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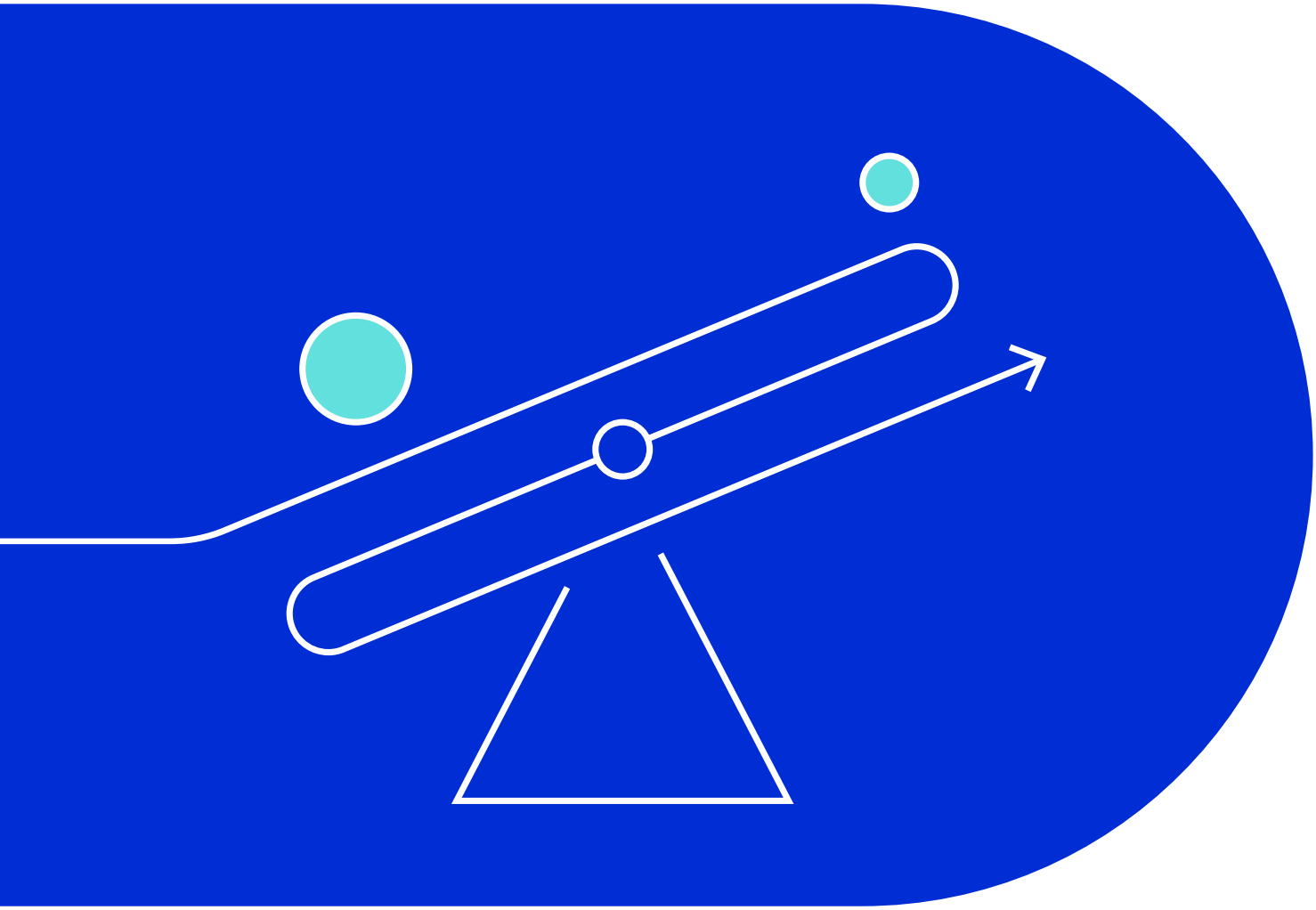

Tax-smart portfolio rebalancing: 6 best practices to reduce your clients' tax burdens and grow your practice

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Introduction

Investors have had a rough year as rollercoaster-like market volatility put the S&P 500 down nearly 20% for 2022, marking the worst performance in 14 years. But investment advisors have a rare chance to make the best of the situation with tax-smart rebalancing – a major value-add, year-round opportunity to help clients reduce or eliminate their tax consequences.

