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**TaxManaged LargeCap Core Equity Strategy**  
***“A Systematic Approach to Maximizing After-tax Equity Returns”***

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## **TaxManaged LargeCap Core Equity Strategy** ***“A Systematic Approach to Maximizing After-tax Equity Returns”***

The vast majority of investable assets are subject to various taxes. However, most investment management practices have been developed without consideration of the impact of taxes on expected rates of return. Failing to properly consider the costs of taxes upon a portfolio can lead to significant erosion to an investor’s long-term rates of return.

### **Why the TaxManaged LargeCap Core Strategy is well suited for a taxable investor**

The TaxManaged LargeCap Core strategy is particularly well suited for a taxable investor due to its simple, broad portfolio structure. Traditionally the equity universe has been separated into value and growth stocks. This segregation of the market is inefficient for a taxable investor due to the necessary rebalancing of a client’s portfolio mix in order to maintain the desired balanced style exposure over time. Rebalancing leads to two specific taxable events: 1) individual manager turnover where, say a growth manager is liquidated to hire a value manager and 2) inefficient trading among managers where one manager is potentially buying what another manager has just sold (at possibly a low unit cost) within the client’s aggregate account. This type of selling within the client’s account creates considerable tax liabilities.

Simplifying the client’s account structure through the use of a broad, diversified core portfolio avoids the necessary style-based rebalancing costs. The TaxManaged LargeCap Core portfolio, with its consistent exposure along the style spectrum, allows rebalancing costs to be avoided while adding value through opportunistic, active stock selection.

In addition to the TaxManaged LargeCap Core’s portfolio structure being well suited for the taxable investor, the strategy’s reliance upon rigorous quantitative methods further enhances the strategy’s ability to systematically analyze and manage tax efficiency. The strategy’s quantitative investment methods will allow a comprehensive assessment of the expected return, risk and tax consequences of trading. Thus, an optimal balance between the portfolio’s alpha, risks and tax liabilities can be established.

### **TaxManaged LargeCap Core Strategy Overview**

The TaxManaged LargeCap Core strategy is based upon the Advanced Investment Partners’ LargeCap Core strategy with special consideration of the tax situation for each individual client’s portfolio. The TaxManaged strategy is designed to produce total rates of return in excess of the S&P 500<sup>®</sup> benchmark index in the most tax efficient manner. All portfolio trading is focused on improving return expectations, maintaining and



enhancing portfolio diversification, and managing tax liabilities. The strategy does not attempt to completely avoid the payment of all taxes, but instead focuses on minimizing taxes in the pursuit of maximizing after-tax returns. Therefore, some taxes will be paid as compelling valuations motivate trading activity.

There will be two primary sources of added value as the strategy maximizes after-tax rates of return: 1) active tax management and 2) active stock selection. The graphic below displays the choices available to the investor regarding these two dimensions of added value.

		<b>TAX MANAGEMENT</b>	
		<b>Passive</b> (Tax Indifferent Traders)	<b>Active</b> (Tax Aware Traders)
<b>STOCK SELECTION</b>			
<b>Active</b> (Information Traders)	Typical Mutual Fund	<b><i>Tax-managed Active Separate Account</i></b>	
<b>Passive</b> (Informationless Traders)	Indexed Mutual Fund	Tax-managed Indexed Separate Account	

The passive, indifferent treatment of the tax consequences of trading is best suited for tax-exempt investors. For the taxable investor, typical vehicles such as commingled mutual funds or separate accounts that are managed indifferently regarding taxes can result in considerable tax-related costs that significantly reduce after-tax rate of returns. Therefore, the taxable investor should pursue strategies that manage client's portfolios individually to maximize after-tax rates of return. Once this choice has been made, the remaining decision is again between active stock selection and passively indexed strategies.

Passively indexed strategies simply attempt to mimic the return of an index. There is no discretion available when selecting securities except for purely risk diversification objectives. The tax-managed passive indexer has to be mindful of the trading that is purely motivated by risk diversification as too often strong positions that have grown far beyond their original unit cost basis are reduced to provide adherence to strict guidelines and constraints.



The TaxManaged LargeCap Core strategy provides active, opportunistic stock selection along with systematic tax management while it not only diversifies the portfolio, but also raises the level of expected after-tax rates of return. The strategy will have the opportunity to add value when making valuation decisions at the time of investment and also when assessing the return expectations of current holdings. As return expectations are judged to be poor enough, the stock will be sold, a gain will be realized, and the proceeds will be reinvested in an alternative stock with superior after-tax expectations. Unlike a passive approach to stock selection that does not attempt to determine which stocks are expected to perform relatively better or worse, the TaxManaged LargeCap Core strategy will rigorously evaluate the investment merits of each stock being held. Therefore, the realization of justifiable gains is allowed as the strategy identifies compelling valuations in the pursuit of its objective to maximize after-tax returns, which goes beyond just minimizing tax liabilities.

## **Loss Harvesting**

Increasing a strategy's tax efficiency is not simply a matter of reducing trading activity within the portfolio. While reducing turnover will generally result in relatively fewer realized capital gains, the impact of portfolio turnover on tax efficiency should be viewed more comprehensively. Even low levels of turnover can be highly tax-inefficient if it is poorly managed.

The objective of active tax management is to systematically offset realized capital gains with realized capital losses. Realized capital gains can result from voluntary trading motivated by expected enhancements to expected returns and/or portfolio diversification, or involuntary activity arising from corporate actions like mergers or acquisitions. Capital losses can be proactively harvested to offset the tax consequences of voluntary or involuntary capital gain realization and to maximize the tax efficiency of portfolio activity. Therefore, it is quite possible that proactive capital loss harvesting might result in relatively higher turnover than a similar tax-exempt portfolio.

## **Closing Comments**

The TaxManaged LargeCap Core strategy is based upon AIP's LargeCap Core strategy and will employ active stock selection plus active tax management in order to maximize the client's expected after-tax performance. Those clients that fund their account with cash will most closely mirror the positions found within the LargeCap Core model portfolio at the time. Clients that fund their account with in-kind securities will have their accounts managed in the most tax efficient manner as their portfolio is transitioned towards the model LargeCap Core portfolio over time. The path in which these in-kind accounts move toward the model LargeCap Core portfolio will be greatly impacted by the tax situation present at the time of the asset transfer.



The TaxManaged LargeCap Core portfolio is expected to differ from the prevailing LargeCap Core model portfolio in the following manner.

- Individual TaxManaged portfolios are permitted to hold relatively more positions to better facilitate desired return and risk enhancements at a greater level of tax efficiency during initial transitions and during on going mirroring of the LargeCap Core model portfolio
- Market cap, style and sector biases are permitted to vary among individual portfolios and will be permitted to depart from the LargeCap Core model portfolio in an optimized trade off between the tax liabilities and portfolio risks of individual accounts

The AIP TaxManaged LargeCap Core strategy offers a fully optimized, active stock selection product that is individually managed to maximize the after-tax rates of return for each client subject to their portfolio's specific tax circumstances.

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