Program #1335
Broadcast: February 17h, 2017

On this week's Consuelo Mack WEALTHTRACK: How to increase your portfolio's performance by decreasing its tax bite. Tips from tax-advantaged investment pros Brian Langstraat and Scott Welch.

BRIAN LANGSTRAAT
Chief Executive Officer
Parametric

SCOTT WELCH
Chief Investment Officer
Dynasty Financial Partners

COPYRIGHT, LEGAL NOTICE AND DISCLAIMER

Copyright © 2017 Mack Track. All rights reserved worldwide. All materials contained on this site, including without limitation any transcripts, are protected by United States copyright law and may not be reproduced, distributed, transmitted, displayed, published or broadcast without the prior written permission of Mack Track Inc. [info@WEALTHRACK.com].
Re-printing of these materials, including any transcripts, for educational or citation purposes is allowed with proper attribution.

The opinions expressed on Consuelo Mack WEALTHRACK are those of the guests and do not necessarily represent the views or opinions of Consuelo Mack or Mack Track, Inc.

CONSUELO MACK: On this week's WEALTHTRACK: maximizing your *after* tax returns. This week's guests are focused on helping us keep those gains and not losing them to Uncle Sam. Parametric's Brian Langstraat and Dynasty Financial Partners' Scott Welch are next on Consuelo Mack WEALTHTRACK.

CONSUELO MACK: Hello, and welcome to this edition of WEALTHTRACK, I'm Consuelo Mack. Founding father Benjamin Franklin told us that, "…in this world nothing is certain but death and taxes." What he didn't add was that one of them is somewhat within our control. And I am not talking about finding the fountain of youth. I am talking about our tax bill. We spend most of our time at WEALTHTRACK focusing on building pre-tax wealth. We talk to top performing fund managers and highly regarded financial advisors, but we have rarely focused on after tax returns. Neither does the financial services industry. This week we are going to rectify that. As one of this week's guests told me, "You can't eat pre-tax returns." Taxes take a huge bite out of investment returns, an estimated 1-3% annually, higher than most management fees and more than the returns or alpha that active managers hope to deliver over the market year after year. The main culprit is trading, especially that generates highly taxed short term capital gains, which is why low turnover portfolios, particularly passive index funds, have such a performance advantage. But taxes are a cost we can influence. This week's guests are experts in tax advantaged investing among other wealth building strategies.

Brian Langstraat is the CEO of Parametric, a global asset management firm with about $180 billion dollars of assets under management, more than $50 billion of that is in tax advantaged investing strategies. Founded in 1987 it describes itself as providing "engineered portfolio solutions" to institutional and private clients. It constructs customized strategies to meet specific risk management, tax management and return objectives. Parametric is a subsidiary of Eaton Vance and runs several mutual funds for them, including its Tax Managed International Equity Fund and Tax-Managed Emerging Markets Fund. Scott Welch is the Chief Investment Officer of dynasty financial partners which provides investment research, portfolio management, technology and practice management solutions to financial advisors and advisory teams. In that capacity advice on optimizing tax consequences is near the top of his list. Welch is on the board of several industry groups including the IMCA and the Editorial Advisory Board of the *Journal of Wealth Management*. I began the discussion by asking them why managing the tax consequences of a portfolio is so important.

BRIAN LANGSTRAAT: On a basic level it's just because taxes can cost you so much. I think people often don't understand; while there's so much focus on fees and risk, the taxes of an investment portfolio are often the largest cost an investor faces. So just the sheer size and impact that taxation has on investment portfolios warrants close looking at.

CONSUELO MACK: When you're talking, Scott, to financial advisors, are they aware of that, of how big a deal taxes can be?

SCOTT WELCH: I think most of them are. I think the challenge really is it can be hard to do at

© 2017 Mack Track. All Rights Reserved

scale when you're trying to run your practice. We can talk more about that, but what I try to tell them is: the two things that an advisor has control over are fees and taxes. They can't control the market. They can't control sort of what's going to happen in the market, but what they can control is fees and taxes. They spend a lot of time on fees. They don't necessarily spend as much time on taxes as they should.

