BARRON'S PENTA

Tax-Overlay Trading Boosts Returns

Wealth managers are using sophisticated programs to minimize taxes on capital gains and dividends.

By KAREN HUBE
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Superior total returns have always generated Wall Street and investor bragging rights, with scant attention paid to how much an investor gets to keep after squaring up with the IRS. No longer. From independent investment advisors to big private banks like Morgan Stanley and U.S. Bank Wealth Management, wealth managers are adopting sophisticated tax-management software known as "tax overlay" to monitor portfolios for opportunities to minimize taxes on capital gains and dividends. (For an example, see our related story on wealth manager Veritable, "Unvarnished Returns.")

"Investment advisors are realizing that it's very difficult to outperform a benchmark, but they can consistently add value by minimizing taxes," says John Longo, who teaches at Rutgers University and is the chief investment officer of MDE Group, an investment advisory firm in Morristown, N.J. "Taxes are the largest transaction costs investors face."

He has a point. Between 1990 and 2012, investors in stock funds in taxable accounts gave up 1.12% of their average annual return to taxes, according to a study by Clemens Sialm and Hanjiang Zhang from the University of Texas at Austin.

It's also important to note that this is an era when after-tax returns really count. The Standard & Poor's 500 has soared over 150% since its March 2009 low-point, while the top rate on long-term capital gains rose from 15% to 23.8%, and short-term gains went from 35% to 43.4% for top taxpayers. Dividend taxes, meanwhile, were increased from 15% to 23.8%.

With software linked to unified managed accounts, advisors can minimize taxes on capital gains and dividends. *Drawing: Robert Neubecker for Barron's*

Tax-overlay technology is made possible by the widespread use among wealth managers of unified managed accounts. A UMA consolidates an investor's various accounts, traditionally a mix of funds and separately managed accounts, each with multiple (often overlapping) holdings, and varying purchase prices, or cost bases.

Once using UMAs, wealth managers buy portfolio models from investment managers, and invest client assets themselves. As changes are made to the portfolio -- daily, weekly, whenever -- the investment manager supplies the wealth manager with a revised model, and the wealth manager makes the necessary trades.

Controlling the trading gives wealth managers executing the portfolio concept the added ability to manipulate individual portfolio holdings through the overlay software, to minimize the trade's tax consequences. Some big firms like Morgan Stanley and Bank of America Merrill Lynch have built their own in-house systems; small or independent advisors typically hire third-party overlay managers, such as Parametric, Smartleaf, Adhesion Wealth Advisor Solutions, Managed Portfolio Advisors, and Placemark Investments.

The major purpose of an overlay system is to identify the most tax-advantageous way to carry out trading instructions. "Our system recognizes that securities are purchased at different times and prices," says Chris Scott-Hansen, Morgan Stanley Wealth Management's head of trust and tax-management services. "Say you bought Johnson & Johnson with different managers five years ago, three years ago, and this year, and now one manager wants to sell. We look at the stock holistically to see which shares to sell for the best tax outcome." And as gains are realized, the software also finds potentially offsetting losses.

"Say you have $50,000 in realized capital gains. If you can reach into a portfolio and identify losses that can eliminate those gains, you avoid paying tax, and that can be a significant performance benefit," Scott-Hansen says.

But the software is more than just a flagging system, says Jerry Michael, president and co-founder of Smartleaf.

When a security tanks, the system suggests selling a cluster of the stock for tax reasons, and then recommends a substitute investment. And there are nuances: If a manager reduced "a stock weighting from 1.5% to 1%, but that would mean a hefty short-term gain [and taxes], then we might only sell to 1.25%," says Jared Gray, director of centralized portfolio management for Parametric, a Seattle-based overlay manager.

Conversely, if the tax managers tamper too much with the investment manager's model, returns may turn to dribble.

Low deviation rates combined with high tax alpha -- the added return due to tax management -- is the ultimate goal, says Rick Pitcairn, chief investment officer of the Philadelphia-area family office Pitcairn. Even with the tax overlay's tweaks, Pitcairn says the performance of his portfolios are within 10 basis points (0.1 percentage point) of the pure investment strategy's returns, while providing an extra 1.1-percentage-point advantage, due to lesser taxes, every year since 2008, when the Pitcairn overlay system was put in place.

But the UMAs and tax-overlay programs don't enchant all wealth managers. Iain Silverthorne, a partner and wealth advisor at Evercore Wealth Management in New York, says the explosion in use of UMA overlay technology is a sign that there is a problem in the industry to begin with.

"There is an inherently tax- inefficient process in place that they are trying to make more tax efficient," he says. At Evercore, a single customized streamlined portfolio is created so that tax management is possible without institutionalizing or automating the process. The UMA overlay platform is simply a Band-Aid that layers on added fees, he says.

AH, YES -- THE FEES. Watch out. UMA platforms cost between 1% and 1.2%; typically, there is an added cost for tax overlay of 0.1% to 0.2%. The UMA and overlay fees are, ahem, overlaid on top of both your wealth manager's advisory fees and the fees charged by the investment managers.

But that might not be as bad as it sounds. Investment managers charge less for models than managing the assets themselves; an equity manager's fee can drop from 1.2% to 0.5%, for example, if your banker is using a UMA and executing the investment manager's trades. So the reduced investment-management fee may compensate for the cost of the UMA and overlay.

Still, it's hard to say to what degree smart tax management will pay off. It can boost returns in excess of 1% in some years for some, but produce negligible results for others. "If anyone promises a specific amount of high annual tax alpha, that's like promising performance. It can't be done; it's so individualized," warns Patrick Newcomb, senior analyst at Cerulli Associates, a Boston market-research firm.

Meaning? In most years, tax overlay systems will add value.

But it's not guaranteed.

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