Offering value-added services focused on estate and tax planning have become more important for advisors to remain competitive and grow their businesses. A staggering 80% of investors believe that their financial advisors should focus on minimizing their taxes, and 90% believe that taxes can erode the growth of their investment accounts over time.[1]

Portfolio rebalancing can help advisors harvest losses and limit capital gains since it combines well with tax planning, reevaluating, adjusting risk tolerances, and resetting financial goals. Asset location optimization, target overrides, capital gains budgeting, and custom thresholds on unlimited sets of tax rules are other powerful ways to meet clients' specific tax strategies and control their annual tax burdens at the individual or household level.

However, 42% of advisors still need to use rebalancing technology[2] and are likely missing opportunities to upmarket their service strategies, scale to meet the needs of a growing client base and gain operational efficiencies. Advisors that do use it may not have the capabilities to meet their clients' tax goals.

Here is why offering tax-smart rebalancing is key to your value proposition and six key ways to leverage it as part of your growth strategy.

What is tax-smart portfolio rebalancing?

Tax-smart rebalancing can help advisors reduce or eliminate their client's tax consequences through:

- Asset location optimization
- Tax-loss harvesting
- Capital gains budgeting
- Applying unlimited sets of tax rules
- Custom thresholds

→ Why tax-saving services are changing the game

In a quest to preserve wealth and assets, clients are increasingly seeking investment advisors who can help reduce their tax burdens. In addition, growing competition across channels is driving firms to look for ways to improve the value they offer to current and potential customers as part of an "upmarket" services strategy.

In response, more firms are offering specialized services to address ideal client needs. For example, 60% of independent registered investment advisors (RIAs) now offering tax planning services to their clients.[2]

44%

of investors want their wealth managers to help reduce their taxes, including inheritance taxes.

Source: 2021 EY Global Wealth Research Report

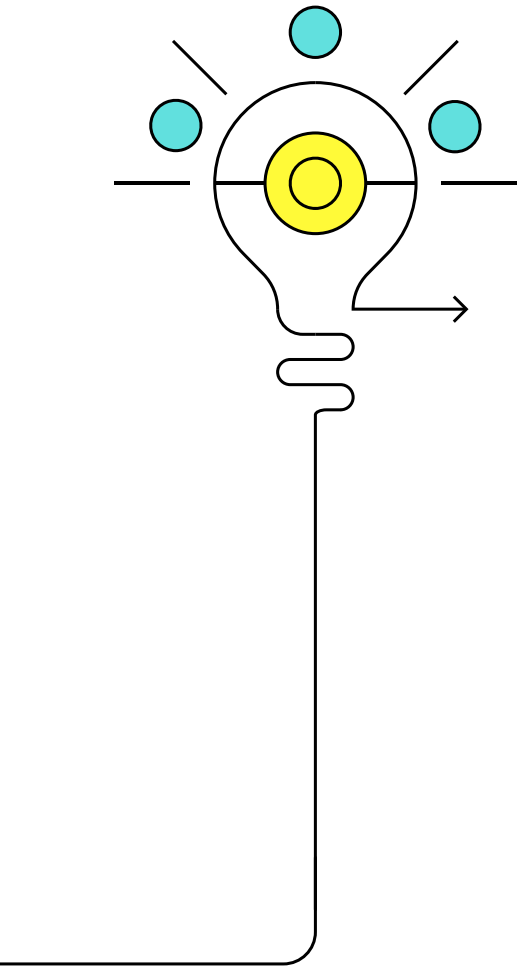
Rebalancing can help advisors add to investment performance without adding risk. By creating "tax alpha," an advisor can incorporate tax-aware strategies into investment management that provide clients with both permanent and temporary tax savings.

By offering tax-smart rebalancing, you can drive more upside opportunities. Some of these include:

Offering tax-deferred solutions

An increased appetite for tax-deferred solutions is especially prevalent among high-net-worth (HNW) individuals.[2] With the development of the direct-indexing industry, investors can now directly hold a specific combination of the individual securities that make up an index based on client requirements like tax management, ESG investing, or other factor tilts.

The use of direct indexing with affluent and HNW investors is also expected to play a prominent role in the forecasted growth of separate accounts over the next two years.[2] Advisors should consider how they can incorporate financial planning into their practice and heighten clients' awareness of tax implications as part of their value proposition to more affluent investors.[2]



Estate taxes and intergenerational wealth transfer

On the cusp of the most significant generational wealth transfer in history, baby boomers are set to pass about $70 trillion on to their children, which could cause many clients to potentially face a federal estate tax rate of 40% to 50%.[4]

Advisors will need to help clients who receive a sizable inheritance confidently grasp tax implications, plan retirement, manage their tax burden and estate planning, and provide support with value-added services related to wealth transmission.[5]

However, 62% of wealth managers say they cannot confidently understand and cater to millennials, which may be the reason at least 80% of millennial heirs will seek a new financial advisor after inheriting their parents' wealth.[5] Advisors that can meet these needs will have a significant competitive and growth advantage.

