Doug Rogers has been actively involved in the IMCA Certified Private Wealth Advisor® (CPWA®) program since inception, volunteering his time and energy when called upon to assist in developing course curriculum and teaching the portfolio management section that includes tax-aware investing. He is an industry thought leader in the specialized niche of tax-aware investing. He is the author of Tax-Aware Investment Management: The Essential Guide and is well-recognized for his numerous articles and conference presentations on this subject.

David Koulish: Doug, to get started, are there any noteworthy articles on this subject that investment professionals should be knowledgeable of?

Doug Rogers: I recommend three articles. Professionals serving taxable accounts should be intimately aware of the seminal pieces written by Robert Jeffrey and Robert Arnott (1993) and Joel Dickson and John Shoven (1993). Perhaps it was an alignment of the stars for taxable investors, but without collaboration and knowing the effort of the other parties, the authors of these two articles reached similar conclusions. Their findings were so enlightening and controversial at the time when they reached their intended audiences, they literally rocked the active equity portfolio management community like a 9.0 earthquake. While still at First Quadrant, L.P., Rob Arnott followed up with colleagues Andrew Berkin and Jia Ye in 2000 with a subsequent article that supported and refined the conclusions of the earlier studies. I encourage anyone serving taxable accounts to have these as part of their professional library.

David Koulish: Now that you have my curiosity, what exactly are the significant conclusions?

Doug Rogers: Analyzing the after-fee and after-tax results of equity mutual funds, the authors found that managers were simply ignoring the tax impact of trading, especially positions with a short holding period where the tax code severely penalizes taxable investors. Each study highlighted how managers were not achieving sufficient incremental return or alpha to outperform a passively managed fund on an after-fee and after-tax basis. In the Jeffrey and Arnott article, of the 71 funds analyzed only nine—or 14 percent—beat the passively managed bogey after fees and after taxes when dividends and realized gains were accounted for, and only two did so by a significant margin. When the unrealized-gains position was accounted for, the results are slightly more favorable for active managers, but still only 13—or 18 percent—outperformed the passive option. Interesting enough, as time went on the two managers in Jeffrey and Arnott that did so well did not repeat in the future, which highlights how difficult it is for managers to achieve competitive results when fees and taxes are considered.

David Koulish: Why do you believe this has been the case?

Doug Rogers: There are two primary reasons. First, at the time of this research, the investment management industry was dominated by the demands of the tax-exempt account arena for pension plans and charitable accounts where taxes are not a factor. This is where the major flows were and managers had not yet recognized the need for taxable-account, client-centric solutions. Second, investors did not have available until after the turn of the century after-tax return information that for mutual funds came about as the last official act of the Clinton administration.

David Koulish: Were there any positive, long-lasting benefits from these studies?

Doug Rogers: Yes, I do not believe most practitioners, especially those relatively young in the industry, comprehend their significance and monumental contribution. Taxable investors need to be especially thankful for the impact the work of these authors and other practitioners has made on the evolution of the body of knowledge with taxable account investing.
pre-tax return basis in a separate account structure, but take advantage of market volatility and the provisions of the tax code to benefit from astutely managed tax-loss harvesting, which are referred to as quantitative tax-aware (QTA) strategies. The research conducted by Dickson and Shoven was funded by Charles Schwab, who personally wanted to determine how best to manage a mutual fund that could minimize capital gains generation and offer the product to investors. To prove their prowess, the Schwab 1000 Inv Fund had the longest history for a mutual fund of not distributing a capital gain until 2007, when the objective of the fund was changed. Moreover, Joel Dickson eventually joined Vanguard, where he has made a significant contribution to the success of their tax-managed funds and has continued to apply and innovate upon the methods discovered through the original research. As a result of their effort and others, taxable investors now have compelling tax-aware investment options that did not exist 20 years ago. Thus, I believe their contribution cannot be understated and is one the most significant developments in the history of portfolio theory.

David Koulish: With the results of the aforementioned studies, what is the hurdle that managers must overcome to demonstrate a value-added proposition on an after-fee and after-tax basis?

Doug Rogers: Unlike with tax-exempt accounts where the benchmark may be the S&P 500, for taxable investors the proper bogey is the comparison with a QTA manager that can replicate the characteristics of any equity benchmark portfolio. When competing against the QTA manager, active managers should not be considered for funding unless they can demonstrate the ability to achieve at least a 3-percent alpha (see table 1).

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<th>TABLE 1: ACTIVE MANAGER ALPHA HURDLE</th>
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<td>QTA tax-loss harvesting benefit</td>
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<td>Active manager tax-cost</td>
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<td>Active manager alpha hurdle</td>
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With the benefit of tax-loss harvesting, a QTA manager should produce an after-tax return 1.3-percent greater than the before-tax return of the passive portfolio over a 10-year horizon. Interesting enough, the average active manager loses from 1.3 percent annually due to the negative impact of taxes, the opposite amount of the benefit of employing a QTA manager. Plus, there is an approximate 0.4-percent fee differential favoring less-expensive QTA managers (0.75% – 0.35%). Adding these elements together results in an objective or active manager return hurdle of 3.0 percent (1.3% + 1.3% + 0.4%).

