

The image features a central yellow horizontal band. Above and below this band are decorative borders with a pattern of grey and yellow abstract shapes, possibly resembling leaves or branches. The main text is centered within the yellow band.

AllCap vs. Tax Managed AllCap

Advanced Investment Partners, LLC

Taxes? We're talking 'bout taxes? How silly is that?

John Bright, CFA

"It's funny to me too, hey it's strange to me too but we're talking 'bout practice man, we're not even talking about the game, when it actually matters, we're talking about practice ... How the heck(sic) can I make my teammates better by practicing?" –Alan Iverson May 2002.

With just a bit of modification we get : 'It's funny to me too, hey it's strange to me too but we're talking 'bout taxes man, we're not even talking about the returns, when it actually matters, we're talking about taxes ... How can I make my returns better by paying attention to taxes? '

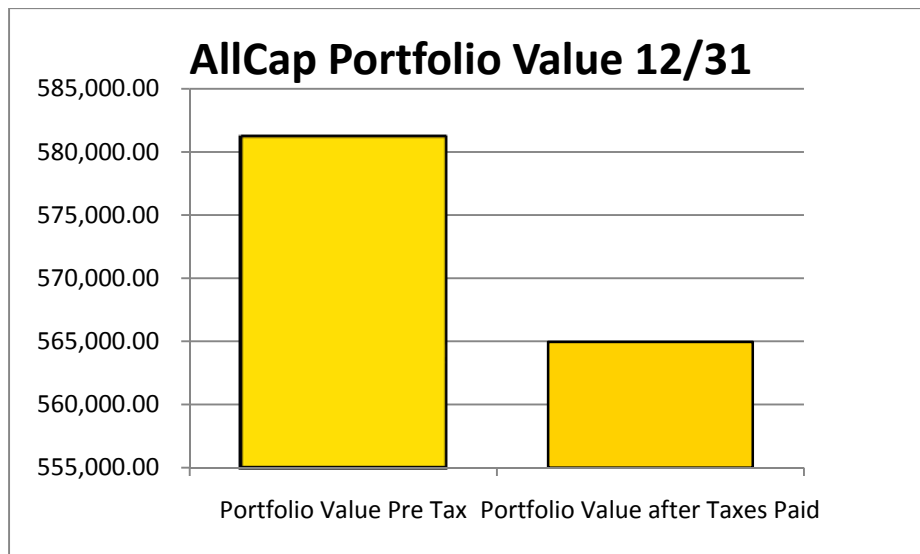
The fact is taxes matter to a taxable investor who wants the best possible result, just as practice matters to a team. Conversations about taxes stopped through the market downturn, but in 2010 with equity markets up over 35% from 2008 levels, and many fund companies resuming capital gains distributions, talking 'bout taxes once becomes an important part of the client/advisor conversation.

Taxable investors should always consider taxes when choosing an investment strategy. Through 2009, Lipper estimated taxable investors gave up 0.98% to 2.08% in annual return over the past 10 years because of taxes. In other words, taxable equity and fixed-income mutual fund shareholders surrendered over 49% and 39%, respectively, of their load-adjusted 10-year returns in the form of taxes.ⁱ

