

## INVESTMENT PERSPECTIVES

# Tax-aware transition planning

Traditional portfolio management strategies often ignore capital gains tax—to the detriment of a taxable investor.

For many investors, strategies that balance pursuit of alpha against risk and tax costs are important in achieving financial goals.

Tax-aware transition of an existing portfolio can potentially achieve higher after-tax returns.

## Introduction

Modern portfolio theory is primarily grounded in a pretax framework. Over the years, many of the product and process innovations we've seen in the investment management space have largely focused on making portfolio management more efficient for large institutional investors, like pension funds, endowments, and foundations, which are mostly tax-exempt.

Nearly two-thirds of investable assets in the U.S., however, are held by taxable investors. For many of these investors, it turns out that taxes—rather than investment management fees and commissions—are their biggest portfolio-related expense. Therefore, taxable investors should carefully evaluate the impact taxes have on their portfolios.

Jeffrey and Arnott (1993), who introduced the concept of tax alpha, demonstrated that for many investors, taxes were clearly the largest source of portfolio management inefficiency that resulted in mediocre investment returns. They argued that investment strategies for taxable investors should be compared against the after-tax performance of a benchmark in order to accurately demonstrate the value-add for investors.

For taxable investors with highly appreciated portfolios, unrealized capital gains are an enormously valuable asset in the portfolio. Unrealized capital gains represent a portfolio's principal growth that's yet to be realized, or "cashed in"—it hasn't been diminished by taxes. But as investors' asset allocation preferences change due to changing market regimes, repositioning or evolving portfolios that have large, unrealized gains (or losses) becomes a challenging and complex endeavor



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for financial advisors. A tax-aware transition framework that guides advisors to reposition their clients' portfolios toward long-term or short-term objectives in a tax-efficient and risk-efficient manner can potentially result in better after-tax performance.

In this paper, we explain what a tax-aware transition approach is and examine its key benefits relative to a tax-agnostic one. Further, we use a hypothetical example to illustrate the potential positive impact of implementing a tax-aware transition approach. Finally, we conclude by highlighting the key considerations one should be aware of when employing this approach to transition portfolios.

## What is tax-aware transition?

Tax-aware transition planning is the process of transitioning an existing portfolio containing unrealized gains and/or losses to active or passive investment strategies by using advanced portfolio management techniques that comprise a risk-based, tax-aware portfolio optimization process. Using this type of process to transition a portfolio in kind provides the opportunity to deliver high tax efficiency (minimizing tax liability) and risk efficiency (minimizing tracking error) both during and after the portfolio's transition.

The value-add for taxable investors is further enhanced when the tax-aware transition of a portfolio to an investment strategy is followed by tax-aware management of the investment strategy. This approach may significantly outperform a conventional tax-agnostic portfolio rebalancing approach due to its ability to preserve and grow the portfolio's after-tax returns.

## Benefits of a tax-aware transition strategy

The key benefit of using a tax-aware approach to transition existing portfolios is its strong potential for achieving higher tax efficiency and risk efficiency during implementation and preserving and growing the portfolio's after-tax returns.

The transition of a portfolio can be challenging—especially when the tracking error of the portfolio to the investment strategy's target portfolio is large. The large tracking error indicates that the risk characteristics of the portfolio to be transitioned bear little similarity to the risk characteristics of the new investment strategy's target portfolio. This is where the tax-aware transition approach can play a key role: striking the right balance between risk efficiency (minimizing the tracking error) and tax efficiency (minimizing the tax liability) during implementation of the portfolio transition. Improving tax efficiency during transition also involves systematically harvesting tax losses embedded in the portfolio.

Tax-aware transition offers two direct benefits to tax-sensitive investors at different stages of the transition process:

- **During the transition process, investors can realize an immediate improvement in after-tax returns due to minimized tax liability.** Also, they can offset their current-year gains against any losses harvested during the transition process, or they can take advantage of carrying their losses forward indefinitely to balance against future taxable gains.
- **After the transition process, investors can realize the time value (compounded) of deferred unrealized gains over the long run.** Reduced tax liabilities during the transition process means that the portfolio can defer realizing gains and compound these gains over time. The ability to compound unrealized gains creates the opportunity to benefit from the time value of money.