CONSUELO MACK: Why isn't there the emphasis on taxes?

BRIAN LANGSTRAAT: If you look back to the way this industry was formed, it formed in the tax-exempt community.

CONSUELO MACK: So institutional investors. They don't pay taxes.

BRIAN LANGSTRAAT: Yes. So the infrastructure, the performance reporting, the manager structures, even the asset allocation came out of a tax-exempt world. The second thing is it's not totally easy to do. You have to spend some time and understand and think about comparisons. A great deal of understanding can be gained quickly, but the industry just hasn't had that as a focus.

CONSUELO MACK: And when you're talking about comparisons, what do you mean? Pretax performance returns versus after tax?

BRIAN LANGSTRAAT: You have to kind of accept the fact that a given strategy: your after-tax return may be different than my after-tax return. In pretax terms that's not true. It's quite likely in a given strategy if we're investing, our pretax look identical, but because of tax rates, cost basis, holding period, there can be differences between investors, and advisors have a real role to play in helping to add value in understanding that.

CONSUELO MACK: Scott, so when you're talking to advisors basically, and you're focusing with them on the tax consequences and what kind of construction of portfolios that they should do with their clients, what are some of the basic things that you're telling them that they should be doing?

SCOTT WELCH: I think the way that I think about it, perhaps a little simplistically, is there are sort of three layers of things that you can do to improve the tax effectiveness or tax sensitivity of a portfolio. The first thing is what the industry refers to as asset location, in other words putting different kinds of investment vehicles in different kinds of legal structures, be they trusts or tax-deferred accounts or 401(k)s or whatever to optimize the tax consequences there. So that is probably the single most important thing that you can do, and even as an investment professional, I admit readily that good tax planning will beat good investment planning every day of the week.

CONSUELO MACK: Let me just stop you there. So it's simple to you two. You're pros, but when you say tax location, so for instance bonds should be, because they pay interest and interest

© 2017 Mack Track. All Rights Reserved

is taxed at your...

SCOTT WELCH: Taxed at an ordinary rate.

CONSUELO MACK: ...at your rate, then they should be in a tax-deferred account.

SCOTT WELCH: In a tax-deferred account. Exactly. That's the most sort of prime example.

CONSUELO MACK: So all of us who have had 401(k)s and IRAs, who have been putting equities in them, we probably shouldn't be doing that?

SCOTT WELCH: It's not a question of shouldn't be doing it. It's just a question of thinking about what are the tax consequences of where that particular investment is. So there's nothing wrong with putting equity in a tax-deferred account, but from a purely tax perspective, putting a taxable bond in there gives you the most tax advantage. The second is what I'll refer to as sort of portfolio implementation and that's the kind of structures that you use in terms of actually putting your investments to work. So if you have an SMA, a separately managed account, versus a mutual fund, that could be a tax advantage because you actually own the individual securities in an SMA versus just owning a share of the fund. So that's a simple example of structural, sort of the tools that you pick to use to implement your investment strategy. So that's the second layer, and then the third layer and probably the third most important is the actual investment itself. So that's where you get into a discussion about ETFs and index funds, tax-managed index funds. So the actual MLPs for example where all...

CONSUELO MACK: Master limited partnerships.

SCOTT WELCH: Master limited partnerships, all of which have different tax consequences and can help to improve the tax efficiency of a portfolio.

CONSUELO MACK: Brian, where does Parametric come in?

BRIAN LANGSTRAAT: One of the biggest areas that we find value and where we can help investors, and they often come in to us, is this choice of active versus passive. We all know that index-based investing is really growing and for a lot of great reasons, and when people think about index-based investing versus active, when they actually consider it after taxes, it becomes even more interesting to allocate to an index-based strategy.

CONSUELO MACK: That is because... just give us the obvious.