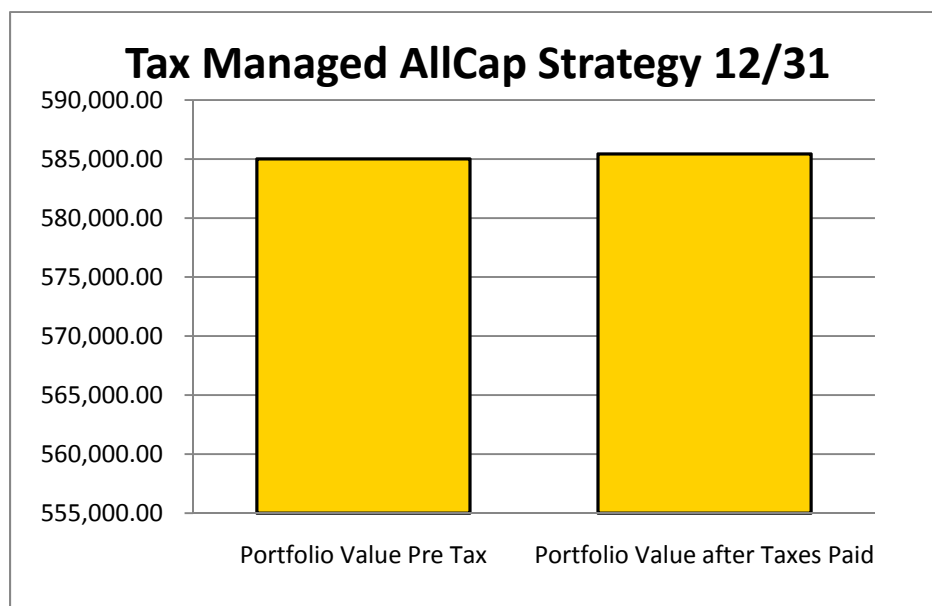
Let's take a snapshot of two of our strategies for 2010 to illustrate why taxes are an important consideration, especially in years with a rising market and periods of heightened volatility like 2010. First, the AllCap strategy benchmarked to the Russell 3000 index, and next our Tax Managed AllCap strategy, which is benchmarked to both the Russell 3000 and also to the AllCap strategy(see [Using Secondary Benchmarks](#))ⁱⁱ.

The goal of the AllCap strategy is to outpace the Russell 3000 while maintaining tight risk controls relative to the benchmark. The Tax Managed AllCap strategy has the same goal, with the added goal of maximizing after-tax return. The strategy does not attempt to completely avoid the payment of all taxes, but instead focuses on minimizing taxes in the pursuit of value-added stock selection. It is important to note every Tax Managed account is managed individually for each client and their specific holdings and tax rates while still closely following the characteristics of the regular AllCap strategy.

Let's consider an investor starting 2010 with a \$500,000 portfolio invested in the AllCap model. Through 12/31/10, the portfolio would have achieved a value of about \$581,135 gross-of-fees. Let's now assume the owner of this portfolio is a taxable investor in the top tax bracket. This same investor would have an after-tax, gross-of-fees portfolio of about \$564,952 if taxes were paid from the account value on 12/31. Taxes reduced the investor's portfolio value by \$16,183 in 2010.



Now let's consider the same taxable investor with a \$500,000 beginning portfolio invested in the Tax Managed AllCap strategy. The average portfolio would have achieved a gross-of-fees portfolio value of about \$585,011 on 12/31. Let's now assume the owner of this portfolio is taxable investor in the top tax bracket. This same investor would have a gross-of-fees portfolio value of about \$585,432. **Instead of a tax reduction in value by \$16,183 we receive a small tax benefit in the Tax Managed AllCap strategy in 2010.** This amounts to the entire value remaining in the portfolio and compounding over time with a small net realized tax benefit of about \$421 that may be used to reduce the client's overall tax bill.

