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summaries

SIGMA INVESTMENT COUNSELORS

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Capital Gains Taxes, a Look Ahead

One of the fundamental underpinnings of Sigma's investment philosophy is diversification among different asset classes as well as within the various asset classes. To maintain diversification, part of our portfolio management discipline is to rebalance to ensure that the asset allocation remains consistent with what was agreed upon with our clients and also to trim successful, but outsized positions and perhaps establish new investments. In most situations, selling existing holdings in taxable accounts generates taxable gains.

At the depths of the market lows in March of 2009, the Dow bottomed at 6,557, the S&P 500 at 677, and the NASDAQ at 1,269. Each one of these indices have since increased several fold, trading near their all time highs (until very recently). The Dow, S&P 500 and NASDAQ now trade at 25,160, 2,730 and 7,190 respectively.

Equity lows of 2009 provided numerous opportunities to harvest tax losses. We took advantage of those opportunities in many taxable portfolios. In most cases those losses provided opportunities to offset capital gains and reduce taxes for many years forward.

As a matter of course, we regularly review taxable portfolios, opportunistically harvesting material tax losses to offset either realized capital gains or to carry them forward for future realized gains. As a result, despite the several fold moves of the major market averages over the last nine years, many clients have experienced substantial realized gains in their taxable portfolios without incurring the commensurate obligation of capital gains taxes that they would have otherwise experienced.

Where possible, heading into November and December of last year we tried to hold off taking gains until 2018. This was done not only to avoid having to pay capital gains taxes in April of 2018 versus 2019 but also to take advantage of any lower tax rates that might materialized for the 2018 tax year versus the 2017 tax year. Conversely, where and when appropriate, we took losses where possible in 2017 as those losses potentially held more value at higher tax rates.

As we review client portfolio holdings today, many clients have very outsized positions due to the bull market run of the past nine years and the particularly strong performance of the last 12-18 months. In portfolios that warranted it we recently trimmed some of the domestic holdings which performed especially well in the past 12-18 months. These holdings became outsized positions within portfolios, reaching levels at which we were no longer comfortable within the context of maintaining a diversified portfolio. In most cases we redeployed the cash, increasing exposure to investments where valuations and opportunities appeared more compelling and where such positions were appropriate for the particular client portfolio.

The several fold increases in the Dow, S&P 500 and NASDAQ indices over this bull market has resulted in substantial unrealized gains for longer term clients. With the exception of a few small losses in bond funds, the good news is that in most portfolios there are **no unrealized losses to take!** The bad news is in most portfolios there are **no unrealized losses to take!** In other words, there are no losses to offset realized capital gains.

In portfolios that were rebalanced since the beginning of 2018, certain sales generated more gains than clients have typically experienced in any of the last nine years, and that was only January! While it would be useful to have a loss to take, that is not something we endeavor to achieve. Our expectation is that even a temporary market pull back, or sell off in an individual security, might not provide the opportunistic tax loss selling we have experienced in years past.

Bottom Line: As we move forward, if we continue to be successful in our investment selection process, clients should anticipate a higher amount of capital gains and capital gains taxes versus what they have experienced in the past nine years. That said, clients have many unique needs and circumstances when it comes to their own tax situation. Given the significant change in dynamics vis-a-vie the environment of the past several years, this will be a topic of discussion as we meet with clients in the coming months. We want to make sure our actions and client expectations are in sync with regard to realized capital gains taxes generated in their taxable portfolios.

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