Upmarket service strategies

Studies show that managing tax implications is one of the most compelling ways an advisor can add value to their clients' portfolios. As a result, more advisors are talking with their clients about ways to take tax-smart approaches to asset location, transitions between portfolios, household-level management, and tax-loss harvesting.

The proportion of investors using estate and tax planning services are expected to grow from 30% in 2021 to 44% and 45% respectively by 2024.[6] As federal estate, gift and generation-skipping transfer taxes increased in 2022 and will continued to do so in 2023[7], investors are even more eager to focus on reducing their tax burdens.

Scaling to downstream markets

Certain aspects of traditionally "higher-end" service offerings are expected to proliferate downstream slowly, provided they can be offered in a scalable manner. They will become more commonplace and expected to offer services such as tax and intergenerational planning.[2]

Separate accounts, historically reserved for more affluent clients with sophisticated needs, are moving down market behind reduced minimum account sizes, allowing advisors to make use of the lower fees, tax advantages, and flexibility.[2]

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Boosting efficiency amid waning new talent

While firms typically rely on adding advisor headcount for growth, they also face talent shortages. Over time, the trend will continue to test traditional wealth managers' abilities to adapt, compete and grow seamlessly. To overcome talent challenges, firms need to streamline and continuously improve their workflows to enable more trading and money management while increasing margins and controlling operational costs.

Automating rebalancing and trading is crucial to drive operational efficiency and standardized, documented rebalancing techniques which ultimately let your team do more in less time. Freeing up your team to implement your firm's unique investment management approach, confidently and quickly respond to market movements, tailor, and scale services, and grow the business – without having to add more headcount.

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→ Six best practices for tax-smart rebalancing

Here are six key ways to ensure your rebalancing and trading remain in sync with your clients' tax requirements and objectives.

1. Harvest tax losses or gains

With ongoing market volatility, your clients may find themselves sitting on losses that can be harvested to offset capital gains and reposition asset allocation while maintaining their desired portfolio allocations. Rebalancing should allow you to easily harvest tax gains or losses and utilize substitute securities to maintain market exposure while avoiding potential wash sales. It should also provide capabilities for:

- Realizing gains or losses at the position or classification level and holistically across investment portfolios
- Factoring in restrictions, minimum trade size, and loss or gain thresholds to influence trade recommendations
- Offering different methods of harvesting gains and losses, including closing the position, selling lots based on cost basis method, and selling specific lots

2. Set capital gains limits

Avoiding short-term capital gains is the simplest example of a permanent tax savings strategy, while location optimization, which places an investment in the most appropriate type of account to best minimize taxes, can provide both permanent and temporary tax savings.

Establishing capital gains limits can help control your clients' annual tax burdens by letting you automatically set budgets for short-term, long-term, or combined capital gains based on a dollar value or as a percentage of the overall portfolio.

During rebalances, your rebalancing platform will alert advisors if a trade is at risk of breaching a pre-specified budget, considering short-term and long-term gains, capital loss carryovers, and gains generated from the orders themselves.

Implementing household tax strategies at scale

With householding becoming a key requirement, Signet Financial Management needed to be able to trade accounts as one account, perform tax-loss harvesting en masse, and distribute all assets to deliver clients trading and tax efficiencies.

In 2016, Signet implemented intelliflo redblack for rebalancing, trading, and order management to customize portfolios at scale with householding, tax-loss harvesting, and sleeve rebalancing to support tactical movements.

"intelliflo redblack has helped tremendously with fulfilling tax strategies and scaling different types of assets across different types of accounts," said Andrey Yashin, MS, CFA® and Director of Portfolio Management at Signet.

3. Optimize asset location

The allocation of various financial assets you set when establishing a client's investment plan may no longer be in line with that plan. Enter rebalancing to realign assets with your clients' strategies while simultaneously helping to avoid triggering taxable gains in taxable accounts. Optimizing the location of assets in various types of accounts can significantly reduce the tax impact of the portfolio. Therefore, rebalancing should also enable you to define location preferences across taxable, tax-deferred, and tax-exempt statuses.

4. Adopt householding models

Householding structures can help you meet clients' increasing demand for location preferences and tax efficiencies.