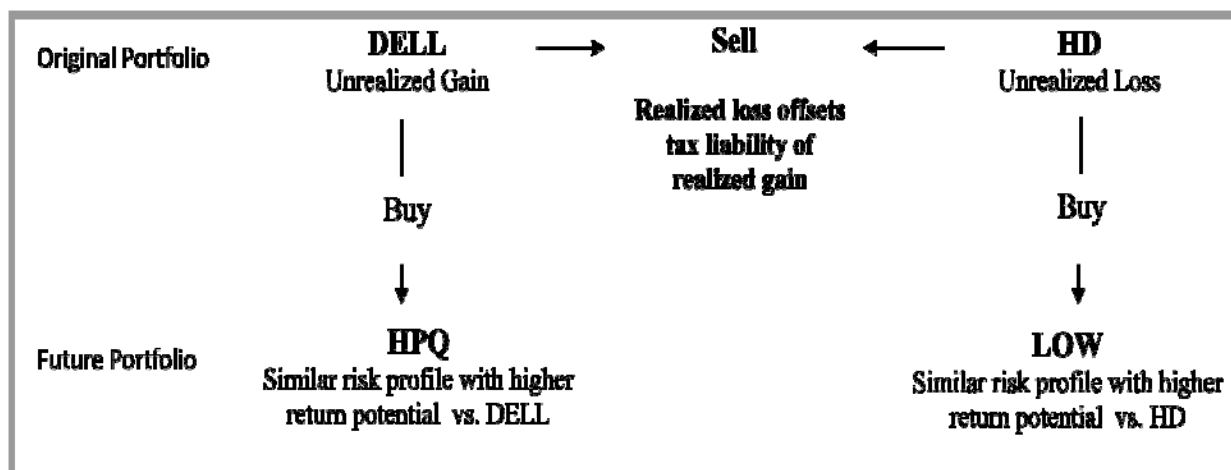


Obviously in 2010, managing taxes within the AllCap equity strategy proved beneficial. This is not to say in all time periods there are such large differences in tax consequence, or so little difference in pre-tax performance.

What's the difference? In the Tax Managed AllCap strategy we focus on maintaining characteristics similar to the AllCap strategy while considering the tax consequence of every trade.

Let's take an example:

In the AllCap strategy we may sell DELL (Dell Inc) to buy HPQ (Hewlett Packard) based on the return forecast of the two stocks. In the regular AllCap strategy, the trade is completed and this completes the transaction. However in the Tax Managed strategy we consider that our holding in DELL has a gain. To minimize the tax impact of the trade we then look across the portfolio, find a loss in HD (Home Depot) and consider LOW (Lowes) we discover LOW has a very similar return forecast and risk profile to HD. We would then sell HD realize the loss and purchase LOW. This realized loss in HD then offsets our potential gain in DELL and we can now sell DELL to purchase HPQ. The result is a portfolio with similar risk characteristics and return profile to the AllCap strategy, but with the added consideration to the tax consequences. This proved to be very successful in 2010 relating to returns and taxes in the AllCap Tax Managed Strategy. This transaction is detailed in the chart below:



Why not just be more tax efficient in AllCap strategy itself?

Every client's portfolio is unique. Every client invests at different times with different beginning portfolios that are taxed at different rates. One client's loss may be another client's gains. In a pure model strategy, even though a particular position may be a loss for the model, it may not be true for each client who invested in that model. The best way to manage a taxable portfolio is to consider each client's tax situation individually when rebalancing. Each portfolio is then not exactly the same, but follows the characteristics of the strategy while minimizing the tax impact for each client.

In many time periods our process proves to be tax efficient even in the AllCap strategy, but taxes are not a direct consideration. In our portfolio construction process, winners are allowed to run (to a certain active weight) while losers are available for sale. When you allow winners to become long-term and sell losers while they are short-term, over time this tends to provide a portfolio which does not generate large tax consequences. However, in many market environments the tax swings can be large in a given year. For non-taxable accounts, tax considerations should not impede the risk and return goals of an investment strategy. For taxable accounts, pre-tax returns should not be achieved at the expense of after-tax performance. The Tax Managed strategies provide consideration to both return and taxes.

Changing investment strategy or manager? What are the options?

When an investor is funding their investment portfolio with cash, choosing the proper investment vehicle is simplified as there are no immediate tax consequences associated with the initial investment. Therefore, one can more easily weigh the investment merits of any alternative vehicle and its associated expected future tax efficiency. However, when existing investment positions are used for funding an account, the decision is more complex.

Separate account managers may keep a limited amount of existing positions. However, if the existing assets are not in the new manager's model portfolio, they will usually be liquidated without additional consideration. AIP's Tax Managed strategies provide transition management, which is a valuable tool in controlling capital gains incurred during the initial transition to a new investment account. This is a distinct advantage of using a tax managed separate account. The economic benefit derived from a reduction in taxes paid by using a transition strategy remains in the account and continues to compound in the portfolio.

Let's look at a simple example of the benefits of Transition Management:

Assume an investor holds \$500,000 in equity securities which they would like to transfer to a new managed account. The current portfolio has \$250,000 in unrealized gains, half of which are short-term and half of which are long-term. In scenario L the existing portfolio is liquidated, and the proceeds are reinvested into a new portfolio. In scenario T the re-allocation is implemented using a transition management strategy which only liquidates 50% of the existing portfolio. By using a transition strategy the tax bill in this example is reduced by half. This amount (taxes not paid) remains invested in the portfolio going forward. **If each portfolio then earns 8.00% per year, the portfolio which was transitioned has \$45,916 in additional value after 5 years.** The liquidated portfolio would have to earn 1.50% more each year to match the value after 5 years in this example. This is a simple example, but shows the value derived by reducing the initial tax bill and compounding those tax savings over time.

