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Practice in Crisis

The current economic environment presents an extremely perilous time for advisory practices. In fact, this might very well be the most challenging time ever for investment advisors. Without judicious and responsive reactions, entire practices could be at risk.

Sheryl R. Rowling

Market volatility combined with plunging values has put pressure on investors and advisors alike. Investors are worried about their account balances and their ability to reach goals. As a result, they are demanding more from their advisors: more planning, more meetings, and more hand holding.

Advisors are feeling the strain. Dealing with drastically diminished revenues, they are faced with ever increasing demands on their time. Meetings, phone calls, emails and correspondence are the only tools available to counteract clients' temptation to react emotionally by moving to cash or — worse – by switching to another advisor. Additionally, the ongoing volatility requires more transactional work such as rebalancing and tax loss harvesting.

To meet the challenges of the current environment, advisors must control expenses and work to satisfy and retain current clients while seeking to increase revenue by adding new clients. This seemingly impossible challenge requires increased performance along with decreased costs. In other words, the challenge is this: How do you free up time and do a better job without hiring more people?

The solution... automating portfolio management. The most time consuming component of portfolio management is rebalancing. Yet, over 90 percent of advisors rebalance portfolios manually. Using an automated system provides the following advantages:

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- Immediately identifies accounts requiring action
- Shortens rebalancing time from days or weeks to hours
- Produces more consistent, optimal trades
- Integrates tax management and location optimization
- Instantly generates cash or invests added funds
- Quickly processes tax loss harvesting, considering wash sales
- Quantifies savings to clients.

With a complete rebalancing solution, the advisor can set portfolio management preferences according to his or her own strategic decisions. Because of the automation, processing transactions can then be delegated to paraprofessionals or less senior staff. This effectively frees up the high level advisor, allowing him or her more time to spend with current and prospective clients.

Through automation, the multiple variables affecting rebalancing are considered and prioritized in a consistent manner. Thus, trades proposed will:

- Rebalance to pre-set tolerance ranges
- Provide for required minimum cash and set-aside cash needs
- Minimize transaction costs
- Avoid short-term gains
- Sell from highest cost lots
- Avoid wash sales
- Avoid redemption fees
- Optimize location of asset classes.

Tax loss harvesting transactions will:

- Process loss-generating trades simultaneously among clients
- Choose lots with pre-set required loss percentages
- Avoid wash sales
- Automatically substitute pre-selected alternate funds.

Clearly, automated rebalancing and tax loss harvesting can save time and produce more consistent, optimal transactions. This can solve the problem of creating more time for advisors. However, to address revenue needs, advisors must still be able to demonstrate value to their current and prospective clients.

To demonstrate value, the advisor must produce value *and* communicate that value. It is difficult to quantify the value of rebalancing to an allocation strategy. After all, in the long run, an un-rebalanced portfolio will tilt to equities over time. And, since equities generally outperform fixed income, the un-rebalanced portfolio should outperform a rebalanced portfolio. On the other hand, rebalancing moderates volatility and this can produce more predictable long-term returns. But, it cannot produce quantifiable savings that can be communicated to clients.

Tax loss harvesting obviously generates value. A loss recognized without disturbing investment strategy creates a tax benefit that is not offset by potentially diminished investment returns. And, this tax benefit can be quantified.

Additional savings from tax-aware rebalancing can be easily generated through automation. Avoiding short-term gains essentially converts ordinary income to long-term capital gains subject to greatly reduced tax rates. Selling from high-cost lots produces lower gains than using average cost. As with tax loss harvesting, the savings from avoiding short-term gains and selling from high-cost

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lots can be quantified.

Finally, automation provides another opportunity for tax advantages that can be quantified: location optimization. Rebalancing with location optimization seeks to place assets in accounts to produce the most beneficial tax treatment. For example, interest and dividends paid on positions held in taxable accounts are subject to immediate taxation. Appreciating assets held in taxable accounts can benefit from long-term capital gains rates. Additionally, appreciated securities held in taxable accounts can escape income tax altogether if held until the owner's death.

The opposite is true for retirement accounts, such as IRAs, 401(k)s and annuities. Interest and dividends generated within retirement accounts are not taxed as paid. Likewise, gains on sales of positions held within retirement accounts are not taxed currently. However, upon withdrawal from the account, all income (interest, dividends and appreciation) is taxed at ordinary rates. Thus, although retirement accounts avoid immediate taxation, eventually all income is taxed. It should also be noted that the liability for ordinary income tax is not avoided by death.

Roth IRAs provide dual benefits of avoiding tax on a current and long-term basis. To take maximum advantage of these tax benefits, the highest returning assets should be held in Roth IRAs.

Therefore, considering location optimization, investments generating ordinary income should be held in retirement accounts to avoid current taxation. Investments held primarily for long-term appreciation should be held in taxable accounts to take advantage of capital gains rates and/or basis step-ups at death. And, high return assets should be held in Roth IRAs.

Automated rebalancing produces optimal trades while minimizing tax costs and considering location optimization. And, the savings from tax loss harvesting, avoiding short-term gains, choosing high-cost lots and location optimization can be quantified and communicated to clients.

With automated rebalancing benefits of extra time, more efficient and consistent portfolio management, and savings that can be communicated, advisors pinched by the current market environment can effectively emerge more profitable and stronger than ever.

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