

INVESTOR CHALLENGE

Maximizing Tax Efficiency by Transitioning from an Underperforming Active Manager to Parametric Custom Core®

CHALLENGE

A client was unhappy with the performance of an active manager but leery of a transition that would trigger a large tax bill.



SOLUTION

Parametric ran a proprietary transition analysis that examined the tax and tracking error trade-offs of moving to a passive portfolio.



RESULTS

The client now holds a more diversified, tax-efficient portfolio with reduced risk relative to the target index.



Challenge

An advisor brought on a new client who held a separately managed account (SMA) with an underperforming US large-cap manager. Given the investor's unhappiness with this manager's lackluster returns, the advisor recommended a more passive and broad US large-cap index exposure. However, despite the underperformance, the market's upward movement meant the SMA held a number of highly appreciated securities. Simply selling out of the client's existing SMA would trigger the realization of a large capital gain and, with it, a large undesirable tax cost. Even though the client and the advisor had both lost confidence in the active manager, the primary hurdle preventing them from acting were the tax ramifications.

Selling completely out of the client's existing SMA would trigger the realization of a large capital gain.

Parametric Solution

Taxes often present a formidable hurdle for investors looking to transition from one portfolio to another. However, Parametric has designed a broad tool kit to help investors and their advisors balance the capital gains they're willing to realize against an acceptable tracking error to the desired benchmark exposure.

Once the client and advisor selected their desired benchmark exposure, Parametric built a transition analysis to explore the tax implications of moving closer to the target exposure via a Parametric Custom Core® SMA.

This analysis provided a number of scenarios, ranging from a full transition (moving the portfolio into complete alignment with the benchmark, regardless of taxes) to one with high tracking error (but no realization of net gains). The client chose Scenario B, which may result in some realized taxable gains while achieving a moderate tracking error. The client also requested that dividends are reinvested and loss harvesting activity is applied in an effort to reduce tracking error over time.

To help understand the trade-offs of incurring taxes and reducing tracking error, Parametric created a custom transition analysis.

Results

The client no longer holds a concentrated, highly appreciated portfolio that reflected the views of an underperforming active manager. Instead the client holds a more diversified, tax-efficient portfolio with less risk relative to the target index. Over time, the deviation between the client's portfolio and the target index will be whittled down by Parametric's continuous management efforts, opportunistically using cash flows and loss-harvesting proceeds.

At Parametric, we manage more than \$232 billion in assets in Custom Core accounts alone.* Focusing on tax management while maintaining adherence to the client's desired benchmark is a critical component of our comprehensive approach.

Sample Transition Analysis

Transition to Custom Core			
	Scenario A	Scenario B	Scenario C
Proposed Realized Gains	\$171,438	\$30,864	\$1,689
Long Term	\$171,438	\$30,864	\$1,689
Short Term	\$0	\$0	\$0
Proposed Realized Losses	\$1,684	\$1,706	\$1,759
Long Term	\$1,684	\$1,706	\$1,759
Short Term	\$0	\$0	\$0
	\$169,754	\$29,159	-\$70
No. Securities Sold (all/part)	33	20	6
No. Securities Bought	293	145	118
Proposed Turnover			
Buys	63%	27%	14%
Sells	59%	23%	10%
Transition Tax Cost[†]	\$40,401	\$6,940	-\$17
	\$32,122	\$65,584	\$72,540
	3.8%	3.8%	3.8%
	0.4%	1.8%	2.4%

Different levels of net realized gains

Different transition tax costs

Different levels of tracking error

Now the client holds a more diversified, tax-efficient portfolio with less risk relative to the target index.

For more information: Investors, please contact your Financial Advisor. Advisors, please contact your dedicated representative at 800-836-2414.

*As of 3/31/2024. There is no assurance that the investment objective(s) will be achieved. All investments are subject to the risks, including the risk of loss.

ABOUT

Parametric Portfolio Associates® LLC ("Parametric"), headquartered in Seattle, is registered as an investment advisor with the US Securities and Exchange Commission under the Investment Advisers Act of 1940. Parametric is a leading global asset management firm, providing investment strategies and customized exposure management directly to institutional investors and indirectly to individual investors through financial intermediaries. Parametric offers a variety of rules-based investment strategies, including alpha-seeking equity, fixed income, alternative, and options strategies. Parametric also offers implementation services, including customized equity, traditional overlay, and centralized portfolio management. Parametric is part of Morgan Stanley Investment Management, the asset management division of Morgan Stanley, and offers these capabilities through offices located in Seattle, Boston, Minneapolis, New York, and Westport.

DISCLOSURES

This material may not be forwarded or reproduced, in whole or in part, without the written consent of Parametric. Parametric and its affiliates are not responsible for its use by other parties.

This information is intended for informational purposes and details investment strategies and opportunities identified by Parametric. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. We believe the information provided here is reliable but do not warrant its accuracy or completeness. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The views and strategies described may not be suitable for all investors. Past performance is not indicative of future results. Investing entails risk, and there can be no assurance that Parametric will achieve profits or avoid incurring losses. Parametric and Morgan Stanley do not provide legal, tax, or accounting advice or services. Clients should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein. Additional information is available on request.

Charts, graphs, and other visual presentations and text information were derived from internal, proprietary, or service vendor technology sources or may have been

extracted from other firm databases. As a result, the tabulation of certain reports may not precisely match other published data. Data may have originated from various sources, including, but not limited to, Bloomberg, MSCI/Barra, FactSet, or other systems and programs. Parametric makes no representation or endorsement concerning the accuracy or propriety of information received from any third party.

There is no assurance that a separately managed account (SMA) will achieve its investment objective. SMAs are subject to market risk, which is the possibility that the market values of the securities in an account will decline and that the value of the securities may therefore be less than what you paid for them.

Market values can change daily due to economic and other events (natural disasters, health crises, terrorism, conflicts, social unrest, etc.) that affect markets, countries, companies, or governments. It is difficult to predict the timing, duration, and potential adverse effects (portfolio liquidity, etc.) of events. Accordingly, you can lose money investing in an SMA.

Investment strategies that seek to enhance after-tax performance may be unable to fully realize strategic gains or harvest losses due to various factors. Market conditions may limit the ability to generate tax losses. Tax-loss harvesting involves the risks that the new investment could perform worse than the original investment and that transaction costs could offset the tax benefit. Also, a tax-managed strategy may cause a client portfolio to hold a security in order to achieve more favorable tax treatment or to sell a security in order to create tax losses. Prospective investors should consult with a tax or legal advisor before making any investment decision.

All contents ©2024 Parametric Portfolio Associates® LLC. All rights reserved. Parametric Portfolio Associates® and Parametric® are trademarks registered in the US Patent and Trademark Office and certain foreign jurisdictions.

Parametric is located at 800 Fifth Avenue, Suite 2800, Seattle, WA 98104. For more information regarding Parametric and its investment strategies, or to request a copy of the firm's Form ADV or a list of composites, contact us at 206 694 5500 or visit www.parametricportfolio.com.

NOT FDIC INSURED | OFFER NOT A BANK GUARANTEE | MAY LOSE VALUE | NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY | NOT A DEPOSIT