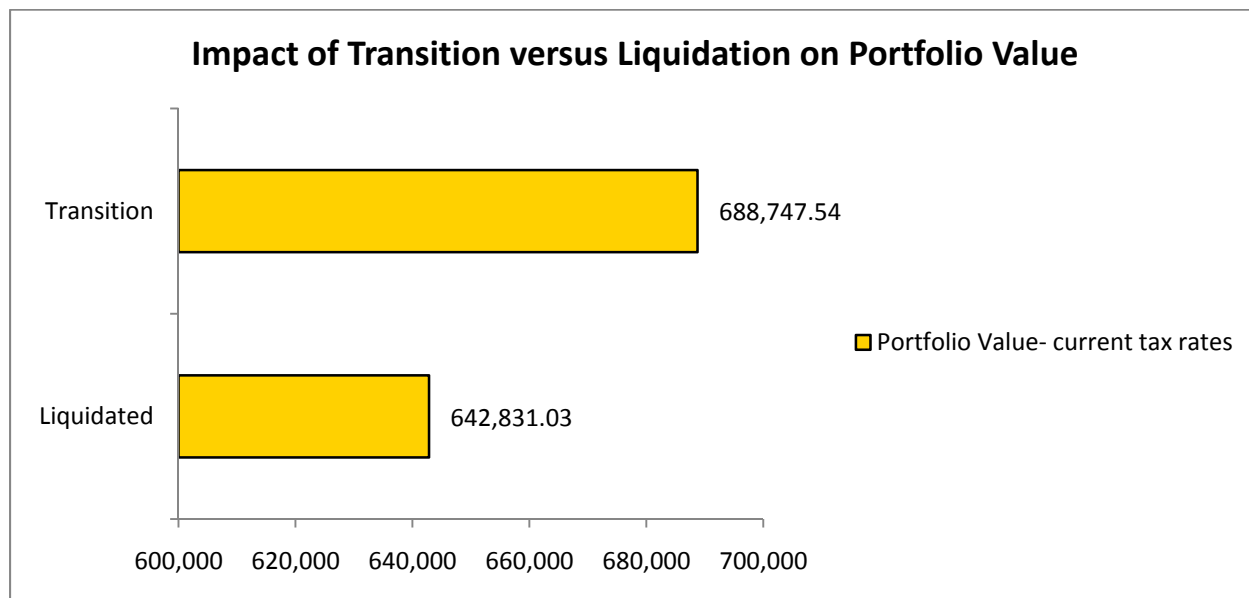
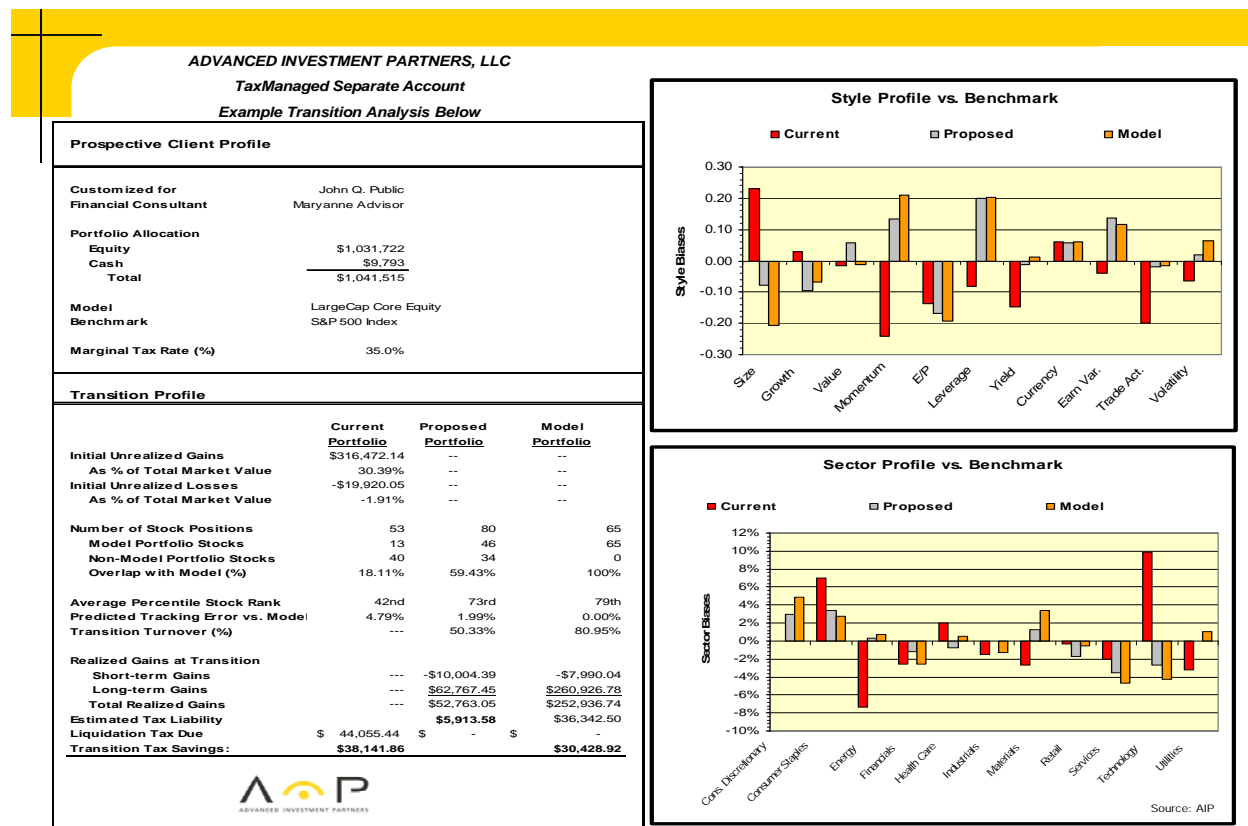


