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BEST TIME FOR HARVESTING TAX LOSSES?

"The early bird gets the worm, but the second mouse gets the cheese."

— Willie Nelson

When is the best time of year to realize tax losses?

There is something unnerving about realizing a loss in your portfolio right at the beginning of the year. It is simply not a natural act for most investors to sell a security for a loss right out of the gate in January. For one thing, investors take pride in their ability to select stocks. A lot of personal pride is invested in doing so. As well, people go out of their way to avoid feelings of regret from bailing out too early. So we preach patience and wait for a better day. By December, investors' patience is typically exhausted and their frame of reference switches from the pain of loss to an opportunity to claim a tax deduction of a realized loss. Thus the majority of tax-loss harvesting takes place in the month of December and is based more on simple convenience rather than any strategic thinking.

Yet for a taxable investor, the value of a tax loss harvested in December is no greater than the value of a loss harvested in January or any other month. In fact, historically December may be one of the worst months to harvest losses as the table below makes very clear.

Average S&P 500 historical returns by month (01/01/28–12/31/15)

Month	Jan	Feb	Mar	Apr	May	Jun
% of average return since 1928	1.14	***-0.07***	0.56	1.24	***-0.08***	0.70
% of standard deviation of monthly returns	4.80	4.22	5.05	6.09	5.94	5.27
% of month's return > 0	63.64	53.41	61.36	63.64	56.82	54.55
Month	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
% of average return since 1928	**1.49**	0.65	***-1.09***	0.54	0.64	**1.40**
% of standard deviation of monthly returns	5.93	6.24	5.90	6.16	5.15	**3.59**
% of month's return > 0	56.82	57.95	45.45	60.23	59.09	**73.86**

Data source: FactSet. Average returns are price returns for the S&P 500 and do not include dividends

In nearly 90 years, the months in which the market's historical average returns come out negative are February, May and September, which means that availability of losses is pretty spread out throughout the year. At least theoretically, investors should have opportunities to harvest losses in both earlier and later months of the year.

Further, nearly three quarters of the time December experiences a positive market return, giving investors the fewest loss harvesting opportunities of all.

December also has the lowest standard deviation of monthly returns, meaning that there is a higher statistical likelihood of a smaller variation in returns around the positive mean return of 1.4%.

So historically speaking, December is one of the best months to stay in the market, and one of the worst months to harvest losses.

Loss harvesting frequency in more depth

To understand the variability in the amounts of losses harvested systematically year round versus once at year end, we ran several back tests using the Columbia Threadneedle Tax Efficient Structured Equity strategy (TESE). The back tests were run starting March 31, 1994. Portfolios started with $1 million and were benchmarked relative to the S&P 500. The upper bound for the estimated tracking error was 1%. Fifty-six discrete, quarterly rolling back tests were run, each lasting seven years. In other words, back test 1 started March 31, 1994 and ended March 31, 2001. Back test 2 started June 30, 1994 and ended June 30, 2001. Each of these windows was run to a monthly, quarterly or yearly (December 31) rebalance. The table below represents the average cumulative losses harvested over the seven-year quarterly windows.

Strategy	Avg. sum net realized gains/losses	Avg. % loss harvest
Monthly rebalance	-$458,925	-45.89
Quarterly rebalance	-$431,334	-43.13
Yearly rebalance (12/31)	-$325,366	-32.54

Data source: Risk model: MSCI Barra US Equity USE3L Model. After-tax Optimizer: ITG.

The results show that on average over the seven-year rolling back tests, the monthly rebalanced portfolio generated 45.89% in cumulative losses versus 32.54% for the once-a year-rebalanced portfolio. By trading monthly instead of yearly, 13.35% or $133,559 more losses were harvested.

For an investor in the highest federal tax bracket of 43.4% (39.6% federal income tax[1]+ 3.8% Medicare tax[2]) this means that $133,559 more of short-term capital gains can be offset, allowing $57,965 in tax savings — quite a substantial difference even as a simple benefit, but when you consider that if these savings are reinvested and compounded over a long time, the end results could provide additional growth for a portfolio. Keep in mind, state taxes are not included in the example and would increase the tax benefit for the short-term loss.

Clearly, by waiting until December to harvest tax losses, investors are missing out. While each year is different, the first half of 2016 serves as a good proxy for this discussion. In January, the S&P 500 was down 5%, but by April the index pulled flat. Despite volatility, which actually affords more opportunities to loss-harvest, by mid-year the S&P has managed to eke out a modest 3.84% gain. If your practice is to defer loss harvesting until the end of the year, then you've missed an opportunity that may not come again.

Loss harvesting strategy versus loss realization

Yet another trap investors fall into by looking to sell losers only at the end of the year is that once the security is sold for a loss, it is very tempting to simply stay in cash and not risk any further decline, or perhaps use the money for some other purpose. This practice is really not loss harvesting but loss realization. If the market rallies shortly after the loss is realized, the investor is out of luck on recouping his original value or gaining actual appreciation.

To better understand how a true loss harvesting process works, let's run through a simple example:

Suppose an investor buys $10,000 worth of Big Box Store A stock. A few months later it has dropped 20% in value and she sells her stock for a $2,000 short-term loss. By immediately buying $8,000 worth of Big Box Store B stock, this investor maintains market exposure and at the same time pockets the economic value of a capital loss. Once again, assuming a federal 43.4% tax rate and $2,000 in short-term gain realized elsewhere in her portfolio, this investor would effectively reduce her federal taxes by $868 ($2,000 x 43.4%). And if the market rallies, she has gotten the best of both worlds.

A true loss harvesting strategy, then, is a strategy that looks to match the pretax returns of a diversified benchmark such as the S&P 500 and outperform it on an after-tax basis by systematically harvesting losses through a quantitatively driven process of stock substitution. This is what the Columbia TESE strategy does. As losses are harvested, a multifactor risk model helps to identify highly correlated baskets of stock to purchase as replacements to maintain beta or market exposure.

By using Columbia TESE strategies, investors have the opportunity to harvest tax losses and be fully invested in the market year round. To borrow from Willie Nelson's odd piece of wisdom, with TESE investors get the benefit of being both the early bird and the second mouse.

To find out more, call 800.521.1297
or visit columbiathreadneedle.com/us

The analysis may vary if a different data source was used.

[1] irs.com/articles/projected-us-tax-rates-2016

[2] irs.gov/taxtopics/tc559.html

The TESE account strategy may underperform its benchmark. There can be no assurance that an account in the TESE program will outperform the relevant benchmark index, and an account's net performance (after the payment of program fees) may underperform the index even when the account's gross performance (before fees) outperforms the index. Furthermore, tax harvesting and investment restrictions by a client can cause that client's account to diverge materially from the model portfolio for this strategy and may cause the account's performance to be lower than that of the model portfolio or the benchmark index.

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