Peanut Butter and Jelly

Using Tax-Loss Harvesting and Exchange Funds to Manage Concentrated Positions

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Overview

Wealth is typically created through concentration but preserved through diversification. A typical example tends to be a long-time executive in a high-growth company earning equity awards as part of overall compensation, and seeing the equity awards produce significant gains.[1] Through a successful career and good timing, many individuals have created substantial wealth with two embedded downsides – a significant single-name concentration and a large unrealized capital gains tax liability.

This is of course a "high quality" problem in that it represents substantial wealth. However, over time this concentrated risk should be managed so that the investor's overall net worth does not depend on the performance of a single name. Simply put, single stock concentration exposes an investor to significant and material risks. Diversifying such a concentrated wealth portfolio helps reduce risk, but can also result in a giant tax bill.

The main mechanism for reducing such risk is the time-tested portfolio strategy of diversification – spreading the idiosyncratic risk over multiple stocks, industries, sectors and asset classes. But the diversification trade often comes at a substantial cost. In the most extreme cases, equity awards could have been acquired at near zero cost, resulting in a potential tax liability up to half of the value of the holdings when accounting for federal, state and local taxes[2].

Fortunately, investors are not without investment tools to address this diversification and tax dilemma. There are several investment strategies designed to help diversify tax-efficiently. While taxes cannot be entirely avoided, there are investment strategies available to help defer and minimize the immediate impact.

[1] According to the Aspen Institute, employee stock-ownership plans represent $1.8 trillion of wealth across 10.1 million participants (https://www.aspeninstitute.org/blog-posts/employee-ownership-and-esops-what-we-know-from-recent-research-2/)

[2] For California, the highest cumulative local, state and federal marginal tax bracket on ordinary income is 54.10%. In the case we present, where the cost basis is nearly zero, the effective tax payable could be as much as 54.10% depending on the holding period of the security.

Ingredients of a tax-efficient diversification trade

We believe that there are three main ways to mitigate single-stock risk exposure without triggering an immediate tax liability:

- **Option strategies** can be used to create collars around the stock price and the premiums received from covered call strategies can be used to offset some of the tax costs
- **Tax-loss harvesting** can be deployed to generate tax deductions, which can then in turn be used to offset capital gains taxes from selling down the concentrated position
- **Exchange funds** can absorb an in-kind investment of the concentrated stock, resulting in immediate diversification

In this white paper we will focus on the latter two approaches, tax-loss harvesting and exchange funds.

Tax-loss harvesting

Diversification through tax-loss harvesting involves identifying positions that are trading below their cost bases, selling them, and replacing them with similar exposures.[3] This process can be repeated throughout the tax year, and each time a tax loss is harvested, a proportional trade can be executed to sell down the appreciated stock position, resulting in a tax-neutral sell down.

The main challenge with this method is that you need to have a portfolio that is large enough to generate tax losses to work out of the concentrated position in a reasonable amount of time. For example, a low-basis concentrated position that is 50% or more of the total portfolio may be difficult to address since it can take half a dozen years or more to meaningfully diversify the position. To make matters worse, if the rest of the portfolio is also at a gain and there are no cash contributions in the horizon, traditional (long-only) tax-loss harvesting strategies are virtually powerless since there are simply no losses to harvest.

Tax-loss harvesting is also contingent on the overall stock market performance and the cross-sectional dispersion of individual stock returns. During periods of rising markets with low dispersion, opportunities for tax-loss harvesting may be difficult to find. And at its best, tax-loss harvesting is often not a permanent reduction in taxes; rather it acts as a deferral.

Fortunately, a recent innovation that combines tax-loss harvesting with familiar long-short equity strategies has provided more powerful tools for investors looking to diversify concentrated holdings.

Enhanced tax-loss harvesting through a long/short extension

[3] See for example:
https://bkln-landing-prd-assets.s3.amazonaws.com/BKLN+White+Paper+-+Concentrated+Positions+-+Q4+2023_v2.pdf

[4]Let's consider a hypothetical situation where an investor has 100% of their wealth in a single stock, acquired at zero cost. This is the most challenging situation, since it does not offer any degrees of freedom for tax-loss harvesting.