Figure 1: Initial portfolio value \$500,000. Assumes taxes paid are removed from account. ST gains taxed at 35%, LT gains taxed at 15%.

AIP's Transition Analysis:

The above example is simple and purely hypothetical; however, we have completed exactly this type of transition for many clients. We offer the Transition Analysis service to clients who would like to see what impact the transition would have on their current holdings, even before opening an AIP account. This proves to be a useful tool in understanding the effects of transitioning into the Tax Managed Strategy and how AIP would manage the portfolio going forward.

We designed the Transition Analysis template to show the client exactly how we would begin to transition their current holdings when we undertake management of the portfolio. We conduct a scenario analysis to analyze the holdings of the current portfolio as they relate to taxes, risk characteristics, sector exposures, and return potential. All of this is weighed to determine the optimal transition into the Tax Managed Strategy for the portfolio. The advisor then receives a report of our proposed changes to discuss with the client including a summary page of the proposed changes:



(Please see the Transition Analysis sample at the end of this document for a more detailed explanation).

One of the most used phrases I have come across when it comes to taxes and investing is: “Don’t let the tax tail wag the investment dog.” It’s used in just about every article related to taxes and investing. True, taxes should not primarily drive many investment decisions, but the most important decision is to choose the right puppy in the first place. When making financial moves you are going to have to live with (just as in adding a pet to the family), it’s important to find a good fit at **inception (or transition)**.

To request a Transition Analysis please contact aiplclientservices@aipllc.com

ⁱ Taxes in the Mutual fund industry 2010- Assessing the impact of shareholders returns. Lipper research study, April 2010, authored by :Tom Roseen Research Manager, US & Latin America Lipper.
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<http://individuals.eatonvance.com/includes/loadDocument.php?fn=2349.pdf&dt=fundPDFs>

