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Editor's Letter

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Thankfully, more and more investment managers are attempting to meet the true needs of individual investors and developing investment solutions geared to generate after- rather than pretax returns. These responses, however, cover a wide spectrum and are based on different premises, which we think it is beneficial to outline here.

It may be useful to restate the obvious. Tax awareness is about avoiding unnecessary and deferring unavoidable taxes. An important benefit of tax-efficient investing lies in the power of compound interest, as investors earn a return on assets that would otherwise be paid out in the form of taxes. Tax-efficient investment process developers must deal with a simple but critical trade-off: Will the restrictions imposed on the investment decision-making provide enough of a return enhancement to compensate for the potential loss of value-added? Dealing with this trade-off, they must also weigh the certainty of the immediate tax cost against the uncertainty associated with the expected value-added.

At one end of the spectrum, some managers have concluded that the costs associated with paying attention to tax implications are not worth the likely benefits. Although it is applied in both traditional and non-traditional asset classes, the proposition tends to apply most where the investment process uses instruments that are inherently tax-inefficient or where the strategy relies on decisions that are highly time-sensitive. Many alternative investment strategies would fall in that category. The expectation, however, is that these strategies have the potential to offer a significant-enough expected after-tax return and portfolio diversification that they remain worth considering in a total portfolio context. Sophisticated investors may try to mitigate the impact of taxes by wrapping these strategies into tax-deferred structures or locating them in tax-exempt vehicles and even inputting ownership to members of the family the farthest away from their estates maturing.

Other managers deal with tax considerations by focusing on passive or very low turnover strategies. They effectively believe that the scope to earn positive value-added after taxes and after fees is so limited that it is better to focus on minimizing all

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forms of management costs (considering taxes and the time needed to monitor active investment strategies more closely as part of these). These strategies are proving quite popular, particularly among investors who do not start their investment programs with cash. Creating a passive portfolio constructed in such a way as to "complete" a portfolio with very large imbedded gains can often be a very attractive alternative. Passive strategies can also be usefully complemented with systematic tax loss harvesting to create another dimension of value-added for the portfolio as a whole.

In fact, passive processes are also evolving along the "passive-active management axis" and taking the form of enhanced index strategies. Probably for much the same reasons as in the institutional world where they have prospered, these strategies respond to the frustrations expressed by many investors with a pure indexed approach. What if the index selected is not really critically relevant? Why settle for a certain negative value-added, as there is some non-zero management cost, some (minimal) tracking error, and no expected excess return? Several approaches have been developed, ranging from a quantitative tilt toward certain risk (and return) factors (such as size, value, growth, yield) to a qualitative exclusion of the least-attractive securities, based on a traditional research process or selected screens.

At the other end of the spectrum, a substantial number of investors still believe that it is possible to combine tax efficiency with active management. Interestingly, active tax-efficient managers currently seem to fall in one of two different camps, using different types of approaches. This probably reflects the realities of a marketplace dominated by managers who cater both to individual and institutional investors. In both cases, these managers are ostensibly attempting to integrate a tax dimension into a discipline hitherto solely focused on the traditional risk/return trade-off.

- One group of managers first proceeds to define a "desirable fishing pond," and then applies a broadly unchanged portfolio construction process. These managers believe implicitly that a certain number of "tilts" in the pool of securities from which they pick will effectively minimize the risk that the portfolio will be overly tax-inefficient. These tilts can be applied through quantitative screens or qualitative insights produced by a traditional investment research process. The security selection universes that such adjustments generate would naturally be tilted toward stocks that pay lower dividends and have steadier growth characteristics, and, conversely, eschew cyclical or traditional basic industry stocks.

- Another group leaves its investment research broadly unchanged, but chooses to apply different portfolio construction rules. In this design, attractiveness is viewed as an absolute that may or may not apply to individual circumstances, depending upon tax considerations. The portfolio construction process thus takes on a critical role. Typically, managers will design a portfolio that they perceive as the "best" portfolio they could construct today, whether the beneficial owner of the assets is taxable or tax-exempt. Each individual client portfolio is then moved closer or not so close to that "ideal," depending upon the tax implications of the move, the potential to harvest losses in the portfolio, and the conviction attached to any marginal trade.

Looking ahead, one might argue that one possible active management variant is still missing. Would it be possible to combine the most attractive features of the two active management approaches? Would it make sense to reengineer a stock valuation process designed to reward the characteristics favored by investors who pay taxes and penalize those that are seen as detrimental? Would it be possible to do so in the context of a valuation model rather than in the form of universe screens? Then, would it be possible to use thus derived valuation readings, combine them with the insights of individual portfolio managers — or not — and construct portfolios that are thus tailored to each investor's needs?

In this issue, we offer three "pairs" of articles broadly focused on three important questions:

- David Stein and James Poterba contribute to the *after-tax performance measurement debate*. Stein focuses on a pragmatic approach to the measurement of after-tax performance, raising questions as to how to measure after-tax performance in a way that is still practical. Poterba looks at the issue from a completely different perspective, effectively arguing that it may not be reasonable to assume that the tax rate for unrealized gains is zero.
- James P. Garland and Bernard McCabe focus on issues with important *fiduciary implications*. Garland considers the issue of unitrusts, which have become more popular as total investment returns have significantly exceeded narrowly defined income, and argues that they may actually not offer many of the benefits one might expect. McCabe proposes a mathematical tool to evaluate the probability of a portfolio not "running" out of money, thus illustrating the interplays of return, cash flows, and capital market circumstances; this could have practical applications in the charitable trust world.
- R.B. Davidson III and Jean Brunel look further into the issue of *tax-awareness in the investment management process*. Davidson focuses on tax trading in a fixed-income portfolio context, and illustrates the value-added that might accrue to well-designed strategies, whether applied to municipal or taxable bonds. Brunel considers a possible multiasset process that requires the use of derivative securities, effectively proposing that portfolios be managed along investment decision, rather than asset class, axes.

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