An elegant way to address situations such as this is to use the stock position as collateral, purchase other stocks (e.g. 30% of portfolio value) on margin to increase portfolio size (to 130%) and short a similar amount (30%) of yet another basket of stocks. This would establish a portfolio that still has full market exposure but permits capturing tax losses within the long/short extension.[5]

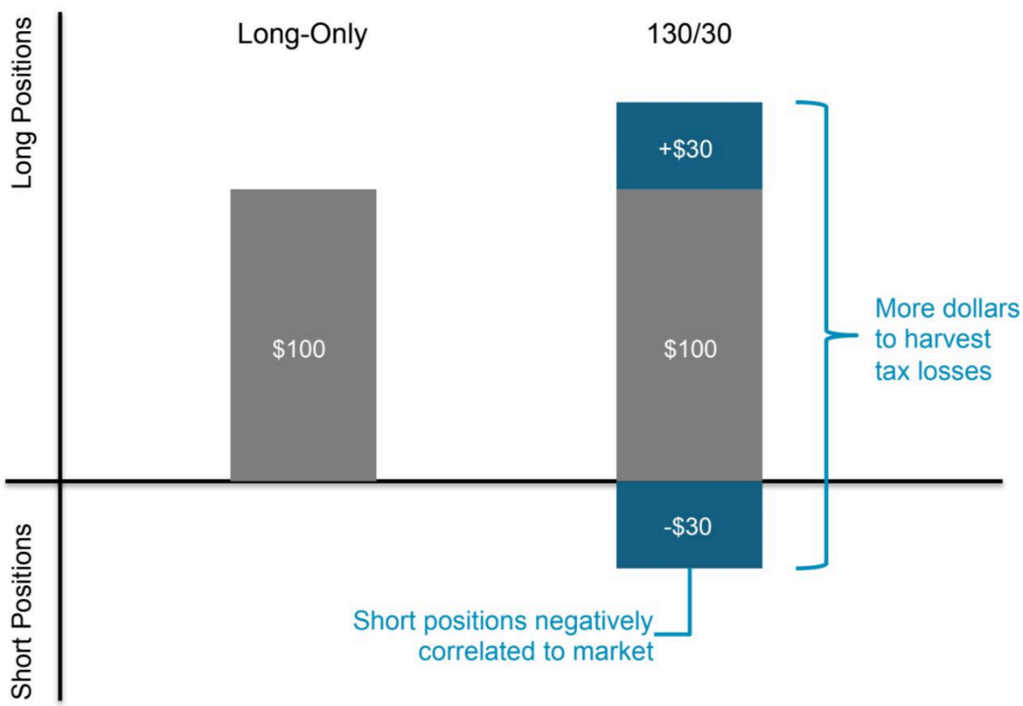

Figure 1: Illustration of a 130/30 long/short portfolio

The power of the long/short extension comes from two sources: First, the portfolio size is greater, so there is more capital at work to harvest tax losses. Second, the short leg of the extension is always negatively correlated to the market, providing the ability to harvest tax losses even during broad-based market rallies. Concretely, if markets were to rise, the short positions would lose money. The investor could then close the short positions at a loss, replace them with new short positions in similar securities and capture the tax-losses that could be in turn used to sell down the concentrated stock position. Similarly, if markets were to fall, the same process could be repeated on the long side of the extension.

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[4] See for example:
https://bkln-landing-prd-assets.s3.amazonaws.com/Brooklyn+Investment+Group+-+A+Motor+for+Your+Sailboat+-+Q2+2024.pdf

[5] Note that this strategy can only be run in a margin account and its viability depends on client or custodian-specific margin rates, which may vary.