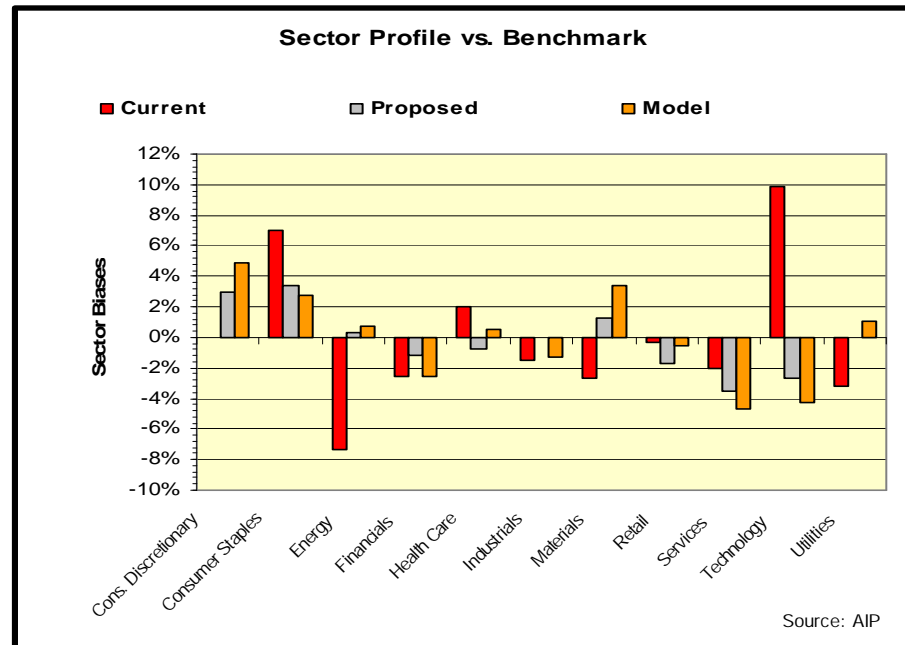
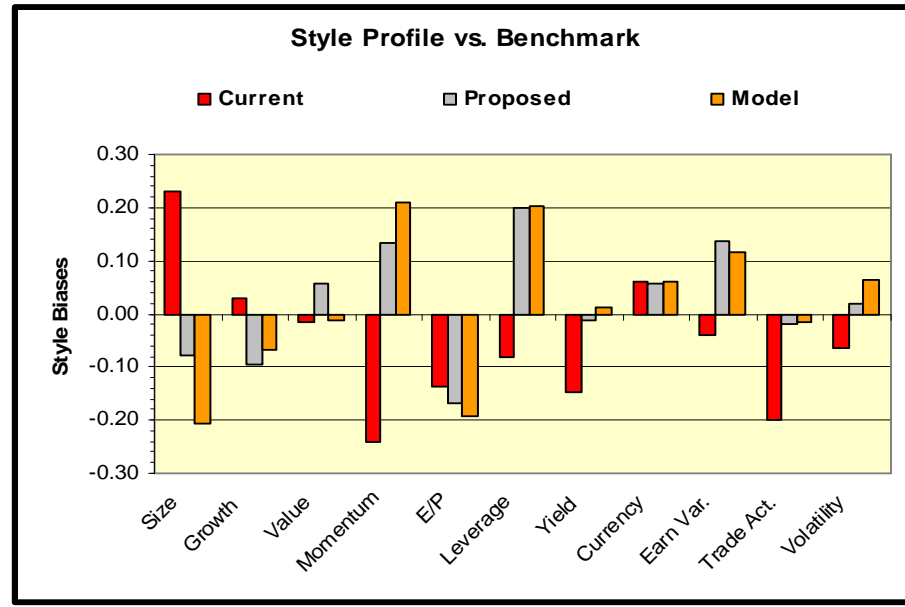
ⁱⁱ http://aipllc.com/en/Sites/AIPLLCcom/Release/User/files/pdf/Using_Secondary_Benchmarks.pdf

