

That Taxing Time of Year

We have bid farewell to 2005: a year with low single-digit stock market returns and a fair amount of turnover within our portfolios. This is in contrast to the previous two years, which saw double-digit stock market returns with an unusually low amount of turnover. For those of you, our clients, with taxable accounts, 2003 and 2004 translated into high portfolio appreciation with a minimal tax effect due to the low turnover. We had the best of both worlds: high returns and low taxes. As a result, when 2005 arrived, we had accumulated a number of holdings with rather substantial unrealized gains. Several of these positions had appreciated to the point of becoming over-valued by our investment criteria and were subsequently sold during 2005.

This activity resulted in the realization of taxable gains, which in many cases exceeded the individual portfolio appreciation in 2005. In fact, the potential exists for a scenario whereby the taxes due on realized gains could be equal to or even exceed the total portfolio appreciation for the year. However, when you consider the total portfolio performance over the past

few years and that some of these gains were accumulated over that time span (and in some cases, even longer), the tax bill appears more in context with the overall long-term portfolio appreciation. Our goal is always to maximize our clients' after-tax returns, given a targeted level of risk.

Let's examine two approaches to minimizing the tax burden that results from large realized gains. First, we will describe the more traditional approach to tax-loss selling and, then, a more opportunistic approach to harvesting tax losses.

Losing the Harvest

We traditionally hear from a number of CPAs towards the end of the year. Their questions are all very similar, such as: "What are the realized gains for the year?" This question is designed to get a handle on a client's expected taxes for the year, in anticipation of the tax filings that will occur by springtime. And for CPAs who are not yet initiated to the CornerCap philosophy, their inevitable follow-up question is almost always: "Do you have any losers that you can sell before the end of the year?" This follow-up question

explores the possibility of reducing the client's realized gains and thereby the amount of taxes owed. This is the traditional approach to tax-loss selling.

Tax-loss selling implies just that: securities whose cost exceeds the current market value are sold in order to realize the loss for tax purposes. Let's illustrate this point with a hypothetical example. Suppose that we have a portfolio at the beginning of the year that contains three stocks: stock A, stock B, and stock C. Further suppose that all three stocks were purchased during the previous year at the same price: \$10. In other words, the cost basis for each of our stocks in this example is \$10. During the course of the year, stock A outperforms the market and is sold in December at a price of \$20, 13 months after it was purchased. Stock B performs in line with the overall market and is priced at \$11, and stock C declines below its cost to a price of \$5 but rebounds to \$7 by December.

By the time December rolls around, most clients with taxable accounts, and certainly their CPAs, are assessing the tax effects of the year's investment performance. In our example, we have a

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realized gain of \$10 on the sale of stock A, which is classified as a long-term capital gain. The current federal capital gains tax rate for most investors is 15%; so in this case, we will owe the IRS \$1.50 of the \$10 in profit that we realized from the sale of the stock. That leaves the investor with \$8.50 in net profit.

Now let's assume that we wish to sell stock C in December for tax-loss purposes. If we were to sell stock C for \$7, we would realize a loss of \$3 from the transaction. The portfolio value would not change, but the amount of tax owed by the investor would be reduced. In this example, the profit for the year would be reduced to \$7 (\$10 gain minus \$3 loss), and the capital-gains tax at 15% would equal \$1.05, or \$.45 less than what was originally owed to the IRS before the tax-loss selling occurred.

Once a security has been sold at a loss, it must not be repurchased for 30 days, or the IRS will disallow the recognition of the loss from the first sale. Violation of this rule is called a "wash sale" and negates the intended tax benefits. Therefore, when using the traditional tax-loss selling approach, investors must wait

31 days before repurchasing a stock that was previously sold for tax purposes. Of course, as we will explain later, a lot can transpire in 31 days, such as a strong earnings report or a positive company press release.