BRIAN LANGSTRAAT: They're naturally broadly diversified. They have low inherent levels of turnover, so they have low inherent levels of capital gain realization. You can buy and hold them and achieve most of the market's return without giving back to taxes. What we've done at Parametric and because we think people do and should allocate a large allocation of their

© 2017 Mack Track. All Rights Reserved

portfolio to index-based strategies… we think it makes great sense … is see if we can take that index-based strategy and make it even more tax-efficient.

CONSUELO MACK: Let me rewind there. Why do you think that most individuals should have a large proportion of their investable assets in index funds?

BRIAN LANGSTRAAT: There's lots of reasons, and I think we can hit any dimension. First of all, everybody's going to have an allocation to the market, to the broad U.S. market, broad world equity market. Most investors should, and then you have to think, well, how do I want to do that? Well, I want to capture that market exposure, what investors call beta, as inexpensively as I can with something that doesn't need to change as broad as exposure. That's before I've thought about taxes. There I've captured my market exposure. That's a real driver of my return, and I've minimized my taxes, and I've got a structure that I don't have to mess with.

CONSUELO MACK: So it's easier, and there's a reason for not wanting to mess with it too. Behavioral finance comes in. Right?

BRIAN LANGSTRAAT: Absolutely.

CONSUELO MACK: I mean is that part of this decision as well?

SCOTT WELCH: Well, I think there's another aspect of it as well, which is active management's hard. So it's very difficult to beat a passive benchmark consistently over long periods of time, and so I call it getting the biggest bang for your buck in terms of your fees. Where do I want to pay active management fees? I don't want to pay them where I'm going to get an index-like return and net of fees may be less than an index-like return. So I'd rather use a passive strategy there and then try to find other strategies that I'm willing to pay more for that I think can actually deliver better performance.

CONSUELO MACK: So to go back to what Scott had been talking about earlier, kind of the three steps that you take.

BRIAN LANGSTRAAT: So we really focus on that portfolio structure. So you think about if you have an index exposure and you surrounded it with quality satellites, that index exposure is the majority of what you have in the market, and if you have it in a separately managed account… and Scott mentioned a little bit of this… you open up the world for customization. Customization means in a tax perspective that the manager can manage it to your cost basis, to your tax rate, can harvest losses, actually seek out when they happen in a diversified portfolio. They're inevitable. Actually realize that loss and use it elsewhere in your portfolio to shield gains and increase your tax efficiency. Maybe they can get involved when you have a giving plan and you want to give securities to a charity. They can identify the most tax-advantageous securities. So that structure of a separately managed account combined with the index approach creates a lot of after-tax power and something most investors should consider.

© 2017 Mack Track. All Rights Reserved

CONSUELO MACK: This is something obviously that Parametric ... it's one of your specialties.

SCOTT WELCH: That's right.

CONSUELO MACK: These customized. These separately managed accounts, but those are also primarily for high net worth individuals. Correct?

BRIAN LANGSTRAAT: That's right.

CONSUELO MACK: So you're talking with financial advisors who maybe don't make the Parametric cut. The separately managed account vehicle - how does that work? How can you apply it to individuals who aren't high net worth individuals?

SCOTT WELCH: Well, it's not quite as customizable, but I think that's where ETFs can play a huge role, because you get that broad market exposure that Brian talked about, but because it's treated like a security, you can get capital gains treatment on it. So you're generating gains in that along the way, but you don't have to realize those gains until you actually sell out of that ETF. So if you're holding it as a core position like Brian suggested, I won't call it tax deferral but you get better tax treatment on it when you eventually being to liquidate it. So from our perspective if we're talking to an advisor, up to a certain amount of a portfolio we would recommend an ETF or just an index fund, but once you got up to a sizable portfolio that would allow you to access a separately managed account, we would definitely recommend that that's way you go.

CONSUELO MACK: So if you're recommending an index fund or index funds, the tax advantage is inherent in it being an index fund, but is there anything else that you can do as well to take advantage of...

