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SUMMARY

- The world is dynamic and market leadership is constantly changing.
- Failure to reposition portfolios purely for tax reasons can lead to lost opportunities and concentration risk, in our view.
- Financial advisors have the tools and the experience to assist their clients in managing capital gains efficiently.

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The Investors' Dilemma

When Should a Capital Gain be Realized?

Nobody enjoys paying capital gains taxes, especially when those taxes can be avoided or delayed. However, we believe that capital gain taxes can be the 'necessary evil' that is difficult to completely extract from any successful investment process. Therefore, we believe that taxes should be an important but secondary variable to consider when making future investment decisions. Over time, we have seen too many investors make poor investment decisions for the sole reason of avoiding taxes. Additionally, investors are increasingly using higher stock weightings in their retirement portfolios and living off systematic or managed withdrawals in addition to the income from bonds and stock dividends. This means for many it is not a question of 'if' but 'when' stocks positions will be sold, and gains realized.

Why Realize a Capital Gain?

1. **Concentration Risk:** We have been taught not to put all our eggs in one basket, but sometimes they can end up that way. Vested company stock, or a few successful investments can quickly put a portfolio out of balance. When a portfolio becomes overly concentrated it can become unsuitable for that investor's risk tolerance and vulnerable to unexpected events.

2. **Opportunity Cost:** Winning investments often pay your capital gains tax for you by outperforming their peers. However, success brings competition which can be fierce, and investors can be fickle. Yesterday's winner is not always tomorrow's leader. In fact, it is more common for former winners to lose their leadership than it is for them to maintain it. Just in the last few decades we have witnessed the struggles of former investor darlings including big banks, big pharmaceuticals, integrated oil, telecommunication equipment, branded consumer goods and big-box retail to name a few. Investors in many of these industries have not only seen the value of their investments decline but have also experienced significant opportunity costs by not having enough exposure to the market's next leaders. Sometimes it can be better to take a step back (sell a low basis stock and pay the tax) to take two steps forward (reinvesting in a more diversified portfolio that keeps up with the market).

3. **'Break-Even' Not the Insurmountable Hurdle Many Believe:** There are times we think investments should be sold and taxes incurred and the 'hurdle rate' guiding that decision may be lower than believed. We calculate the break-even period for a 'sell' versus 'hold' decision as follows. We look at the length of time it takes for a replacement to fully offset the cost of paying the capital gains taxes on the original investment. In our example we make the following assumptions:

    a. Assume maximum tax rate (23.8%): Maximum cap gains rate (20%) + Net Investment Income rate (3.8%).

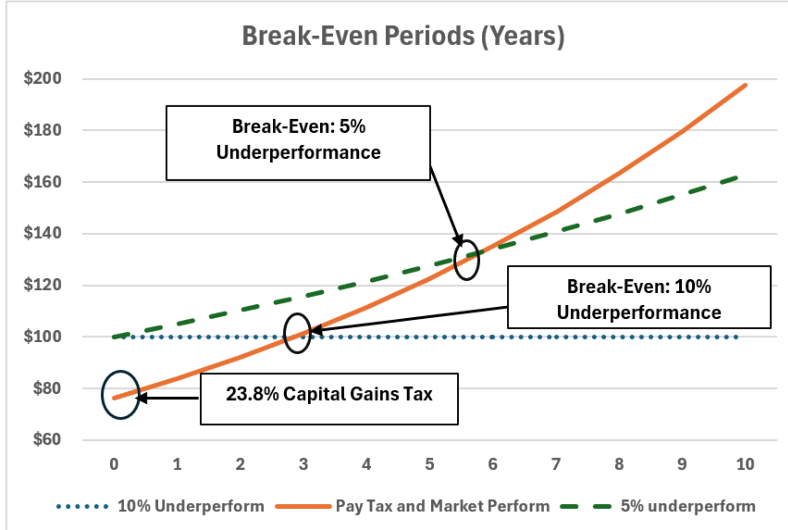
    b. Assume $0 cost basis.

    c. Assume no long-term capital losses, which can be netted to lower capital gains.

    d. Assume reinvestment in S&P 500 which has historically risen by about 10% annually.

    From the chart at the top of the next page, we can see the different breakeven periods for different rates of underperformance by a stock. For example, the decision to swap out of an investment that underperforms by 10% annually, will take less than three years to break-even (solid orange line crosses dotted blue line). A 5%

underperformer will take about 6 years to break-even (solid orange line intersects dashed green line). If the underperformance continues after the break-even period, the extra return that an investor receives could be significant. Furthermore, the investor who continues to hold the underperformer will likely still face the 'sell or hold' dilemma given that the unrealized gain remains.



Source: RiverFront. Chart shown for illustrative purposes only. Past performance is no indication of future results. You cannot invest directly in an index.

4. **Tax Rates Can and Do Change:** Since 1913, Americans have been taxed on their capital gains. In 2024 the long-term capital gains tax rate for those making between $47,026 and $518,900 is 15%. A 20% rate is applied for those with taxable income greater than $518,900. For many Americans this tax rate is significantly lower than their tax rate on ordinary income. The tax rate has changed 21 times since it was incepted and has ranged between 12.5% and 35% over those 110 years. Given that the tax rate has been higher than today's rate during most of those years and given the Federal government's penchant for running larger and larger deficits, we would not be surprised to see tax rates climb in the future. The fact that tax rates are dynamic and have the potential to be meaningfully higher in the future is an important thing for investors to consider since avoiding a lower tax today can result in paying a higher tax tomorrow.

How Do You Know When the Time is Right?

1. **Fundamental Change in Business:** Occasionally, impending weakness can be spotted by investors before a stock underperforms. Examples include new leadership, product misses, sales declines, rising costs, deteriorating customer satisfaction, etc. A significant negative change in a company's prospects should lead to a review of whether that company's stock is still appropriate in a portfolio, cost basis notwithstanding.

2. **Stock Performance Provides 'Early Warning' Alarm:** More often negative fundamentals are preceded by share price declines which is why we look to a stock's relative performance as an 'early warning' indicator. Declining relative strength relative to the broad market or a company's peers can indicate current or future problems for a company, in our view.

Conclusion

Could the behavior that causes great companies to fail be the same behavior that causes great portfolios to fail?

Clayton Christensen's 1997 book The Innovator's Dilemma speculated that great firms often fail because they do not seize the next wave of innovation in their respective industries. This is because change is difficult and change often requires sacrifice (cannibalizing existing businesses). The dilemma of an innovator is not that different than the dilemma of an investor. Successful investors share many of the same difficult choices faced by successful companies. Like a lasting business, an evergreen portfolio requires regular adjustment and refreshment. Not only does this require more work than a 'buy and hold' strategy, but it may require some sacrifice, like selling a winning investment and paying capital gains taxes. Fortunately, today's financial advisors are experienced and equipped to help investors on this journey with tax-focused investment advice and solutions.

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Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

Definitions:

A capital gains tax is a tax imposed on the sale of an asset. The long-term capital gains tax rates for the 2023 and 2024 tax years are 0%, 15%, or 20% of the profit, depending on the income of the filer.

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