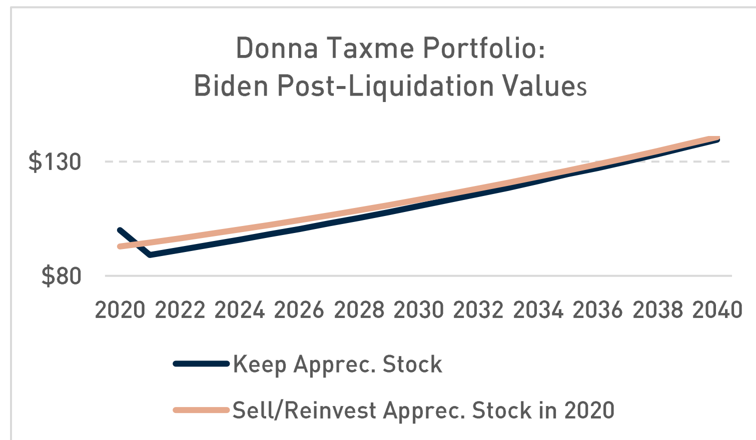
taxes on gains earned after 2020 at the higher tax rate but the gains from 2009 to 2020 will have been settled at today's lower rate.

As can be seen from the chart below, irrespective of the year in which Donna ultimately dies, her daughter is better off financially if Donna elects to realize the existing embedded long-term capital gains in 2020 at today's lower rates. It is important to note that the magnitude of this benefit diminishes slowly over time ultimately disappearing sometime after 2041. By way of example, in year 10, the benefit to Donna's daughter is around $2.8M. Of course, this analysis assumes that the Biden tax regime stays in place for the next 20 years which, given the current polarized political climate, seems highly unlikely.



Of course, if the current tax regime doesn't change, meaning that long-term capital gains rates remain favorable and the step-up basis at death remains, Donna and her daughter will be worse off in every period if they elect to realize gains in 2020 (see chart below). Again, by way of example, in year 10 Donna's daughter would be $6.5M worse off for having sold appreciated stocks in 2020.

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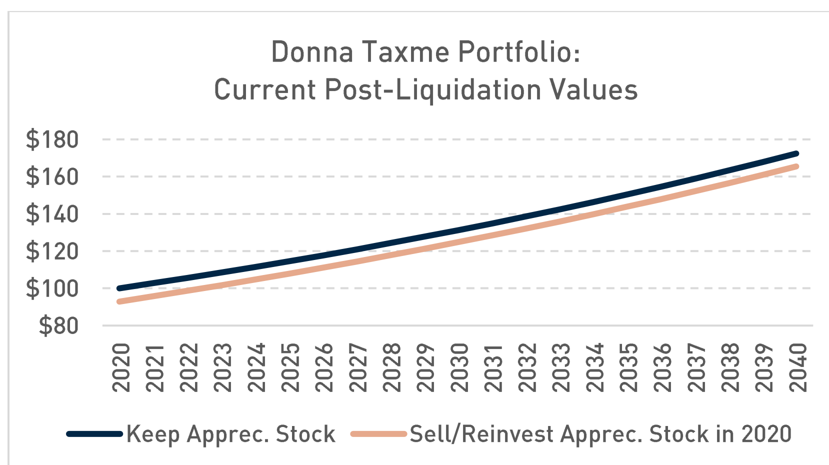

Given (1) the asymmetry of outcomes depending on which tax regime prevails, (2) the uncertainty of whether a new tax regime will persist over time and (3) the diminishing benefit as time goes on of intentionally realizing embedded losses in 2020, we believe investors should be extremely cautious about engaging in tax-driven actions until we know more about the election outcomes.

SUMMARY

This paper has sought to examine how the proposed Biden tax plan might impact asset class returns, alter UHNW asset allocation strategy, require investors to re-examine risk tolerances and/or spending, and (possibly) prompt tactical actions. Whatever ultimately transpires, developing a sound analytical framework through which to examine potential tax changes is always a good idea.

This paper was written by Greg Friedman, CEO and Jeff Moyer, CFA, Director of Greycourt & Co, Inc. Please note that this presentation is intended to provide interested persons with insights on the capital markets and is not intended to promote any manager or firm, nor does it intend to advertise their performance. All opinions expressed are those of Greycourt & Co., Inc. The information in this report is not intended to address the needs of any particular investor.