BRIAN LANGSTRAAT: I think you can absolutely. I think the concept of being aware of where your gains and losses are in a portfolio is important even if you have a portfolio just of ETFs. It's not as granular as a separate account with all the securities in it, but if you have a broad base portfolio of ETFs, you can do loss harvesting. You can consider that and swap one ETF out and put another one in and realize net loss, and that'll have an advantageous effect on your portfolio over time. But just setting it up… and I think this is important… just setting up that ETF portfolio as core with satellites around it will create a lot of benefits and efficiencies, tax-efficient, before you get in to the high net worth separate account.

SCOTT WELCH: That question also goes to sort of that second layer that I talked about, this portfolio implementation, because part of what you can do as the advisor is set a rebalancing policy that optimizes the tax efficiency of that portfolio. You can pick different kinds of ETFs that maybe give you more choices to buy and sell out of that you need to realize losses or harvest losses or something like that.

© 2017 Mack Track. All Rights Reserved

CONSUELO MACK: So that's yet another step that a lot of people aren't doing on a regular basis, and explain the harvesting taxes concept.

BRIAN LANGSTRAAT: It is a little bit counterintuitive because you're actually harvesting the losses, and losses are bad. We don't want them. We don't seek them, but it's a recognition that if you build a broadly diversified portfolio, there are things that are going to up and go down. Sectors are going to struggle, security names, and what people don't realize is that when a security falls below what you paid for it, that's an economic asset to you. You can choose...

CONSUELO MACK: They do not realize that, Brian. (Laughs) Oh, this is an advantage to me!

SCOTT WELCH: You now have something that you can do something with.

BRIAN LANGSTRAAT: So if you do this systematically year after year, not just at the year-end but clean through your portfolio, you can have a meaningful impact on your after-tax experience over a long-term investor by using that loss harvesting technique to reduce your tax bill to increase your after-tax return and to get back some of that. We talked about taxes being the largest bite in your portfolio. You can get some of that back. Put it to work for you.

CONSUELO MACK: This is an ongoing process. I mean, Brian, you said it's not just at year-end when everybody...

SCOTT WELCH:This is where advisors can add real value.

CONSUELO MACK: You're constantly looking for opportunities to book those losses and to offset the gains.

BRIAN LANGSTRAAT: Absolutely. You don't necessarily know when those gains are coming. You may have them in your portfolio. The thing about a loss once it's booked in our tax code is if you don't offset a gain with it this year, it'll carry forward, so maybe you have a gain in the future. So you've in a sense warehoused it, and you can set up rules, and you should have a rule of thumb if you're doing this yourself. We certainly embed those in. You want to realize a loss that's large enough that the value of it overcomes the transaction cost. That wouldn't make sense.

CONSUELO MACK: I see. So what are the rules? That would be one.

BRIAN LANGSTRAAT: Well, you'd have to think about what are your transaction costs, where you're trading, but for example when we screen through an index portfolio looking for losses, we're looking for a loss that is eight percent or larger relative. So if I bought it for $100, it's got to kind of fall to 92. Now that's a rough rule of thumb before we think the tax value of that, the transaction, the work to do it. So you want to have a process not just in December but through the year that gives you a sense of, okay, let's check into the portfolio and see if there's an

© 2017 Mack Track. All Rights Reserved

opportunity.

SCOTT WELCH: I was going to say you've got to remember that it's an interesting point because forget about the taxes for just a second. The intention is to give you the investor an index-like return. So you've got to set those parameters at a level where you don't track too far away from the index performance. Otherwise you're not having an index. You're doing something different.

CONSUELO MACK: Let me ask you at Parametric because what are the kinds of the tax alpha you call it that I can get from this kind of tax management versus if I just held the index for instance?

BRIAN LANGSTRAAT: That's the crucial question.

CONSUELO MACK: What should we expect?