David Koulish: Doug, could this hurdle be even greater with higher tax rates in 2013?

Doug Rogers: Yes. Under the provisions of the American Taxpayer Relief Act, the highest wage earners will be subject to a 39.6-percent tax on ordinary income and short-term capital gains, and the tax on qualified dividends and long-term capital gains is 20 percent. An additional 3.8 percent is levied on net investment income when income exceeds $250,000 for couples. Thus, under the new tax scheme the hurdle is now at least an even more challenging 3.5 percent.2

David Koulish: With these hurdle rates it must mean that informed private wealth firms immediately eliminate most managers for consideration. Is this true?

Doug Rogers: Yes, for those as you say are “informed” firms. In the core-and-satellite allocation structure this eliminates what Brunel (2001) coined the “murky middle,” i.e., managers that can do little more than offer expensive market exposure and really have no place in the taxable account framework. In taxable accounts, QTA managers essentially replace core managers, especially bank portfolio managers that historically have worked from a recommended list. Moreover, once consultants and clients become comfortable with QTA managers and fully comprehend their value proposition they rarely change back to active management for the core equity allocation.

David Koulish: Do you believe it is possible for active managers to achieve this lofty after-fee and after-tax hurdle?

Doug Rogers: Even with the high hurdle, I do believe active managers can achieve favorable results, but not by employing traditional portfolio management practices that have evolved from the tax-exempt account industry. Unfortunately, style box investing with highly diversified portfolios and tight tracking error that is the focus of tax-exempt account consultants and sponsors is the bane of taxable investors. Also, as assets continue to migrate to passive strategies, many believe the reduction in cross-sectional volatility is making it increasingly more difficult to achieve alpha even in the most inefficient market segments where there is less analyst coverage, such as domestic small- and micro-cap equity or emerging markets.

David Koulish: What are the characteristics of the managers you do find attractive?

Doug Rogers: To achieve the results necessary to be competitive with a QTA strategy paired in the equity manager allocation mix requires a focus on high-conviction, concentrated managers that can clearly demonstrate skill. They understand that to achieve compelling results requires focus on a limited set of best ideas. For example, if a manager wants exposure to discount retailers, the tax-exempt manager may hold Family Dollar Stores, Ross Stores, TJX Companies, etc., whereas the focused, concentrated manager will do in-depth research and purchase only one of the options, constructing a portfolio of fewer than 35 securities and still achieve sufficient diversification. The manager is not
wed to overly restrictive, tight tracking error and will go out-
side the style box, as necessary, to identify the best opportu-
nity for potential return. I find that most of these managers
have managed assets at large organizations with success and
later in life seek a boutique-type environment where they
can more freely practice the true art and science of portfolio
management. They demonstrate extreme pride in their work
and are more interested in serving a limited number of dis-
criminating clients with distinction rather than becoming
mass market asset gatherers.

David Koulish: Doug, you have been a chief investment
officer for several wealth management firms. How do you
develop your investment manager research analysts to be
more effective in a tax-aware framework?

Doug Rogers: I ensure they rely less on quantitative anal-
ysis and focus more on identifying the value proposition of
the strategy and security selection process to understand
the return potential of a particular approach. Additionally, I want
them to fully comprehend the ability of the manager to exe-
cute whatever edge they appear to possess. To complement
this portion of the process, I institute a 10-item scoring sys-
tem that identifies a manager’s knowledge and commitment
to tax-aware investing principles (Rogers 2006):

<table>
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<th>TABLE 2: HIERARCHY OF TAX-AWARE INVESTING</th>
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The scoring is meant to be progressive in nature, i.e., the first
couple of items listed in table 2 represent the basics you expect
to find in a tax-aware manager and as you get closer to item 10
you enter the realm of the elite practitioners in the field.

