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By William O. Creedon

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Investing during the volatility caused by the COVID-19 pandemic hasn't been for the faint of heart. For example, during the first half of 2020, the S&P 500 Index had 68 days with daily moves of at least 1 percent—an unusually high percentage.[1]

However, market volatility does provide opportunities for investors and financial professionals who use tax-loss harvesting strategies throughout the year. Exchange-traded funds (ETFs) may be an efficient vehicle to potentially save on taxes by harvesting losses when markets move quickly lower.

Taxes tend to come in focus at the end of the year in December, and of course on Tax Day, which was postponed this year from April 15 to July 15. Smart investors, though, are on the lookout year-round to harvest losses to limit the tax bills in their taxable accounts. And the ability to trade ETFs and their transparency of holdings make ETFs attractive vehicles for these tax strategies.

BASICS OF TAX-LOSS HARVESTING

Falling markets can be unnerving, but they let investors harvest losses by selling investments that have declined in value in order to offset gains.

Here's how it works: Investors can sell a position that's lost value, book the loss, and use it to offset capital gains they realize elsewhere in their portfolios. What's more, losses can be used to limit tax exposure from noninvestment

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income as well as to offset investment gains. Under current law, a capital loss deduction allows an investor to claim up to $3,000 more in losses than in capital gains, meaning investors can reduce their taxable income dollar for dollar, up to that $3,000 limit.

With markets climbing steadily in recent years, there haven't been many chances to take losses to offset gains in portfolios. Yet, the speed and breadth of the market decline in the first quarter of 2020 created opportunities to harvest losses in many asset classes. Also, the speed of the subsequent stock market recovery showed that these opportunities can be fleeting, so investors need to be ready to quickly react and harvest losses.

WASH SALE RULE AND ETFs

When tax-loss harvesting with ETFs or any investment, it's very important to remember the wash sale rule.

The wash sale rule is an Internal Revenue Service restriction on the repurchase of a "substantially identical" security within 30 days after the sale. If investors want to remain invested after taking the loss, they can invest in a similar investment that isn't substantially identical.

Let's take a basic example using ETFs. Investors can use the recent weakness to sell an index fund or ETF tracking the S&P 500 Index and book the loss. Then, they can invest in a similar ETF, such as a multifactor ETF that invests in U.S. large-cap stocks, without running afoul of the wash sale rule.

There are also more specific and complex ways to use ETFs in tax-loss harvesting strategies. One example is an investor who has a concentrated position in an individual stock. The investor can sell the stock and book the loss—at the same time diversifying the portfolio and reducing single-stock risk with ETFs. In this example, the investor could sell a bank stock, take the loss, and then purchase a financial-sector ETF to maintain exposure to the banking sector, without triggering the wash sale rule.

TAKE ADVANTAGE OF TAX OPPORTUNITIES WITH ETFs

Many investors are familiar with the tax efficiency of ETFs. But ETFs also can be attractive vehicles for implementing tax-loss harvesting strategies. In general, when deciding between a mutual fund or an ETF, the answer depends on the investor's specific goals, time horizon, tax situation, and other factors.

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Volatile markets are always difficult to navigate, but at least they create opportunities for investors and financial professionals who seek to lower their tax bills throughout the year. We believe ETFs offer an attractive vehicle to book losses in equities, while staying out of cash and remaining invested to participate in a potential recovery.

William O. Creedon is director of ETF capital markets at John Hancock Investment Management in Boston, Massachusetts. He earned a BS from Boston College's Carroll School of Management. Contact him at wcreedon@jhancock.com.

ENDNOTE

1. DataTrek Research, as of June 30, 2020.

The S&P 500 Index tracks the performance of 500 of the largest publicly traded companies in the United States.

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INVESTMENTS & WEALTH INSTITUTE®

5619 DTC Parkway, Suite 500
Greenwood Village, CO 80111
Phone: +1 303-770-3377
Fax: +1 303-770-1812
www.investmentsandwealth.org