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How to Avoid the No. 1 Value Killer in Retirement Portfolios

By Jane Wollman Rusoff

t's not difficult to unwittingly harm clients' money-making possibilities in retirement assets: Neglect investing in tax-efficient securities or fail to learn tax-smart — perhaps little-known — strategies.

"A poorly tax-managed portfolio is the No. 1 reason that retirement portfolios are robbed of their potential value," Barrett Ayers, president, CEO and co-founder of Adhesion Wealth Advisor Solutions, maintains in an interview with ThinkAdvisor.

Adhesion, a subsidiary of AssetMark Financial Holdings that serves RIAs and other fiduciaries exclusively, focuses on generating income during retirement and passing on wealth to heirs. Its technology platform has a variety of tools, including managed account solutions.

In the interview, Ayers discusses the benefits of losses — "They create capital value," he says — and explains why "unwrapping" mutual funds and exchange-traded funds enables active tax-harvesting, among other tax-efficient approaches.

Ayers, previously with Wachovia and Fidelity Investments, highlights a process for advisors and clients who are moving from one firm, or investment strategy, to another: a tax-transition account combined with a tax budget to gradually move assets to a new target portfolio.

Here are excerpts from our conversation:

THINKADVISOR: Why is tax awareness for retirement income critical?

BARRETT AYERS: A poorly tax-managed portfolio is the No. 1 reason that retirement portfolios are robbed of their potential value.

Few forces are as potentially corrosive to investment returns and retirement preparedness.

What's tax alpha?

Tax alpha is simply how much should I save you from paying the IRS. If you were going to pay $10,000 and I reduced your taxes to $5,000, I've saved you 50% to 60% tax alpha.

You strongly believe in the value of investment losses. Tell me why.

The losses you're creating today can be used as a capital asset in the future when your tax brackets are lower and you can start taking distributions at a lower rate.

Banking losses, looking for losses, actively harvesting losses are always good things to do because they create capital asset value.

We can do active harvesting — regularly harvesting opportunistically by looking for losses.

Another strategy is direct indexing, a passive investment strategy that allows a host of opportunities to do tax-loss harvesting, for example.

Combined with tax overlay services, it [helps] navigate volatility and maximizes after-tax returns.

When would you apply tax-gain harvesting?

If you believe that tax rates are going up, it makes sense to do tax-gain harvesting [immediately].

The other reason is when you're relocating your portfolio and have had losses.

If it's time to rebalance your portfolio and, say, you move from aggressive to moderate and have built up a sufficient amount of losses, it could be time to look for the gains to offset your previously banked losses.

You've built up the losses, and now it's time to take some of those gains because you want to move the portfolio to a different place. That's the reason we banked all those losses.

What else is an effective tax strategy?

[Monitoring] wash sales [because gains are taxable.] They happen so frequently, but many advisors aren't watching [for them] because they're happening outside their purview, [perhaps] in multiple accounts [with different managers]. Keeping everything inside a single account is a secret to making sure all of that is mitigated.

How can smart tax strategies help when an advisor and their clients move to a different firm?

Here's a tool that allows them to not have to sell and repurchase and go through all that tax churn.

[You can also use it when] you want to move the client from conservative to aggressive or vice versa.

The old way of doing a transition used to be selling everything and buying everything, which is highly tax inefficient.

Tax transition is a process that holds a certain amount of assets off to the side in a tax-transition account. We put together a budget with the end investor, who may say, "I have an appetite to pay only $25,000 in taxes this year."

Then what happens?

Every year we'll move a little more out of the tax-transition account into the new target portfolio, being respectful of the tax budget.

What's left behind looks like an index; for example, the Russell 1000 or the S&P 500.

Please explain tax overlay management.

It's a bucket of services run by a "quarterback." For example, Adhesion oversees the end client's entire portfolio [but doesn't have a direct relationship with them]. There's one single account for everything.

The effect of direct indexing combined with tax overlay services [helps] navigate volatility and maximize after-tax returns.

What should the advisor consider first for tax efficiency?

Unwrapping pooled vehicles, like mutual funds and ETFs, which by their very nature are tax inefficient.

Unwrapping is selling a mutual fund or ETF and moving into a managed account, where the end client holds individual securities.

What's great about unwrapping?

You can do a lot of really neat things, like active tax harvesting — and do it multiple times a year, or every day.

You can look opportunistically for tax-loss harvesting, bank those losses and use them for future capital gains.

On top of that, you can customize the portfolio with things like "do not sell"-type restrictions on individual securities.

About unwrapping, ETFs are promoted to be tax efficient. Aren't they?

ETFs can be efficient except you can't loss-harvest them. But if you have a managed account instead of a single ETF, you have 20 or 30 holdings and many, many more opportunities.

How can planning the sequence of withdrawals from various accounts minimize taxes?

Harvesting in conjunction with a diversified portfolio is the best way to systematically avoid sequence risk — taking distributions at the most inopportune time. It's one of the biggest [causes] of portfolio

erosion.

In a bear market, it's one of the most costly things that can happen.

Selling gains [results in] taxable impact. So the key is to make sure you have really good harvesting strategies, in addition [to the gains].

For example?

If you have a non-correlated portfolio and want to avoid sequence risk, then you're selling securities that are at the top of the market. You also have to keep selling losses to generate offsetting losses.

What's another critical part of retirement planning when it comes to paying taxes?

Carrying losses forward so that the taxable distributions are made at lower tax rates.

Please talk more about distribution strategies to lower taxable income.

Part of it is location optimization. You're lining up things for the least tax impact.

Group types of securities in different types of accounts. You may have higher-return investments in a Roth IRA, tax-inefficient investments in [other] retirement accounts and tax-efficient investments in taxable accounts.

At what point would an advisor do such grouping?

Ideally, when you're setting up the portfolio and starting to develop a relationship with the client.

How else can advisors be smart about taxes?

There are things like monitoring short-term gains in a taxable account. If the gain is about to go long term, you can hold it for a period of time and wait till it becomes long term and drops from, say, the 33% tax bracket to the 15% or 10% bracket.