

THE TAX VS. INVESTMENT CONFLICT: HOW TO WIN BOTH

Traditionally, we find most taxable investors engaging in a common year-end activity: tax-loss selling. Offsetting the year's investment gains by liquidating losing positions is a very common and widely advocated tax-saving strategy. But is it a wise investment strategy? If one has realized taxable gains for the current tax year, it is tax-efficient to offset those gains *throughout the year* by selling losing stocks that *no longer meet one's investment criteria*.

The italicized portions of the preceding sentence are the keys that most tax professionals and investment advisors overlook. If a stock still fulfills the risk/reward profile of your investment strategy, why would you sell it? And if the stock no longer meets those investment criteria, why wait until year-end to sell?

Most tax advisors would advocate selling a losing position at year-end to realize the tax loss and then buy back the position 31 days later (in order to recognize a loss for tax purposes, the IRS requires that the security whose sale generated the loss not be repurchased by the seller for a minimum of 30 days; otherwise, the transaction is considered a "wash sale," and the loss is disallowed). This year-end selling strategy produces offsets to realized gains, resulting in some current-year tax savings.

However, from an investment viewpoint, here's the problem: you are selling the same securities at precisely the same time as everyone else. Virtually everyone who owns a losing stock in a taxable account is receiving exactly the same advice from tax advisors at year-end: sell.

As this flood of sellers enters the market in December, the natural supply-and-demand balance for the security becomes distorted, resulting in further price declines to an already depressed stock. One is almost guaranteed to receive a less-than-fair price for his investment, and the execution of this transaction goes against the basic key to successful investing: buy low, sell high.

In fact, the "January effect," whereby stocks tend to exhibit sharp price appreciation at the beginning of the year, is the result of indiscriminate year-end tax-loss selling. Because such selling depresses the stocks but has nothing to do with their fundamental worth, bargain hunters quickly buy in, causing the January rally. Unfortunately for 2008, there has been no "January effect" as the significant market decline has kept the bargain hunters on the sidelines.

Many investors who follow the traditional tax saving advice and sell out at year-end fully intend to repurchase the stock in 31 days. But what typically happens is that the investor has now associated the purchase of this stock with the realized loss – in other words, a negative mental reinforcement – and the stock is not repurchased. Also, the "out of sight, out of mind" phenomenon sets in and the bad feelings are soon forgotten.

In such instances, the seller "loses" twice, both from an economical and a psychological point of view. Economically, money was lost on the investment, even though the investor may view the very visible and immediate cash savings on his tax return as a benefit. Psychologically, by selling the stock at a loss, there is the tacit admission that the purchase decision (or timing) was wrong. It may just be that the timing of the buy was "early," but

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Unfortunately in the investment arena, it is hard to distinguish between “early” and “wrong.”

Aside from bad feelings, what is the real harm of allowing one’s investment discipline to be compromised by tax considerations? Interestingly, we at CornerCap manage several accounts for clients who demand aggressive tax-loss selling at year-end. To quantify the effect of this strategy, we measured the performance of the largest of these portfolios over a ten-year period and compared the results to another portfolio of similar size with similar investment objectives and holdings but with no requirement for tax-loss selling.

The performance differential was over 1.5% per year, demonstrating the negative impact of traditional indiscriminate year-end, tax-loss selling on investment performance. For a portfolio with a beginning value of \$1 million, the difference amounts to more than \$485,000 over the 10-year period.

To avoid selling your losers along with all of the other “losers” each year-end, why not consider an alternate strategy to achieve the same tax efficiency but with improved investment results? For example, consider selling holdings with losses that no longer fulfill one’s investment criteria throughout the year – and certainly well before the closing weeks of December. In this manner, you will

avoid selling with the herd and stand a much greater probability of receiving a fair price.

Another tax-efficient investment strategy is to harvest losses from key holdings throughout the year in the following manner: begin by purchasing a duplicate position of the holding (this is only applicable for stocks that continue to meet one’s investment criteria), and then sell the original (i.e., losing) tax-lot 31 days later. In this fashion, you have remained faithful to your investment philosophy, will capture any potential upside, and have “harvested” the tax benefit.

We at CornerCap are also sensitive to taxes. Like commissions and trading spreads, taxes are a cost of successful investing. Taxes on short-term capital gains are particularly onerous and should be avoided or offset when possible. However, investments, not taxes, should be the driver. Do not fall victim to allowing the very immediately visible tax savings to negate the less immediately visible longer term investment performance.

Your tax professional strives to reduce your taxes each year; CornerCap, on the other hand, strives to maximize after-tax investment results over the long-term. We hope that this insight into our contrarian philosophy will enable you to understand better how we balance tax management with investment management, resulting in greater after-tax assets.