Let me explain each of them for you. For item 1 the man-
ager is aware that excessive trading has a cost. In item 2 the
manager realizes that, when contemplating selling a security
that was purchased 11 months ago for a substantial capital
gain, there is a meaningful benefit to holding it a month lon-
ger if the position is not likely to be subject to a substantial
drop in price. In the past, there have been times when divi-
dends have been taxed at the ordinary-income and higher
rates than they have been recently. Item 3 highlights that
the manager should be aware, all else being equal, that if
two securities offer the same total return potential it may be
advantageous to seek those securities where a greater por-
tion of the return is likely to be from appreciation. Item 4 is
very important. Ideally, you want to align with managers that
understand that the opportunity for tax-loss harvesting can
disappear. The late winter of 2003 and 2009 are examples. If
you waited until the end of the year, you would have missed
the economic value of tax-loss harvesting earlier in the year.
Item 5 identifies managers that review the multiple tax lots
of a security position. A manager might have a security posi-
tion with 10 purchases or tax lots. In the aggregate, the posi-
tion might not show a gain or loss, but when you look under
the hood there may be individual lots where a purposeful
transaction can add value. In item 6 managers ensure custo-
dians adhere to specific lot identification or high-in, first out
(HIFO) versus the average cost or first in, first out (FIFO)
accounting conventions. Doing so may add 10 or better basis
points in incremental after-tax return annually. When you
reach item 7 on the hierarchy you are now identifying firms
that have a genuine commitment of excellence to taxable
accounts. Rather than having a generalist servicing both tax-
exempt and taxable accounts, the elite firms will assign a spe-
cialist to taxable accounts conversant in accounting issues,
e.g., alternative minimum tax and estate and planning mat-
ters. Item 9 is when you really have found a high-perform-
ing firm where the best analysts and portfolio managers are
assigned to taxable accounts, as senior management fully
understand that the opportunity for tax-loss harvesting can
be very important. Ideally, you want to align with managers that
understand that the opportunity for tax-loss harvesting can
disappear. The late winter of 2003 and 2009 are examples. If
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ing firm where the best analysts and portfolio managers are
assigned to taxable accounts, as senior management fully
comprehends that taxes complicate the process and require
the best and most-experienced talent available. Topping it
off with item 10 is the Holy Grail, after-tax reporting. Firms
that have this capability realize it demonstrates their value
proposition, which clearly separates them from the competi-
tion, and they are not afraid to be compared to a significantly
higher standard. If they have a sound value proposition and
can simultaneously execute both their strategy and tax-aware
investing principles, I do believe they can overcome the hur-
dle, but admittedly this is a small universe of managers.

I need to share a note of caution. When applying the hier-
archy do not expect every element to be satisfied to a partic-
ular level, as it is likely to be somewhat hit and miss. Like any
other method this is simply a tool that can guide the evalua-
tion process and is not by any means foolproof or perfect.
While this discussion focuses on equities, there is a similar
methodology for fixed income.

David Koulish: Do the elite managers apply any tech-
niques to compare the value of one security against another
on an after-tax basis?

Doug Rogers: Yes, in item 9 one of the things they do is
calculate the additional return potential required of a secu-
rities being considered for purchase to replace an existing posi-
tion with a significant unrealized capital gain to overcome the
tax cost of transaction. An example highlighted in Chapter
11 of my book was first made public by Joanne Howard of
Rosenberg Capital Management for equities and is also of
merit when rebalancing or making taking allocation shifts.
From a tax perspective, buy-and-hold growth represents a long-term investment approach that benefits from tax deferral, while value represents more of a trading strategy.

David Koulish: Do you encounter any particular concerns with managers that follow a particular style, e.g., growth or value?

Doug Rogers: Style has its own set of issues. Taxes serve as a leveler between before-tax outperformance of value over growth. From a tax perspective, buy-and-hold growth represents a long-term investment approach that benefits from tax deferral, while value represents more of a trading strategy. This is better understood when analyzing rebalancing in value and growth index portfolios. When securities exit the value index fund they are more often at a much higher price-to-earnings or price-to-book ratio value resulting in significant gains realization. With the growth index fund, the opposite is true, resulting in less gains or even losses that can offset gains.

With value managers the primary concern is adhering to the double-down trade mentality on positions falling in price rather than take a loss. Growth momentum managers are typically so tax-inefficient that it is near impossible to be competitive over longer holding periods. Currency hedging activity in international equity portfolios can prove difficult to justify in taxable accounts.

David Koulish: Are there any particular statistics that are helpful for analyzing after-tax performance results?

Doug Rogers: Two statistics are helpful. The first is the relative wealth measure appropriate for separate accounts. The second is the Morningstar tax-cost ratio for mutual funds derived from the relative wealth measure. Mutual funds cannot pass through losses, so the ratio is simply subtracted from the before-tax result to achieve performance after fees and taxes. Listing the tax-cost ratio information, unrealized gain or loss position as a percentage of assets, and the score from the tax-aware hierarchy on manager profile reports results in more-informed funding decisions.

David Koulish: Doug, one last question. If a manager does not offer after-tax returns, how can an analyst calculate them?

Doug Rogers: The best way for separate accounts is to ask for several years of custodial statements that list income and gains information. For partnerships obtain copies of K-1s. It is best to ask for these statements for an account with minimal flows in and out, because they complicate the process.

An analyst can enter the information into a spreadsheet and apply applicable tax rates to achieve a net amount that can be added or subtracted, as appropriate, from the ending account market value to calculate the after-tax return.

David Koulish: Thank you for taking the time for this interview and your support of the IMCA CPWA program.

Douglas S. Rogers, CFA®, is a faculty member with the IMCA Certified Private Wealth Advisor certification program and author of Tax-Aware Investment Management: The Essential Guide. He earned a BS in engineering from the United States Military Academy at West Point and an MBA in finance from the Cox School of Business at Southern Methodist University. Contact him at dsrogers76@gmail.com.

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Acknowledgments

The interviewee thanks Steve Riley and Brad Summers for their comments.

Endnotes

1 Today the fund is called the Schwab 1000 Index Fund.
2 For a more-detailed discussion, see Bouchey and Vadlamudi (2012).

References