It is critical for the success of this strategy to ensure the following:

- The combined long/short extension must be as close to market and factor neutral as possible to avoid introducing potentially unwanted exposures in the rest of the portfolio
- Long and short positions must be very diversified to minimize stock-specific risk from creeping in the portfolio, particularly on the short side (recall, for example, the challenges caused for professional short sellers by GameStop's unexpected rally in 2021)
- The long/short portfolio must be carefully implemented in the context of the holdings of the entire household to avoid wash sales and accidental shorting against the box (i.e., selling short a stock that is held hold elsewhere) in related entities
- Stock selection in the long/short portfolio must follow a reasonable investment thesis, preferably gaining some pre-tax alpha through security selection (i.e., long positions outperforming the short positions on average over time)

It is also important to have an exit strategy. A 30% long / 30% short extension, in our estimation, can diversify a hypothetical zero-cost basis-position to a broad market index in a period as short as 4 to 5 years, depending on market conditions and individual tax considerations. At the end of this period, the 130% long / 30% short portfolio will mostly consist of highly appreciated securities. At that juncture, the investor needs to consider unwinding the long/short extension or maintaining it as an alternative source of return in the portfolio (e.g., replacement for hedge fund exposure).

It should be noted that unwinding a long/short strategy may involve risks that are not currently foreseen. For example, a rapid unwind may force the investor to realize some capital gains. Alternatively, the strategic approach of unwinding positions gradually may end up resulting in a longer unwind period than anticipated. Given the recency of the introduction of the long/short strategy, there is limited amount of empirical data on actual outcomes of the unwind.

Exchange funds

Exchange funds, also known as swap funds, are private investment funds that allow investors to immediately diversify their stock positions tax-efficiently by exchanging stocks for shares in a broader portfolio. These funds accept stocks from many investors holding various stocks, and each investor receives a share of the pooled fund equal to the value of the stocks they contributed.

Exchange funds uniquely provide for tax-efficient diversification by avoiding the "sell" part of the sell-and-diversify strategy. In an appropriately structured fund, no capital gains taxes are triggered when stocks are contributed to the fund, so an investor's entire principal can grow tax-deferred. Since an investor exchanges stock for shares in a diversified fund, such an investor (and all the other investors) is diversified by virtue of participation.

After a seven-year holding period, an investor can withdraw a diversified basket of stocks from the fund in kind. The current tax code treats in-kind contributions to – and redemptions from – qualifying exchange funds as non-taxable events. Such an investor's taxes are deferred until they decide to sell the assets withdrawn from the exchange fund with the cost basis from the original contributed stock carried over.

There are three primary benefits of an exchange fund:

- Exchange funds can be a powerful tool to achieve immediate diversification without incurring taxes for investors with concentrations in low-basis stock.
- Many exchange funds are built around well-known benchmark indices, such as the Nasdaq-100 or Russell 3000, reducing the volatility and investment risk to a benchmark exposure upon investment.
- Properly established exchange funds can allow the investor's entire principal to grow on a tax-deferred basis, which could result in higher compounding over time. Estate events can result in a step-up in basis for heirs, allowing for a tax advantage when they sell inherited assets subject to the estate tax exclusion available.

Exchange Fund Benefit Illustration		Sell and Reinvest	Exchange Fund
Value of investor's AAPL stock	Cost basis of $100,000	$1,000,000	$1,000,000
Tax paid to diversify	At 34.75% effective LTCG tax rate	-31.3% - $312,750	NO TAX TRIGGERED - $0
Diversified portfolio value		= $687,250	+45.5% **$1,000,000**
Capital gains after 7 years	At 10% annual growth rate	+ $652,006	+ $948,717
Diversified portfolio value in 7 years		= $1,339,256	+45.5% **$1,948,717**
Tax paid at liquidation	At 34.75% capital gains tax rate	- $226,572	- $642,429
If liquidated immediately after 7 years		= $1,112,684	+17.4% **$1,306,288**
Exchange Fund upside after investing period			**+ $193,604**

This chart presents an illustration of the benefits of a potential tax deferral. Exchange fund investments involve risk and the actual performance of any exchange fund investment will vary. See Chart Disclosure below for additional information including a description of the assumptions used in this illustration.