Liquidating securities to cash across all those accounts, putting them into a household, and using location preferences to dictate where the securities should be held is a clean-slate approach but may present significant tax consequences. In contrast, a natural drift approach prescribes slowly moving or weighting securities according to the household model as changes in prices or managers occur.

Reviewing a client's risk profile holistically across all accounts within a household lets you assess the proper alignment between risk tolerances, preferences, and capital gains budgets. To maximize tax efficiencies, a rebalancing system should offer wash sales logic across the household.

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Testing out tax-loss harvesting scenarios

A wealth management firm was looking to tax-loss harvest across 6,000 accounts but was unsure of the specific day it would (or should) execute the rebalance.

Using what-if scenarios in the intelliflo redblack platform, the firm could run a tax-loss harvesting rebalance each day to mock-up orders in case it decided to trade that day.

When the day came to execute the tax-loss harvest, the firm could run over 70,000 orders worth over $1 billion seamlessly using intelliflo redblack's order management capabilities.

5. Use what-if scenarios

Many financial advisors leverage what-if scenarios on model allocation changes or tax-loss harvesting events. Using automated rebalancing, advisors can have the flexibility and power to test different types of capital gains budgets, tax goals, or other scenarios across their entire client base or a subset of clients before following through on trades.

Behavioral finance users are more inclined to use tax-loss harvesting and a phased investment approach.[8] Exploring tax-loss harvesting opportunities and what-if scenarios can help you better position clients for the future.

6. Do year-round tax planning

Experts agree that checking in on clients' investments regularly is key to taking advantage of significant tax benefits. Rather than an annual event centered solely on tax season, apply tax-sensitive rebalancing approaches throughout the year to ensure your clients' investment policies and tax efficiency goals are consistently met.

Rebalance at least quarterly, harvest material losses during the year, avoid material capital gains distributions and adjust the location of assets in retirement accounts for maximum tax benefit.

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The need to automate rebalancing

Today's investors want tailored models that fit their specific preferences, rules, exceptions, and opportunities to gain tax efficiencies. Therefore, advisors must be adaptable to personalize and tailor models to each client's situation and do it at scale.

Manual techniques are time-consuming and will likely cause you to miss tax-savings opportunities. A sophisticated rebalancing platform is needed to meet a variety of strategies throughout the year while enabling you to bring on more clients and give each the same high-quality service – without additional overhead or complexity.

Functionality such as asset location optimization, tax-loss harvesting at the position or tax lot level, and capital gains budgeting can enhance the ability to meet clients' specific tax strategy goals.

To help maximize tax efficiencies for your clients, your rebalancing solution should enable you to:

- Ensure rebalancing and trading remain in sync with client risk profiles and tax requirements
- Set an unlimited set of tax rules
- Personalize and scale rebalancing and trading across accounts and households
- Support intergenerational wealth transfers
- Quickly see potential tax consequences across a household in a single portfolio
- Define location preferences across taxable, tax-deferred, and tax-exempt statuses
- Create an unlimited amount of location preference sets
- Import restrictions, equivalents, and account and household attributes
- Customize the rebalance settings for a group of portfolios
- Tailor thresholds created at the account, asset classification, or household level
- Offer wash sales logic across a household

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→ What your clients want

As today's investors demand reduced tax burdens, tax-smart rebalancing plays a more significant role in how firms deliver personalized and scalable value-added services. Addressing evolving client preferences and providing highly individualized service can give you a competitive edge. Ongoing volatility, inflation, rising interest rates, and estate tax increases are placing a premium on solid fiduciary advice.

Many advisors are leveraging automated rebalancing to implement different tax-saving strategies like tax-loss harvesting and location optimization to ensure clients are where they need to be while supporting the next generation of investors.

With a greater focus on tax efficiency and the help of powerful tax-aware rebalancing, advisors can strengthen client engagement and grow their practices.