A conventional tax-agnostic approach fails to deliver on both immediate improvements to after-tax returns and compounding of deferred unrealized gains over the long run.

# Key considerations in employing tax-aware transition

Even though a tax-aware transition approach offers significant benefits over a tax-agnostic approach for many taxable investors, this approach isn't a panacea and can't be viewed through a narrow, one-size-fits-all lens. A tax-aware approach to portfolio transitioning needs to be flexible enough to accommodate key considerations arising from both the portfolio and the client's objectives. By factoring in a client's objectives and thoroughly understanding the current portfolio as well as the client's desired target state, a tax-aware transition strategy can be tailored to seek optimal outcomes for clients.

## Client considerations

**Facilitate income and cash withdrawals.** Interest income and dividends are the two primary income sources in clients' portfolios. Also, clients might be looking to withdraw cash from their portfolios on a one-time basis or based on a periodic, ongoing schedule during or after the transition period. A tax-aware transition approach should factor in clients' income and cash withdrawal needs alongside their tax and risk considerations. A well-designed transition plan can achieve these objectives in a tax-efficient manner by minimizing the overall tax liability to clients.

**Enable portfolio customization.** A tax-aware transition approach integrates client preferences, be it value-based or focused on financial goals. Financial objectives and/or preferences include yield and dividend targets, credit quality, factor tilts, industry and sector preferences, risk targets, and tax objectives, among others. Value-based goals include considerations such as environmental, social, and corporate governance preferences.

Other customization options include reinvestment of proceeds or aggressive tax loss harvesting, which can help position the portfolio for its ultimate goal(s). These goals could include, for example, donating to charity (in which case the portfolio may benefit from a tax-exempt status) or passing the assets on to heirs (which could enable a step-up in cost basis).

**Achieve diversification.** Diversification is a key consideration for many clients who are looking to achieve optimal outcomes in their portfolios over their investment horizon. Lack of diversification generally increases a portfolio's uncompensated risks and can lead to suboptimal outcomes for clients. A tax-aware transition should be structured to balance various objectives in the target portfolio while minimizing concentration risks through diversification across multiple portfolio characteristics (market capitalization, investment style, duration, sector and industry exposures, credit quality, and issuer, among others).

## Portfolio considerations

**Evaluating the investment universe.** When designing a tax-aware transition plan, the investment universe should be a key consideration. Not all constituents in a given asset class offer the same opportunity from a tax-awareness perspective. For example, in equities, the much larger and more volatile small-cap equity universe offers more opportunities to add marginal value using a tax-aware strategy than the much smaller, less volatile mega-cap equity universe does. Depending on the client's objectives and target strategy, thoughtful selection of the investment universe can enhance the efficacy of a tax-aware transition process.

**Switching investment strategies and/or managers.** As clients' objectives change through time, so does the need to transition their portfolios to a different investment strategy (active or passive) and/or a different investment manager to meet those revised objectives. For taxable investors, the cost of replacing an investment strategy and/or a manager can be quite high due to transaction and tax expenses. But by implementing a tax-aware transition framework, the punitive tax and transaction costs in this replacement process can be mitigated. As our working example shows, once the tax implication of switching an investment manager is considered, a portfolio's total return may be diminished by a significant amount annually.

## The benefits of a tax-aware transition from a legacy portfolio may be best illustrated via a simplified example.

In this hypothetical example, we've made the following assumptions about the initial portfolio, the applicable tax rates, and the return characteristics of the investment strategy in which the portfolio is invested:

- At the beginning of the transition, the portfolio's market value is assumed to be \$1 million.
- The portfolio has a \$150,000 unrealized short-term loss and an unrealized long-term gain of \$200,000. Not all of the positions held short term (typically for a period of less than one year) have been at a loss. The gross loss in such short-term positions generally has been partly offset by gains.
- The capital gains tax rates are assumed to be 45% for short-term gains and 22.5% for long-term gains.
- The portfolio experiences an 80% turnover annually.
- The hypothetical investment strategy of this portfolio has an expected 7.5% annual return. In real life, such high returns tend to come with a fair amount of volatility. To keep it simple for the purpose of this example, though, we've assumed that the portfolio invested in this strategy will realize a 7.5% return every year.