To receive the full benefits of an exchange fund, the investor has to commit to a seven-year term and, therefore, manage their liquidity needs outside of the fund. Redemption requests before the seven-year mark are satisfied by distributing some or all of the original contribution back to such investors. Additionally, as exchange funds seek to provide a benchmark index exposure, the availability to invest is subject to an exchange fund's ability to accept such stock[6]. Furthermore, Exchange Funds are only open to accredited investors or qualified purchasers so an investor needs to meet the eligibility requirements.

Combining tax-loss harvesting and exchange funds

As discussed herein, each of these methods comes with certain benefits and drawbacks. Both offer a tax-neutral way to diversify an investment portfolio consisting of concentrated stock. We believe that an optimal strategy could be to use a combination of both. We believe there are three key considerations:

1. Preference for liquidity. If the investor has a high degree of preference for current liquidity, tax-loss harvesting is the more attractive option. Conversely, if the investor has ample liquidity elsewhere in their portfolio, an exchange fund may be more attractive.
2. Preference for immediate diversification. There are two considerations: risk and cost basis. Highly volatile stocks could benefit from immediate diversification within an exchange fund. Similarly, if the cost basis of the stock is very low, it may take some time to effectively diversify the stock using tax-loss harvesting unless a high degree of leverage is used in the long/short extension.
3. Available capacity in exchange funds. Exchange funds offer exposures to different indices and have different capacities for highly appreciated stocks. For example, certain widely held stocks may not have room in exchange funds. In these cases, tax-loss harvesting may be a more attractive option.

In other words, tax-loss harvesting and exchange funds may both be attractive solutions to concentrated stock portfolios, depending on an investor's unique preferences, risk tolerance, and capacity considerations.

This trade-off will be specific to each investor and cannot easily be quantified. As an example, a client at age 45 with $10 million in a single stock could desire to have access to 50% of the assets at all times and be comfortable with a 7-year waiting period for the other 50%. For a client closer to retirement, this ratio might shift in favor of tax-loss harvesting (e.g., 70/30) to allow for higher current income to be derived from the assets.

Conclusion

Both tax loss harvesting and exchange funds can provide diversification solutions to investors with concentrated stock positions. While differences exist between the strategies, an investor may be well-served to consider and potentially invest in such strategies as part of an overall diversification strategy. How much to allocate to tax-loss harvesting and how much to allocate to exchange funds will depend on each investor's unique situation.

[6] Exchange funds seek to implement a specific benchmark index exposure. If a given stock is not suitable for that investment strategy or is offered in quantities that would force a given fund to deviate from its stated objective, the fund may decline to accept that stock.

Much like how a peanut butter and jelly sandwich is often seen as greater than the sum of its parts, a concentrated stock portfolio that combines tax-loss harvesting with exchange funds for diversification may offer a more effective investment solution compared to relying on either strategy alone.

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Diversification does not guarantee profit or protect against loss. Long/short extension strategies have associated short-sale, borrow, and leverage risks, among others. These and other tax-loss harvesting strategies defer taxation but do not eliminate the capital gain potential of the portfolio as a whole. Exchange funds also defer taxation on contributed assets but do not eliminate tax obligations upon sale. To benefit from tax deferral, investors must comply with the restrictions outlined in the offering documents for any such fund. Please consult a tax advisor for guidance specific to your situation.

Exchange funds are alternative investments which may be available only to accredited investors or qualified purchasers. For more information on eligibility criteria and the difference between accredited investors and qualified purchasers, please view this article. Investors in exchange funds should carefully review offering materials before investing. Cache do not provide investment recommendations or consider individual financial objectives; investors are responsible for determining whether an investment is suitable for their needs.

Chart Disclosure: The illustrative tax saving chart is provided for illustration only and is not a prediction of actual past or future results. Actual results for any particular investment will vary. The chart assumes a net return of 9.5% annually and a gross return of 10% annually. Gains in an exchange fund are deferred until a sale or other taxable event occurs. Investing involves risk, including potential loss of principal, and illustrated returns are not guaranteed. Investment losses may reduce or negate the benefits of tax deferral. Additionally, ordinary income tax rates on capital gains and dividends affect after-tax returns. Investors considering an exchange fund should consider their time horizon and tax bracket, as illustrations may not fully account for these factors.