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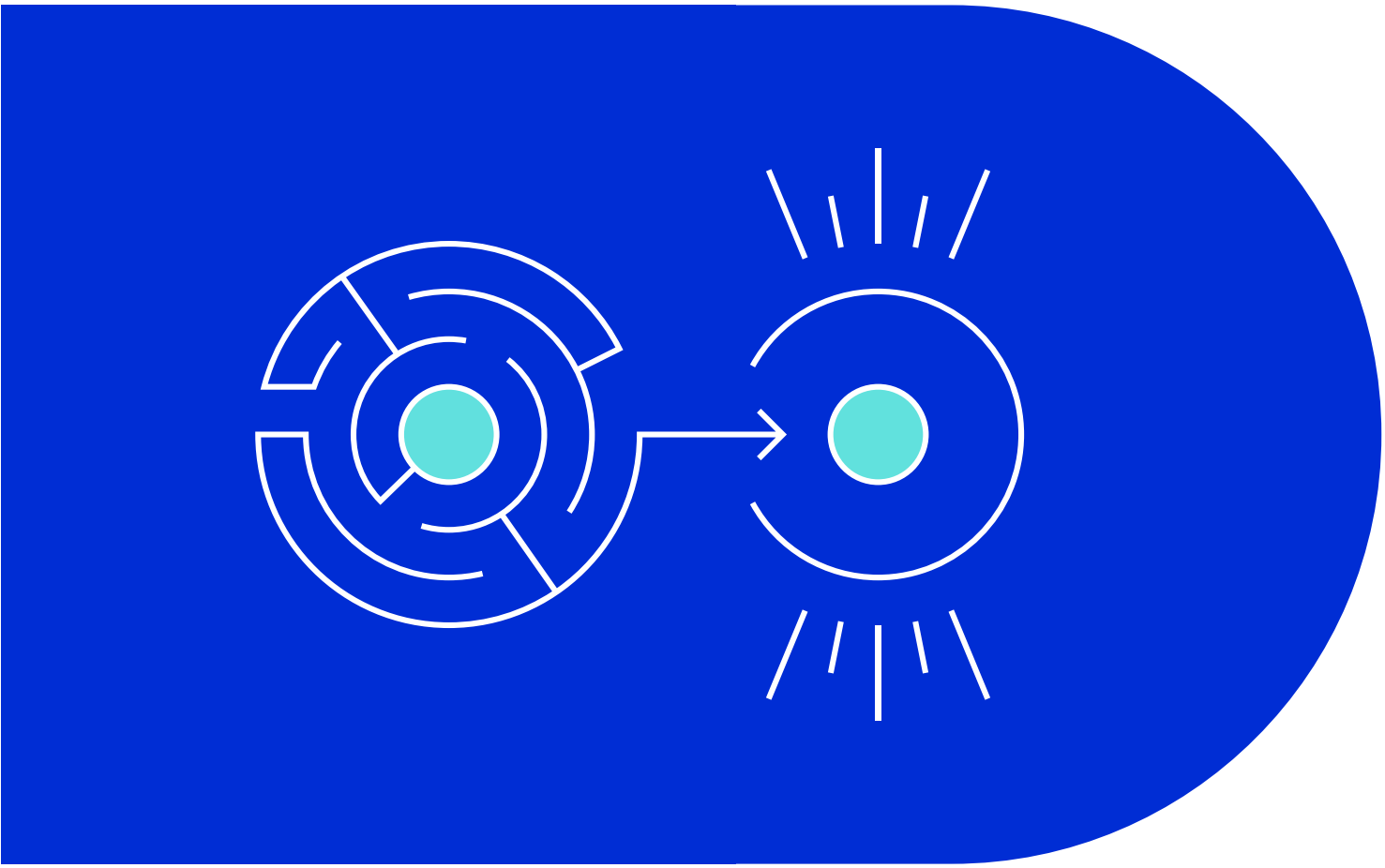

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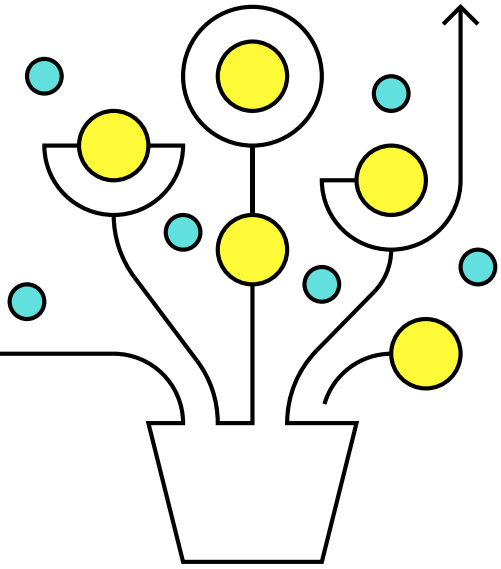
→ About intelliflo

intelliflo widens access to financial advice through leading technology powering the financial advisory experience. We use open software architectures combined with unmatched industry experience to simplify a complex digital landscape to help advisors compete and grow.

Our solutions support over 30,000 financial advisors worldwide, representing over three million end-investors, with over $1 trillion serviced across our platforms.



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