Timely insights on the issues that matter most to investors.

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Equities | Taxes | Volatility

What to do in a downturn? Consider a tax loss harvesting strategy

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Seattle - We stand corrected: As of March 11, the S&P 500 Index[1] is down 19% since its high-water mark on February 19, well in excess of the 10% threshold that defines a market correction and just shy of what's considered bear-market territory. Sparked by the news of the spread of the coronavirus, the downturn that began in late February has intensified in early March as more cases of the virus are reported.

And while there are some individual stocks, largely in the pharmaceutical and cleaning-supply industries, which have benefited from the outbreak, all economic sectors were at a loss for February. It's been a swift and stunning plunge across the board, made all the more startling since it arrives on the heels of the longest bull market in history. Sometimes the best parties leave us with the worst hangovers.

Does that mean it's time to get out?

We don't think so. We've seen about five or six steep downturns since 1987 when Parametric first opened for business, and in our experience, this is a time to pause, take a deep breath and keep four things in mind.

"While market corrections like the one we're experiencing are stressful for investors, there's still something positive they can do for the long-term health of their SMAs."

Long-term equity market returns are the goal

Over the long term, equity markets are expected to deliver a meaningful excess return over less risky investments such as Treasury bonds. In the short term, there will be downturns and there will be volatility. A separately managed account (SMA) can take advantage of this short-term volatility by harvesting tax losses[2] when available and reinvesting the proceeds of these sales to support the objective of long-term equity returns. It's worth also keeping in mind that the loss harvesting one does now in an SMA resets cost basis and sets the portfolio up for more potential tax losses in the future.

The strategy doesn't change in this environment

Since the market peaked on February 19, volatility has increased, prices are dropping and losses are plentiful in many investors' portfolios. But that doesn't mean the strategy should change. In fact, the market downturn is an opportunity to collect additional tax losses, to harvest them and reinvest the proceeds to maintain market exposure. The fundamentals still apply: Since no one can time the market, it's important to maintain full market exposure at all times.

Don't worry about missing out on losses

After an initial loss-harvesting trade, the market may fall further and an investor may notice additional losses in their portfolio. Or they may believe that if a loss isn't harvested immediately, they'll miss the opportunity. Keep in mind that on any given day the losses in a portfolio could either be reduced or continue to deepen depending on whether the market recovers or continues to fall.

Watch for wash sales

Under its wash-sale rules, the IRS disallows a tax loss if the investor purchases the same (or a substantially identical) security within 30 days (before or after) the sale date. As a result, it's typically most efficient to trade accounts when there are no outstanding wash-sale restrictions, on a monthly basis at most. This is one reason SMA investors may see unharvested losses in their portfolios. It usually means the SMA manager is trying to navigate the wash-sale trade restrictions and avoid the risk of nullifying the loss-harvesting benefit.

As you can imagine, loss-harvesting opportunities during this downturn have been plentiful. In the S&P 500® Index in February, over 400 names showed a loss of greater than 5%, and 72 showed losses of greater than 15%. We saw similar numbers in the international markets.

Bottom line: So while market corrections like the one we're experiencing are stressful for investors, there's still something positive they can do for the long-term health of their SMAs. Loss harvesting allows investors to potentially reap valuable tax benefits while helping to position their portfolios for when markets turn around again.

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[1] S&P 500 Index is an unmanaged index of large-cap stocks commonly used as a measure of US stock market performance.

[2] Tax loss harvesting is a strategy for managing taxes in an investment portfolio. Selling a security that's trading at a loss creates a realized tax loss, which can be used to offset a capital gain realized in the same year.

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