RESEARCH

Dimensional

Dimensional's Multifaceted Tax Management of SMAs

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A separately managed account (SMA) provides many opportunities for improving after-tax returns through thoughtful tax analysis and the systematic integration of tax considerations into a daily implementation process. In this paper, we outline how Dimensional's SMA offering can benefit from the firm's multifaceted approach to tax management.

I. Applying Tax Management Considerations at Onboarding

A tax transition analysis with robust data lenses helps advisors assess the tax and investment implications of alternative onboarding scenarios.

Clients often come to financial advisors with legacy investments that are highly concentrated in a few stocks. Our research suggests that a broadly diversified strategy with a systematic focus on higher expected returns can improve investment outcomes over the long term compared to a concentrated portfolio.[1] However, transitioning such concentrated portfolios could trigger undesirable realizations of capital gains. To evaluate the tradeoffs among diversification, the pursuit of higher expected returns, and expected capital gains, Dimensional offers a thorough and transparent tax transition analysis.

The tax transition analysis provides three scenarios to help investors assess the implications of alternative actions (see **Exhibit 1**). Scenario 1 seeks to minimize the estimated net capital gains necessary for the transition. In contrast, Scenario 3 aims to achieve the highest overlap with the customized strategy. As a result, Scenario 3 will require the highest amount of turnover and realized capital gains. Scenario 2 falls in between.

EXHIBIT 1: Tax Transition Analysis

Existing Portfolio

ANALYSIS PARAMETERS	
Cash *	$8,000
US Equities / ADRs	$8,896,354
Total	$8,904,354
Gains Budget (optional)	—

EMBEDDED CAPITAL GAINS / LOSSES	
Unrealized Gains	$2,727,362
Unrealized Losses	–$198,821

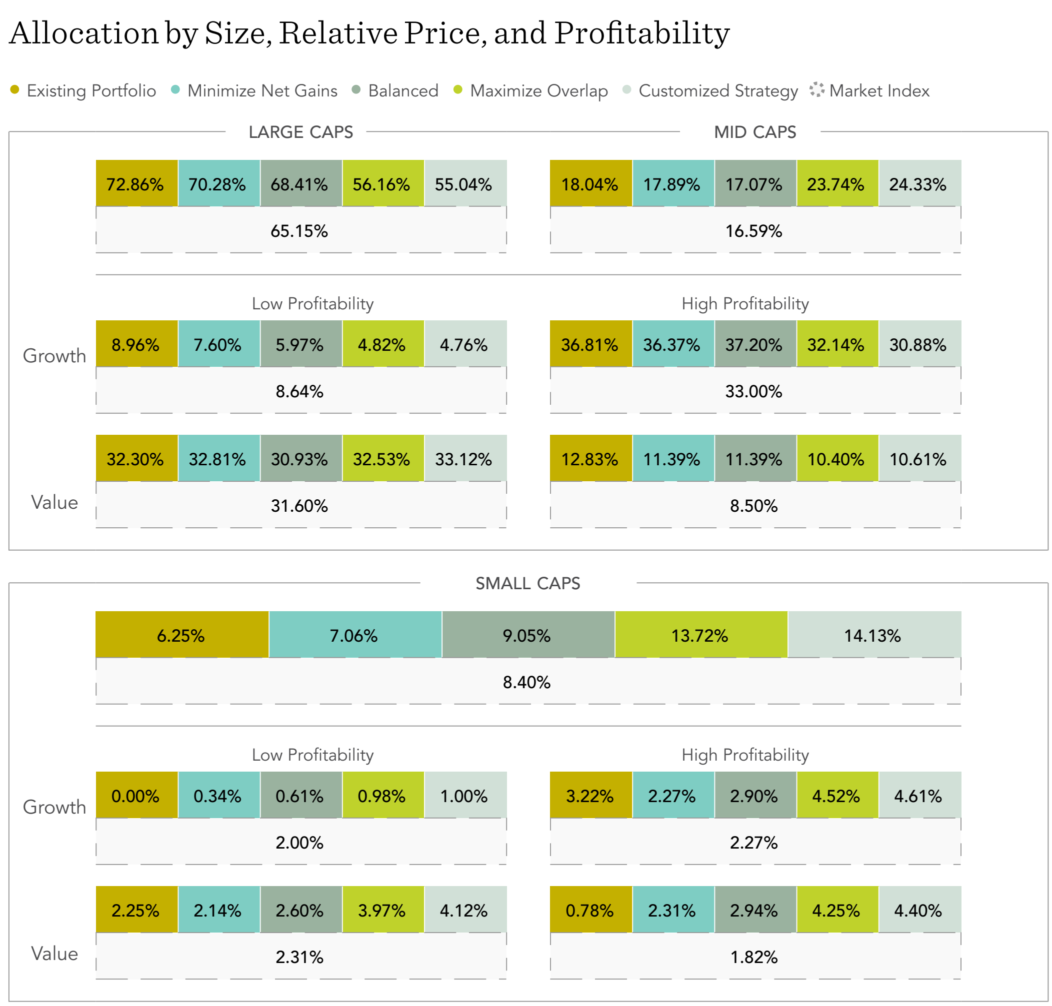
*Includes proceeds from sale of ETFs, Mutual Funds and other securities.