ADVANCED INVESTMENT PARTNERS, LLC

TaxManaged LargeCap Separate Account

Example Transition Analysis Below

Prospective Client Profile			
Customized for Financial Consultant	John Q. Public Maryanne Advisor		
Portfolio Allocation			
Equity	\$1,031,722		
Cash	\$9,793		
Total	\$1,041,515		
Model Benchmark	LargeCap Core Equity S&P 500 Index		
Marginal Tax Rate (%)	35.0%		
Transition Profile			
	Current Portfolio	Proposed Portfolio	Model Portfolio
Initial Unrealized Gains	\$316,472.14	--	--
As % of Total Market Value	30.39%	--	--
Initial Unrealized Losses	-\$19,920.05	--	--
As % of Total Market Value	-1.91%	--	--
Number of Stock Positions	53	80	65
Model Portfolio Stocks	13	46	65
Non-Model Portfolio Stocks	40	34	0
Overlap with Model (%)	18.11%	59.43%	100%
Average Percentile Stock Rank	42nd	73rd	79th
Predicted Tracking Error vs. Model	4.79%	1.99%	0.00%
Transition Turnover (%)	--	50.33%	80.95%
Realized Gains at Transition			
Short-term Gains	--	-\$10,004.39	-\$7,990.04
Long-term Gains	--	<u>\$62,767.45</u>	<u>\$260,926.78</u>
Total Realized Gains	--	\$52,763.05	\$252,936.74
Estimated Tax Liability		\$5,913.58	\$36,342.50
Liquidation Tax Due	\$ 44,055.44	\$ -	\$ -
Transition Tax Savings:	\$38,141.86		\$30,428.92



Source: AIP

Proposed Portfolio: This portfolio is the best combination of the client's existing holdings and the AllCap model portfolio in terms of risk positioning, tax efficiency, forecasted return and forecasted risk.

Model Portfolio: The current AIP AllCap model portfolio.

Line 1: Current market value of positions with gains less cost basis of positions with gains.

Line 2: Current market value of positions with losses less cost basis of position with losses.

Line 3: Compares the number of securities in the current portfolio to those in the proposed and AIP AllCap model portfolios.

Line 4: Indicates the number of securities in the noted portfolio that are also in the model.

Line 5: Indicates the number of securities in the noted portfolio that are not in the model portfolio.

Line 6: Provides the overlap of the noted portfolio with the model in percentage terms.

Line 7: Indicates the average percentile ranking of stocks held in each portfolio relative to the investment universe using AIP's forecasts. The higher the number the more attractive the excess return potential. In this example, the relative attractiveness of the average stock improves significantly.

Line 8: This is a statistical estimation of expected performance. We estimate the portfolio's return will be within this % of the model's return in the coming year.

Line 9: This is the lesser amount of total purchases and sales we will effect in order to move the client to an improved risk/reward combination for the noted portfolio.

Line 10: Estimate of the total net short-term gains/(losses) realized by moving to the proposed or model portfolios.

Line 11: Estimate of the total net long-term gains/(losses) realized by moving to the proposed or model portfolio.

Line 12: line 10 + line 11

Line 13: (Estimated total long-term gain or loss * 15%) + (Estimated short term gain or loss * client's marginal tax rate)

Transition Profile

	Current Portfolio	Proposed Portfolio	Model Portfolio	
Line 1	Initial Unrealized Gains	\$542,572.52	--	--
	As % of Total Market Value	38.62%	--	--
Line 2	Initial Unrealized Losses	-\$162,236.60	--	--
	As % of Total Market Value	-11.55%	--	--
Line 3	Number of Stock Positions	57	71	47
Line 4	Model Portfolio Stocks	9	36	47
Line 5	Non-Model Portfolio Stocks	48	35	0
Line 6	Overlap with Model (%)	19.53%	43.78%	100%
Line 7	Average Percentile Stock Rank	41st	70th	75th
Line 8	Predicted Tracking Error vs. Model	6.56%	3.01%	0.09%
Line 9	Transition Turnover (%)	---	34.36%	80.27%
Realized Gains at Transition				
Line 10	Short-term Gains	---	-\$2,283.95	\$23,148.18
Line 11	Long-term Gains	---	<u>\$2,275.91</u>	<u>\$381,104.31</u>
Line 12	Total Realized Gains	---	-\$8.04	\$404,252.49
Line 13	Estimated Tax Liability		B -\$458.00	C \$65,267.51
4	Liquidation Tax Due	A \$ 44,553.89	\$ -	\$ -
5	Transition Tax Savings:	\$45,011.88		\$65,725.51

Estimated tax liability if the entire portfolio is liquidated.
(Estimated total long-term gain or loss * 15%) + (Estimated short term gain or loss * client's marginal tax rate)

This represents the estimated tax savings if the client chooses the proposed portfolio rather than liquidating the entire portfolio (A - B).

This represents the estimated tax savings if the client chooses the proposed portfolio rather than the model portfolio (C-B).

2