

ARTICLES OF INTEREST

DEFERRING CAPITAL GAINS TAXES WITH EXCHANGE-TRADED FUNDS

Stock Investing

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Damn! It's January and you forgot to check the tax status of your stock portfolio!

You told yourself in October that you would sell your "underwater" positions in December to lock in the losses. But you got busy and forgot...again

Tax loss selling involves the sale of a security trading below your cost, Adjusted Cost Base (ACB) to be specific. You can use resulting capital losses in three different ways:

1. Shelter taxable capital gains in the current year (until the net gain is zero but not below).
2. Carry the loss back (up to three years) to be applied against gains in those years.
3. Carry the loss forward indefinitely to apply against future gains.

Sound great? There is a catch, of course! The security sold to realize the loss can't be repurchased for thirty days or you violate Canada Revenue Agency's (CRA) "superficial" loss rule. "Superficial Loss"? Well there's an oxymoron! Every loss I've ever taken has been pretty real!

Sometimes, not being able to repurchase a loser is a good thing, akin to treating a hangover in the morning by having a "hair of the dog". Sometimes you feel better, most of the time you feel worse.

But other times, a security you really like drops below your ACB and you want it back. By waiting 30 days, you could miss the bounce. In any event, your portfolio has been changed for the period of the wait.

Much has been written in this space and elsewhere about the core satellite approach ("CSA") to portfolio management. If you haven't considered it, you should. Smart institutions have been using it for years.

CSA involves allocating a portion of your portfolio to a low cost "core", managed passively, and the rest – to an actively managed "satellite" portfolio (satellite) seeking to beat an index. For instance, a core portfolio could consist of ETFs that are tax efficient and realize very little, if any, capital gain. The second portion, the satellite, is managed actively and could be represented by a portfolio of hedge or mutual funds, individual securities, and/or

country/sector/industry/commodity/currency/ETFs.

The satellite is likely to realize a portion of capital gains regularly due to higher turnover. These capital gains are taxed at the end of the period, causing a real cash outflow – money that could have continued growing in the portfolio, contributing to higher returns. Of course, taxes have to be paid sooner or later, but there is value to tax deferral (the additional return that could have been generated had tax money stayed in the portfolio longer). The investor keeps this added return permanently. This is the value added of tax loss harvesting.

The real benefit of harvesting strategies can be even greater. In Canada, where tax-loss-carry forward is indefinite, controlling when exactly you realize your capital gain can carry significant value. In retirement, when most investor's marginal tax rate will be lower, an even higher benefit to deferring taxes occurs.

Finally, in the case of a step up in cost basis, the portfolio retains the amount of deferred taxes altogether.

ARTICLES OF INTEREST

The strategy involves capturing losses in the core. Using ETFs, it is possible to sell one ETF (example SPY) at a loss and buy another one, with an equivalent risk (example IVV), at the same time! You capture the loss AND retain your market exposure. Because each ETF in the example is sponsored by a different firm, SPY or SPDRs are sponsored by State Street Global Advisors and the IVV or iShares S&P 500 by Barclays Global, CRA views them as different securities (and they are because they trade separately). Therefore the superficial loss rule does not apply.

MEASURING THE BENEFIT OF TAX LOSS HARVESTING

How do we measure the benefit of tax loss harvesting? Since the core portfolio generates the tax loss credit, we assume that every time a tax swap occurs, the amount of tax savings, that would otherwise have to be paid out, is reinvested in the core portfolio that has generated it. The differences in market value of a portfolio employing a tax loss

strategy and one that does not, will give us an indication of the value added of tax loss harvesting.

When is it optimal to realize a tax loss? In an ideal world without transaction costs – anytime the cost basis is below market value. In reality, every time we perform a trade, including a tax swap trade, we incur transaction costs. Therefore, it is best to swap only if the net economic benefit is optimal.

To estimate the net economic benefit, we compare the value of tax deferral to the impact of transaction costs.

When is tax harvesting particularly beneficial? One could argue that if an investor is lucky to enter the markets at the beginning of a bull phase, there is no opportunity for tax loss. However, a well-constructed portfolio, that includes low correlated asset classes, is likely to have some short term losses in individual asset classes, even though the overall return for any period might be positive. An investor can take advantage of these small losses even in an overall bull market.

CONCLUSION

If you are clipping tax losses throughout the year, you don't have to worry about remembering next December. You can defer paying capital gains taxes and keep more money working for you longer. ETFs make the process more flexible by allowing you to capture losses immediately without a change in portfolio risk (without waiting 30 days). Some investment counsellors have automated the tax-loss capture process so ask your advisor to put you on the programme. If you manage your own money, set up a core satellite portfolio now and start sheltering your gains.

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