

Portfolio Strategies for Tax-Loss Harvesting.

By John J. Lah, CFA

Let's face it, this has been another dismal year in the stock market with the S&P500 Index down some 30% year to date, on top of the 13% loss in 2001 and a drop of 10% the year before. In fact, the last time the U.S. stock market suffered through three consecutive calendar year losses was back during World War II. As a result of all this market mayhem, investors are undoubtedly holding some significant capital losses. What's an investor to do? Well, if your losses are sitting in a taxable account, why not make the best of the situation and have "Uncle Sam" help cover some of your losses through a portfolio management strategy called "tax-loss harvesting". Tax-loss harvesting is a time-tested method for making the best of a bad situation, and if you haven't already done so in the past couple of years, what are you waiting for? One reason might be that, some investors are reluctant to sell their losing positions because they fear that their stock or mutual fund might finally rebound after it's been sold. For these investors, we recommend that they sell their losing positions and replace it with another stock or fund that has a high correlation or similarity of movement with the position being sold.

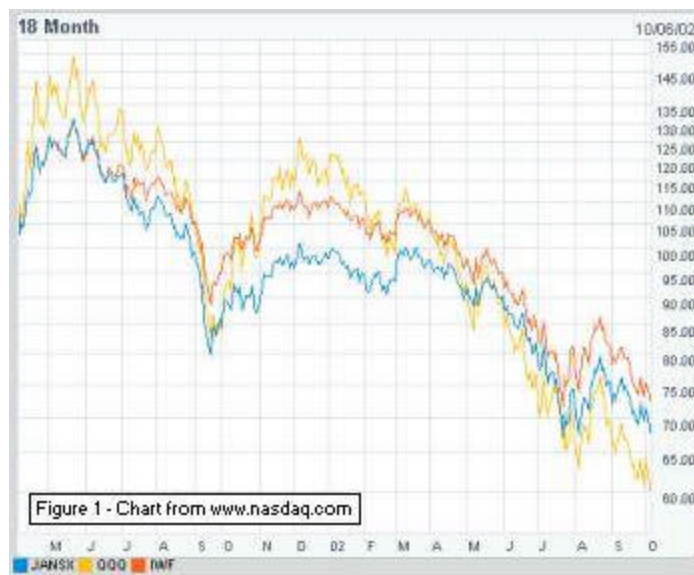
Essentially, tax-loss harvesting entails realizing capital losses in a taxable account, and then redeploying the sale proceeds among similar funds, leaving the investor's portfolio largely unchanged. The major benefit from tax loss harvesting is that a realized loss can be offset against realized gains in the investor's portfolio, or up to \$3,000 of the loss can be used to reduce ordinary income for income tax purposes. Tax-loss harvesting can be effective even for those with unrealized losses that are far in excess of the amount that could be used to offset their realized gains or the \$3,000 of ordinary income on their tax returns. Because once these losses are realized, they can be carried forward indefinitely and used in future years. Of course, investors considering tax-loss selling will need to weigh any costs that would be involved, such as brokerage commissions or fund redemption charges, and also the IRS "wash-sale" rule, which disallows the purchase of "substantially identical" securities within 30 days of a sale.

Nowadays, with the proliferation of a wide variety of exchange-traded funds (ETF as they are commonly referred), an investor could easily pick up an ETF with a similar investment objective as the stock, or mutual fund that is being sold. In this way, an investor can effectively side step the 30-day wash sale rule and maintain their portfolio exposure when selling a losing position

by buying an ETF with a similar objective. For those that are not familiar with ETF's, these are various stock market index and sector funds that trade on the major stock exchanges. They are bought and sold like stocks during market hours, and can be used to easily replicate ownership in virtually all market indexes and sectors.

Let's take the example of an investor that bought the actively managed Janus Fund (JANSX) in a taxable account anytime over the past couple of years. This fund was one of the best performing technology-oriented large cap growth mutual funds in the 90's, but it is very likely that the investor now holds that fund at a substantial loss. If in this situation, an investor wanted to create the tax loss that will be generated by selling that fund, but feels that the stock market is oversold and doesn't want to

lose his exposure, they can sell this fund and buy a technology-oriented growth fund such as the QQQ (Nasdaq-100 Index Trust) or the IWF (iShares Russell 1000 Growth Index Fund). After generating the tax loss, the investor can either reverse the "swap" in 31 days by buying back the Janus fund or simply continue to hold the new ETF position.



100 Index Trust (QQQ), you can see how closely the three appear to move together. While the correlation is not perfect, it is very close indeed. Correlation, you'll remember is a statistical measure used in portfolio analysis to describe how closely different securities tend to move together in the same direction. In fact, the correlation between the Janus Fund and the Russell 1000 Growth Index Fund was .95 while the Janus fund and Nasdaq 100 Index Trust was .89. This means that about 95% of the movement over the past 18 months in the DJ Technology index was also observed in the Janus Fund as well 89% of the movement in the Nasdaq 100 Index Trust.

Using these or other highly correlated funds for tax-driven "swaps" effectively allow an investor to realize losses and maintain their portfolio exposure to a given sector, while sidestepping the 30-day wash sale rule. While selling at a loss is never going to be easy, tax-loss harvesting is one way of reducing the pain, and is a necessary step to optimize an investment portfolio's performance.

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