BRIAN LANGSTRAAT: Because I started and you asked me why be concerned, and I said taxes matter. They're a big bite. Well, the second, why be concerned, is you can do something. You can have a meaningful effect. We have done this for a long time. We started this strategy actually in 1992, and over the years we've seen, and it varies a little bit by the volatility in the market and the tax rates, but you can see one percent a year in after-tax outperformance, sometimes more than one, one and a half percent a year in the performance of a customized tax managed separate account versus the same after-tax performance in an ETF or a mutual fund. Now what's interesting is that's a heroic result. I mean active managers who spend all their time and energy selecting the right stocks or timing the market, over time if you can produce 100 to 150 basis points, one to one and a half percent, you'll find yourself...

CONSUELO MACK: Over the (Overlap/Inaudible).

BRIAN LANGSTRAAT: ...over the bogey, over the benchmark. You'll find yourself right at the top of your peers.

SCOTT WELCH: I've known Brian and his firm for over 20 years, and I can vouch for that stated number.

CONSUELO MACK: The other interesting thing is that this strategy seems to work best in either very volatile or down markets. I looked at the figures from Parametric, and for 2008 and 2009 those were great years for this kind of a strategy. Why is that?

BRIAN LANGSTRAAT: A loss harvesting strategy takes advantage of volatility. When stocks are going up and down, you can grab that loss. You're really creating that economic value of that asset you're warehousing. When markets fall you're going to warehouse more. Eventually you think, am I ever going to use these realized losses? Well, markets tend to recover and you do

© 2017 Mack Track. All Rights Reserved

have capital gains again. So the amount of value from loss harvesting and from tax management does, as you indicate, vary by volatility. The more volatility in the market, the more, and the direction of the market. So if the market's straight up market, tax management's not going to add as much, but the investors who experience that aren't too dissatisfied because, look, they're getting everything they want from the market.

CONSUELO MACK: So in down markets then you should be very active in harvesting your tax losses, because again it carries over year to year.

SCOTT WELCH: Absolutely. It's really important to realize. I mean the cliché is you can't pretax returns. So pretax number, which is what the industry focuses on, is illusory. I mean 12 percent looks like a great number. Ten percent looks like a great number, but that's not what the investor actually realizes. They don't realize anything until they sell it, and once they sell it they have to pay taxes. So taxes is real money in your pocket. It's not just a number, and so if you can manage taxes better in any of the variety of ways we've talked about, you're actually putting real live dollars into your client's pocket. From an advisor's perspective, like I said, that's one of the few things you can control. It is one of the most highest added-value services you can provide, and it's just something that we emphasize with our advisor base consistently.

CONSUELO MACK: A couple more questions. Each of you mentioned kind of the satellite positions (Laughs) with actively managed funds. Why bother?

BRIAN LANGSTRAAT: Well, look. There are a lot of talented managers out there, and there are a lot of strategies that can add value. They can be diversifying. They can bring a different risk profile. They can create a better overall experience. To have any satellites or not really comes down to, can you find some of those? When you're considering which active strategies to choose, it makes a huge difference in understanding what's the tax bite or the tax drag. These are the terms that some people use for strategy Y versus strategy X, and how does that fit in my portfolio?

CONSUELO MACK: Are there any rules of thumb for that? Would you avoid high-turnover active managers like the plague?

SCOTT WELCH: Well, taxes comes into the equation, but you have to start with the performance.

CONSUELO MACK: Yes, the pretax performance.

SCOTT WELCH: But if you have two managers that have comparable performance, then you would want to take a look at things like turnover and holdings and consistency and those sorts of things. Another way of thinking about it, let's say I had one of these satellite investments that actually was very good at generating alpha or outperformance to the market but was tax-inefficient. Let's call it a hedge fund. So that takes that illusory gain like I talked about and it

© 2017 Mack Track. All Rights Reserved

makes it look not so attractive.

CONSUELO MACK: Unless you put it in a tax-deferred account.

SCOTT WELCH: Well, that goes to that portfolio implication. I can put that hedge fund into a private placement variable life policy or something like that and improve the tax efficiency of it, or I could let it earn its gross returns and then use the tax losses harvested elsewhere in the portfolio to get to turn that illusory gain into a tangible gain.

