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The Only Practice Management/Technology Newsletter for Financial Advisors.

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Guest Columnist: Sheryl Rowling, CPA/ PFS, Total Rebalance Expert

After the Fall: Tax Loss Harvesting, Location Optimization and Tax Lot Identification


Sheryl Rowling

With the recent stock market downturn and continued volatility, advisors are feeling the pinch. Lower "assets under management" (AUM) translates into lower bottom lines, meaning advisors are earning less. At the same time, clients are demanding more interaction, reassurance and planning. With less time on their hands, greater demands and less revenue, advisors can't find a way to do what they desperately need to do: retain their current clients and bring in new ones.

As talented as advisors are, they can't guarantee positive returns in a down market. Sure, diversification can cushion the blow, but reporting negative quarterly returns is never a positive experience for either the advisor or clients. Even now, as the market is experiencing a shaky recovery, most portfolios have not fully recovered from the big downturn. Clients might be feeling somewhat less frightened, but they're certainly not pleased with their investment results. That leaves them ripe for courting by stockbrokers and other "financial planners" who promise them better results. Even loyal clients are not exactly jumping at the chance to refer new business.

To turn clients into cheerleaders and attract new business, advisors need to have time for face-to-face meetings and must differentiate themselves from the competition. How can this be accomplished?

Simply put, to succeed in today's environment, advisors must embrace technology to handle routine, time-consuming tasks and to leverage their investment strategy to produce tangible tax savings for clients. Many advisors believe their clients are not concerned with tax savings since they've lost so much in their portfolios. That might be true in the short-run, but remember, there are two things that clients truly dislike: losing money and paying taxes. Advisors can't control periodic market declines; they can only mitigate them

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through diversification and rebalancing. Advisors can't ensure that clients will never pay taxes, but through tax loss harvesting, location optimization and tax lot identification, they can certainly minimize taxes imposed. And, through education and quantification, clients can be trained to get excited about how much money their advisor is saving them!

Basic rebalancing software, such as Schwab's rebalancing tool, can help automate rebalancing. However, such software cannot concurrently implement high level tax savings strategies. More robust software, such as Total Rebalance ExpertTM (TRX), can not only perform household level (across-account) rebalancing, it can also automate tax loss harvesting, location optimization and tax lot accounting.

So, how can automated rebalancing and tax savings translate to client loyalty and a marketing edge? In this period of accumulated capital losses, most clients will not realize a material current-year tax benefit from moves made in 2009. This does not mean advisors should ignore opportunities, however.

Benefits from tax-aware portfolio management include:

Tax Loss Harvesting: Tax loss harvesting produces capital losses that can be carried forward indefinitely until used up, thereby offsetting future gains realized from rebalancing (both short-term and long-term) or distributions.

Location Optimization: Current taxes may be reduced by shifting ordinary income producing bonds from taxable accounts to IRAs. Future taxes may be reduced by shifting appreciating securities to taxable accounts (where gains can be taxed at capital gains rates) from IRAs (where gains would be taxed at ordinary rates).

Tax Lot Identification: Capital gains may be minimized during the rebalancing process by choosing high cost lots. Although clients with capital loss carryforwards might not notice the savings in the current year, tax lot identification can help to preserve the loss carryforwards for use when rebalancing gains are unavoidable.

To get "credit" for future tax savings, advisors will need to educate their clients. To get "credit" for current tax savings, advisors will need to give them numbers. For example, let's say that an advisor used a program like TRX, accomplishing the following for a $1,000,000 account during 2009:

Tax Loss Harvesting: Recognized $200,000 of losses
Location Optimization: Moved $100,000 from municipal bonds paying 4% in the taxable account to corporate bonds paying 7% in the IRA.
Tax Lot Identification: Reduced gains recognized by $50,000 from selecting high cost lots over average cost.

In the annual performance report, the client's pre-tax return will be increased by 0.3% (($100,000 x (7% - 4%))/$1,000,000). In a supplemental report, the advisor can point out that, assuming a 15% capital gains rate, $37,500 of taxes were deferred (($200,000 + $50,000) x 15%), or 3.75% of the portfolio. Finally, in quarterly report letters or client seminars, the advisor can explain the value of tax savings strategies, including the significant benefit of utilizing capital gains rates (or possibly basis step-up at death) by shifting growth assets to the taxable account (rather than the IRA).

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Advisors who are not providing state-of-the-art portfolio management are depriving their clients of significant tax benefits. Through automation, advisors can more easily fulfill their fiduciary responsibility and differentiate themselves from the competition. Showing clients continued added-value will give advisors the edge they need to retain happy clients and attract new business!

Sheryl L. Rowling, CPA/PFS is CEO of Total Rebalance Expert and Managing Partner of Rowling, Dold & Associates LLP. She can be contacted at sheryl@trxpert.com.

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