**Figure 1. Summary of all assumptions**

Initial portfolio market value	\$1,000,000.00
Initial unrealized short-term loss	\$(150,000.00)
Initial unrealized long-term gain	\$200,000.00
Assumed short-term capital gain rate	45%
Assumed long-term capital gain rate	22.50%
Expected annual portfolio return	7.50%
Expected annual portfolio turnover	80%

This is a hypothetical example for illustrative purposes only.

A traditional strategy that's not tax efficient can be expected to result in taxable capital gains each year. How much capital gains? Strategy turnover is a good proxy—higher turnover means more realized gains but also more short-term gains. As noted in Figure 1, the portfolio is subject to a higher tax rate on short-term capital gains. Each year, the portfolio generates capital gains, some of which are paid out as capital gains tax. The remainder of the portfolio grows for another year, and then the cycle repeats. The portion of the portfolio that was used to pay taxes doesn't participate in this growth, of course, which causes a wealth drag from the tax effect.

After 10 years, the portfolio is liquidated and taxes are paid due to the gains from selling all of the positions. The post-liquidation value after 10 years is \$1,585,947—not bad, as having started with \$1,000,000, this portfolio ends up with an extra \$585,947 in value.

Now, let's consider a tax-efficient alternative. We'll use the same initial portfolio, invested in a strategy that generates the same 7.5% pre-tax return each year. Even though the overall portfolio appreciates, all positions don't appreciate similarly and some may be held at an unrealized loss.

The tax-efficient strategy finds these losses at the beginning of the transition to the tune of \$200,000 in short-term losses. The tax-efficient strategy also strives to offset much of the short-term gains by finding offsetting losses throughout the year (we assume 90% in our hypothetical example) and waiting for positions to become long-term holdings whenever possible before selling to benefit from the much-lower long-term capital gains tax rate. These efforts lead to a lower wealth drag from the tax effect, so more of the portfolio’s gains remain in the portfolio to participate in returns the following year.

However, this creates deferred gains. As a result, at the end of 10 years, the portfolio has more unrealized gains than the previous portfolio did. Even after liquidating and paying capital gains taxes on the deferred gains, though, the post-liquidation value is \$1,890,767.

In case you’re keeping track, that’s \$304,820 more than the final value of the previous portfolio.

**Figure 2. Comparison of investment profit: Tax-efficient strategy vs. tax-indifferent strategy**

	<b>Tax-efficient strategy</b>	<b>Traditional tax-indifferent strategy</b>
Initial portfolio value	\$1,000,000	\$1,000,000
Liquidation value of portfolio at the end of 10 years	\$1,890,767	\$1,585,947
Total investment profit	\$890,767	\$585,947
Annualized portfolio return	6.58%	4.72%

**This is a hypothetical example for illustrative purposes only.**

On an annualized returns basis, the tax-indifferent portfolio returned 4.72% (post liquidation, after tax), whereas the tax-efficient portfolio returned 6.58% (post liquidation, after tax). The difference is tax alpha—which remains with the investor instead of being paid out in taxes.

# Conclusion

Taxes play a critical role in the investment-planning process for taxable investors. That's because for these investors, taxes are the biggest expense—they're generally higher than investment management fees and commissions. This is the case during both the strategic asset allocation process and the portfolio management process of individual sleeves. Therefore, the impact of taxes on taxable investors' portfolios should be an essential consideration.

As clients' objectives change through time, their portfolios usually need to be transitioned to a different investment strategy and/or an investment manager to pursue the revised objectives in a tax-efficient and risk-efficient manner with the goal of maximizing after-tax returns. A risk-based, tax-aware transition approach may significantly outperform a conventional, tax-agnostic approach in achieving high tax efficiency and risk efficiency both during and after implementation of the transition process.

A tax-aware transition strategy needs to be flexible enough to accommodate key considerations arising from both the portfolio's and the client's objectives. In essence, we view the tax-aware transition approach as a powerful tool that will help advisors unlock opportunities and potentially deliver strong after-tax performance for their clients.

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## Reference

Jeffrey, R.H., and R. Arnott. "Is Your Alpha Big Enough to Cover Its Taxes?" *The Journal of Portfolio Management*, Vol. 19, No. 3 (1993), pp. 15–25.

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