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Invest Wisely™

When the markets give you lemons, it's time to make lemonade.

Greetings!

For the first time in decades, all major asset classes have declined this year – the US stock market is down ~10%, almost every international market is down more than 10%[1] except Brazil and India, and even US bond funds have not been a safety play as the benchmark AGG is down -3%[2], as I warned would happen at the beginning of the year in this newsletter and in my interview with the *Wall Street Journal*.[3]

But for some investors, there is a silver lining to stock market losses – the ability to sell those losses to lower your tax bill to Uncle Sam. I suspect some of this month's extreme market volatility can be attributed to hedge funds and others conducting tax-loss harvesting. Have you gotten into the action or have you missed out on this opportunity? Unfortunately, many investors have been lured into buying "diversified" index and mutual funds which often have too many accumulated gains and so little dispersion that you cannot benefit from tax-loss harvesting.

Below is an example of how investing in a basket of stocks can be more tax-efficient and yield better returns than investing in index and mutual funds. This analysis is based on year to date performance as of December 26, 2018.

Suppose you have the good fortune of earning or inheriting a large concentration of a single stock. For example, perhaps you received stock of Apple ten years ago which has since risen 1,110%. Suppose your holdings were worth $1 million at the beginning of the year. If you wanted to sell it in order to diversify your stock holdings or make a purchase of a home, you would have to pay an estimated $200,000 in capital gains taxes - assuming that your cost basis was very close to 0 and you are in the top tax bracket. Now, imagine you "diversified" this holdings into an index that tracks the S&P index fund. Alternatively, you can "diversify" the holdings into a basket of individual stocks such as the top 25 stocks in the S&P. What would be the difference in your financial situation by the end of 2018 given these separate approaches to diversifying your US stock holdings?

<u>The Results:</u>

1. **Your portfolio would have performed 7% better by investing in the top 25 S&P stocks over a S&P Index.** If you put $40,000 ($1M/25) into each of the top 25 S&P stocks at the beginning of the year, your portfolio would have lost 5% vs. -12% had you put your investment in S&P Indices like SPY and VOO. You would be almost $70,000 and 7% better off by investing the top market cap stocks[4]
2. **More winners.** If you invested in the top 25 stocks, 10 of your stocks would have gained on the year - most notably Merck up 26%, Amazon and Mastercard up 15%, and Pfizer and Microsoft up over 10%. Again, no major asset class or international market (except India up 5% and Brazil up 11%) gained on the year.
3. **Greater dispersion and diversification.** While Merck was up 26% on the year, Facebook was the laggard down 30% on the year. This 56% dispersion between holdings is almost impossible to find if you only have conglomerated ETFs and mutual funds. Yet, the greater dispersion implies better diversification/less-correlation and provides more opportunities to match gains and losses to lower your tax bill and rebalance your portfolio with new opportunities. This is what I was able to do for my clients as the market tumbled.

4. **If you did not tax-loss harvest, you would have to pay $200,000 for year-end 2018 taxes because you sold your Apple stock at the beginning of the year.** This is another 20% loss.
5. **However, if you did tax-loss harvest, you could save over 2.4%.** Index funds boast small fees but they don't have the advantages of holding individual stocks. As well, you can carry over your losses to future years.
6. **In years when the S&P 500 is flat to up, there are few tax-loss harvesting opportunities.** Therefore, most years you are better off in a basket of stocks if you want to tax-loss harvest. Some robo-advisors have claims about their tax-loss harvesting strategies with ETFs but their tactics are questionable and the SEC has recently fined Wealthfront and others for false claims regarding their tax-loss harvesting strategies.[5]
7. **In years like this one in which the S&P 500 is down, you can tax-loss harvest but at the risk of losing out at a big upswing in the markets.** The wash sale rule forbids you from buying the same security in a 30 day period after selling it – so had you sold earlier this month, you would not be able to buy to take advantage of today's 1,000 point upswing.
8. **Owning a basket of individual securities means you can tax-loss harvest every year to bring down your taxes and rebalance your portfolio with minimal taxes.** For instance, at the beginning of the year, many portfolios had a high overweight in tech given tech stock outperformance in the past few years – wise investors took some of the gains in high-flying tech stocks offset by poorer performing stocks to lock in their gains and rebalance their portfolios. This is what I did for my clients.
9. **Owners of mutual funds generally fare even worse in tax-efficiency.** Most mutual funds send out their year-end capital gains tax distributions which the owner of the fund must pay. Even in years when the market is down, these capital gains can be high! American Funds' declared a 9-11% expected capital gains distribution on its "The Growth Fund of America"[6] If you had put your $1,000,000 into mutual funds like this, you could have another ~10% or $100,000 in capital gains on which you would have to pay taxes. As these holdings would be within a year, it is a short-term gain and you would have to pay a much higher ordinary income rate on this $100k gain.

Above are just a few of the reasons that owning a basket of stocks can achieve a better pre-tax and after-tax performance than owning a "more diversified" index or mutual fund. Skilled active stock picking and management can better the performance – for instance, if Facebook were sold on July 25, 2018, the stock would have been up 23% on the year in contrast to its December 24 fall YTD of almost --30%.

Please let me know if you would like to learn more about my approach to single stock, single bond, and income alternative investing and how you can benefit from greater transparency, tax-efficiency, performance, and risk management.

For the keen eye, you may have noticed I have joined Perigon Wealth Management as Senior Investment Strategist. New contact details below and more to come... I'd love to hear from you. This weekend I will be speaking on the markets and investing at the Renaissance Weekend conference in Charleston, South Carolina.

Best regards,
Maya Joelson

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Footnote:

1. Markets Digest. *The Wall Street Journal*. December 27, 2018. B7.
2. Ycharts. Accessed December 27, 2108.
3. Coppola, Alex. Joelson, Marisa. "Bonds vs. Bond Funds: A Distinction Wealth Advisers Should Explain." *The Wall Street Journal.* December 26, 2017. https://www.wsj.com/articles/bonds-vs-bond-funds-a-distinction-wealth-advisers-should-explain-1514307496
4. This analysis is based on data from Ycharts on YTD price performance of VOO, SPY, and the top 25 stocks in the S&P 500 as of December 26, 2018. The market subsequently shot up 1000 points but is dropping the following day so this analysis is as of the data accessed end of day December 26, 2018.
5. Morris, Meghan. "Wealthfront, the second biggest robo-adviser, just settled with regulators over misleading clients." *Business Insider.* December 21, 2018. https://www.businessinsider.in/Wealthfront-the-second-biggest-robo-adviser-just-settled-with-regulators-over-fraud-charges/articleshow/67201554.cms
6. https://www.americanfunds.com/individual/service-and-support/tax-center/2018-year-end-distributions.html

Marisa (Maya) Joelson recently joined Perigon Wealth Management as Senior Investment Strategist and Wealth Advisor. Maya has two decades of experience advising top CEOs, policy makers, technology executives, and hedge fund managers, corporate executives, families, and individuals on their investment decisions. She has worked for leading firms in the US and London including Merrill Lynch, Credit Suisse, Renaissance Capital, and Rio Tinto. Her differentiated ideas have been featured in the ***Wall Street Journal, Barrons.***, ***Seeking Alpha*** and the **World Economic Forum**.

She earned a MPA from Harvard, MBA from Kellogg, and BA from Wesleyan.

Maya speaks Spanish, Russian, French and English, in reverse chronological order.

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If you have received this email, you have met Maya Marisa Joelson in person and given her your business card or contact details.