MAKING LEMONADE OUT OF LEMONS: TAX-LOSS HARVESTING AND SWAPPING FROM MUTUAL FUNDS TO ETFS

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We have witnessed an almost unprecedented four to five weeks of market disruption, and many investors are wondering what they can do to stem the tide.

We can't predict what markets will do from here, but what we *do* know is that the market declines have generated unrealized tax losses in many individual positions.

Tax loss harvesting is a tangible way of adding value for investors by, possibly, putting money in their pockets in the form of tax savings. Investors can swap out of existing positions and into comparable strategies, thereby realizing tax losses while remaining fully invested. Those losses can then be used to offset realized gains elsewhere in the portfolio.

After a 30-day holding period to satisfy the wash-sale rules, investors can then swap back to the original position if they so choose. Please note, however, that there are tax rules regarding which losses need to be matched to which gains, and investors should seek appropriate tax advice before initiating these transactions.

This exercise might be especially useful for investors considering a swap out of active managers, for two reasons:

1. For many investors, the default tax loss swap might be to a market cap-weighted beta ETF. But by deploying a WisdomTree strategy instead, the investor can maintain a more similar factor tilt to the active manager and, therefore, potentially a more consistent portfolio performance.
2. Swapping out of a mutual fund and into an ETF strategy with similar active tilts makes sense from a structural perspective. With ETFs, investors get a more transparent, tax-effective and potentially much lower cost investment vehicle compared to mutual funds.

Many investors have refrained from making the advantageous structural move to ETFs because of unrealized embedded capital gains in historical mutual fund positions. But if the recent market declines have altered that situation, investors should seriously consider "making lemonade out of lemons" by harvesting tax losses and migrating to a new investment vehicle (the ETF) while still maintaining their active management factor tilts.

We think this idea is one excellent way to "lean into" these disruptive markets and add tangible and proactive value to investor portfolios.

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DEFINITIONS

Tax Loss Harvesting : Selling securities at a loss to offset a capital gains tax liability. Tax gain/loss harvesting is typically used to limit the recognition of short-term capital gains, which are normally taxed at higher federal income tax rates than long-term capital gains.

Wash-Sale Rule : An Internal Revenue Service rule that prohibits a taxpayer from claiming a loss on the sale or trade of a security in a wash sale. The rule defines a wash sale as one that occurs when an individual sells or trades a security at a loss, and within 30 days before or after this sale, buys a "substantially identical" stock or security, or acquires a contract or option to do so.

Active : Funds that attempt to outperform the market by selecting securities a portfolio manager believe to be the best.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.

Beta : A measure of the volatility of a security or a portfolio in comparison to a benchmark. In general, a beta less than 1 indicates that the investment is less volatile than the benchmark, while a beta more than 1 indicates that the investment is more volatile than the benchmark.

Factor : Attributes that based on its fundamentals or share price behavior, are associated with higher return.

Active manager : Portfolio managers who run funds that attempt to outperform the market by selecting those securities they believe to be the best.