CONSUELO MACK: I see.

SCOTT WELCH: So it's not just the index, because he's going to give me the index. He's not trying to generate performance alpha. He's trying to generate tax alpha, but I hire other managers, these satellite managers to actually try to generate alpha for me, and I'd like to keep it. If they earn it, I'd like to keep it. That's where the tax management can come into play.

CONSUELO MACK: So interesting.

BRIAN LANGSTRAAT: Your question is an interesting point. Nobody wants to build a portfolio that minimizes taxes. You want to maximize after-tax return, and that's the crucial difference.

SCOTT WELCH: That's a good point.

CONSUELO MACK: That's crucial…

BRIAN LANGSTRAAT: Because just lowering taxes apart from maximizing after-tax return, you could do it by just putting 100 percent in municipal bonds, zero taxes. You're probably not going to get to your goals. You need to think about maximizing. So there are times to pay taxes. There are times to allocate to that satellite that has a high tax bite, but you have to maximize that after-tax return.

SCOTT WELCH: It's important to realize you only have tax if you have a gain, so the objective it to get the gain.

CONSUELO MACK: Is to get the gain. (Laughter)

SCOTT WELCH: Rule number one, get the gain and then, rule number two, figure out how you can keep more of that gain, as much of that gain as you can.

CONSUELO MACK: Final question to each of you. We always ask our guests at the end of every WealthTrack, if there's one investment we should all have in a long-term diversified portfolio, what would it be?

© 2017 Mack Track. All Rights Reserved

SCOTT WELCH: Regardless of their wealth size, everybody should have some level of passive or indexing in their portfolio. A, it's cheap. B, it gives them exposure to the broad market like Brian's been emphasizing, and that's important so they need to have that. If they're wealthier, if they're high net worth clients and they have access to the markets, I think everybody should have some level of private investment in their portfolio as well, private equity, private credit. As we sit here today, I happen to think that's where the better opportunities are versus where the public markets are trading today, but regardless of that, from a tax efficiency perspective those are very tax-efficient because by definition any of the gains are going to be long term just because of the structure of the deal.

CONSUELO MACK: Brian.

BRIAN LANGSTRAAT: Consuelo, I would answer with a portfolio structure idea, and we've talked about it, but I think it's the most fundamental and powerful thing people can do and that is take a look at their portfolio and consider the core versus satellite structure, that allocation, separating out what you want to capture the market versus where you are seeking those excess returns. In doing that, just by a fact of that, you're going to deal with risk. You're going to deal with costs, and you're going to deal with taxes all through that portfolio structure decision.

CONSUELO MACK: Terrific. Thank you both so much for joining us on WealthTrack, a fascinating discussion.

SCOTT WELCH: Thank you.

BRIAN LANGSTRAAT: Thank you.

CONSUELO MACK: And long overdue about tax efficiency and tax strategies.

SCOTT WELCH: Thanks.

CONSUELO MACK: Thank you very much.

CONSUELO MACK: At the close of every WEALTHTRACK we try to give you one suggestion to help you build and protect your wealth over the long term. This week's action point is maximize your after tax returns. We all spend an inordinate amount of time on getting capital gains. |The real trick is keeping as much of them as possible. Langstraat and Welch gave us some really good and basic tax management advice. I will certainly never look at a loss the same way. Especially in volatile or declining markets, tax loss harvesting can turn a negative into an asset to use in the future.

I hope you can join us next week for a WEALTHTRACK exclusive with award winning unconstrained bond fund manager Dan Roberts who will explain why this is anything but a Reagan bull market. To see this show again or any other previous WEALTHTRACK episodes,

© 2017 Mack Track. All Rights Reserved

just go to our website Wealthtrack.com. And for those of you reaching out to us on Facebook and Twitter- thank you and we will respond. Have a great Presidents day weekend and make the week ahead a profitable and a productive one.

© 2017 Mack Track. All Rights Reserved