We call this approach the traditional method because it is the method that is most commonly employed by investors, CPAs, and money managers. Therefore, if a stock is widely held and has experienced a significant price decline during the year, it is highly likely that there will be considerable selling pressure in the last month of the year. Returning to our example, stock C was \$7 in the beginning of December. Assuming that most investors were below their cost basis, it would be reasonable to expect further declines in the price of stock C during the month, as the result of tax-loss selling pressure. This behavior is an example of the herd mentality in action, and we believe that this selling pressure pushes already out-of-favor stocks further below their intrinsic value.

If we allowed our investment discipline to be compromised by tax considerations, what would be the harm? Interestingly,

we have compiled data that quantifies this effect. We have several accounts that demand aggressive tax-loss selling at year-end. To test our philosophy, we went back and measured the performance of these portfolios and compared the results to other portfolios with identical investment objectives and similar holdings but with no requirement for tax-loss selling. The negative impact of the traditional year-end tax-loss selling on investment performance was over 1% a year!

Leveraging the Harvest

As you undoubtedly know by now, we avoid following a herd-like behavior such as the one described above; it goes against our contrarian nature. Furthermore, we feel that there is a more opportunistic, value-adding approach to accomplish tax-loss selling. To illustrate an approach that we prefer, recall our earlier example with the three stocks: A, B and C. Stock A was sold for \$20, stock B performed in line, and stock C declined to \$5 and then rebounded to \$7 by early December.

Throughout the year, we constantly monitor the realized portfolio gains as

well as the individual holdings. Assuming that we still felt that stock C was a good value after its initial decline to \$5, we would have taken the following action: we would have purchased a duplicate, fully weighted position of the stock in the portfolio (in this example, 2 shares at \$5 each) for \$10. Then, 31 days later, we would sell the original share of stock C with a \$10 cost basis. This would realize a \$5 loss for tax purposes, and the portfolio would not be without exposure to the potentially undervalued stock. In effect, we would have swapped the cost basis and, for a 30-day period, slightly over-exposed the portfolio to the stock. In the event of a positive earnings report or other upside catalyst, the portfolio would have leveraged the benefit of owning the stock.

Over time, the first approach described above (traditional approach) results in selling stocks low. The second approach (CornerCap approach) tends more towards buying stocks low. The basic principle is to buy low and sell high, but many investors forget this simple concept or fail to recognize that the conventional “wisdom” may be an impediment to following this basic rule.

Don't Let The (Tax) Tail Wag The (Investment) Dog

While we are aware of our clients' tax sensitivities, we constantly strive to remove these considerations from our investment process. We work hard not to compromise our investment discipline; we will sell a stock when our investment process indicates that it is overvalued. Sometimes, the sale will generate a large gain, even at the end of the year, or excess cash at a quarter end, and we are aware of these effects. This is not to say that we will not accommodate a year-end request for tax-loss selling, but it is the exception rather than the rule.

Because the psychological impact of writing a large check to the IRS on April 15 is so immediate and so painful, it is easy to lose sight of just how immaterial the economic benefit of tax-loss selling really is for an individual. Assuming that the tax loss that was available in December would also be available in the next year, the true economic “savings” is the time value for one year on the amount of tax that was offset. In our illustration of the traditional approach, we offset \$3 of gain through tax-loss selling of stock C,

reducing the tax by \$.45 for the year. Therefore, if short-term interest rates remain at 4.25%, the true savings to the investor is really \$.02 (\$.45 times 4.25%), which could easily be recovered by a \$.02 movement in the price of stock C.

It is easy to let short-term tax considerations affect the long-term performance of your investment portfolio. Your tax professional strives to reduce your taxes each year; on the other hand, we strive to maximize investment results over the long-term. We hope that this insight into our contrarian philosophy will enable you to understand our investment process better and avoid any performance pitfall due to short-term tax considerations.

Nothing mentioned in this commentary should be construed as tax advice. You should consult your tax advisor for specific advice regarding your own tax situation.