Transition Scenarios

	Overlap with Customized Strategy	Estimated Realized Short Term Net Gains	Estimated Realized Long Term Net Gains	Estimated Realized Total Net Gains
Existing Portfolio	26%	—	—	—
Minimize Net Gains	47%	–$123,041	$123,041	$0
Balanced	67%	–$2,705	$527,782	$525,078
Maximize Overlap	98%	$273,987	$1,104,831	$1,378,818
Customized Strategy	100%	—	—	—

The tax transition analysis also provides thoughtful data lenses to allow for a holistic evaluation of each scenario. A strategy's aggregate equity characteristics and positioning relative to the market indicate its emphasis on known drivers of higher expected returns (see **Exhibit 2**). Overlap, top 10 holdings, and sector weights can help set expectations of performance deviation over time.[2] Lastly, aggregate emissions data indicate the degree of emphasis on certain environmental considerations.

EXHIBIT 2: Positioning Relative to Market



II. Applying Tax Management Considerations in Portfolio Design

Dimensional SMA strategies integrate tax efficiency in portfolio design by:

- Excluding REITs and PFICs
- Systematically focusing on higher expected returns in a low-turnover manner
- Providing broad diversification to increase opportunities for tax loss harvesting and enable flexibility in implementation

At Dimensional, we strongly believe that building efficient investment solutions requires the thoughtful integration of portfolio design, portfolio management, and trading. Therefore, rather than starting with third-party indexes, our SMAs start with proprietary strategies designed with an eye toward tax efficiency.

First, the strategies exclude real estate investment trusts (REITs) and passive foreign investment companies (PFICs). Why? Because those types of investment vehicles tend to generate nonqualified dividend income, and at Dimensional we focus on all aspects of tax management—not just capital gains and losses.

Second, the strategies target higher expected returns by emphasizing companies with lower market capitalization, lower relative prices, and higher profitability through a weighting schema that seeks to minimize unnecessary turnover, trading costs, and tax costs. How? By applying controlled over- and underweights to groups of securities with similar characteristics, by gradually changing those over- and underweights across groups, and by taking advantage of the natural rebalancing that happens within an expected return group since securities in a group are generally market cap weighted relative to one another.

Finally, our SMA starting strategies are designed to offer broad diversification across securities, sectors, and (where relevant) countries. Broad diversification can help tax management in two ways. A wide array of names means that there can be more opportunities for tax loss harvesting. Broad diversification also provides us with more flexibility in daily implementation. This means more flexibility in the daily balancing of tradeoffs between the pursuit of higher expected returns and tax considerations.

For example, suppose both stocks A and B have become less profitable and now offer lower expected returns. To maintain a focus on higher expected returns, investors might want to reduce the allocation to those names in their portfolio. Suppose stock A has an embedded long-term capital gain of $100, while stock B has an embedded long-term loss of $10. If both stocks are held in the portfolio, tax-sensitive investors could sell shares of stock B, as it presents a more tax-efficient opportunity to improve the expected returns of the portfolio. If only stock A is in the portfolio, investors have less flexibility. If they want to improve the expected returns of their portfolio, they must realize a taxable gain.

In summary, the design of our SMA starting strategies incorporates multiple tax considerations that seek to improve after-tax returns by refining the investment universe and enabling flexible low-turnover implementation. We now turn to the multiple tax considerations we apply during our daily management of SMAs.

III. Applying Tax Management Considerations in Portfolio Management

Tax considerations are applied in daily portfolio management to:

- Harvest meaningful losses throughout the year
- Minimize realized gains while considering return premiums, diversification, and trading costs
- Avoid wash sales within and across linked accounts
- Monitor for gifting opportunities throughout the year
- Manage qualified dividend income (QDI) to emphasize income taxed at a lower rate

A. Tax Loss Harvesting

Unlike mutual funds and exchange-traded funds, SMAs can pass through capital losses from the sale of individual securities below their purchase price. Under current tax law, these capital losses can offset realized capital gains and up to $3,000 of ordinary income in the same tax year. Any unused losses can be carried forward to offset realized gains and/or ordinary income in future years. As a result, tax loss harvesting (TLH) is often promoted as the key benefit of SMAs.

The opportunity to harvest capital losses provides investors with multiple tax timing options. This optionality has value. It can improve tax efficiency. Hence, we look for tax loss harvesting opportunities daily, but we also acknowledge that the potential benefits of TLH could be limited and should be evaluated against the potential costs.

TLH is often positioned as offering two benefits: an immediate benefit (a reduction in tax liabilities when the harvested losses are used to offset realized gains and income) and a deferred benefit (higher end wealth through the potential growth of assets not used to pay taxes).

The immediate benefit is an illusion if tax rates stay the same through time and you pay tax at the end. In that case, the lower tax payment today gets completely offset by a higher tax payment at liquidation. In other words, you just defer the tax payment through an interest-free loan from the government. The immediate benefit may even be negative if tax rates are higher in the future. The immediate benefit is positive if tax rates are lower in the future—or if TLH allows you to convert a short-term gain into a long-term gain and the tax rates for long-term capital gains remain lower. The immediate tax benefit is also strictly positive if you plan to donate or bequeath your portfolio since, in this case, the tax bill is forever avoided.

The deferred benefit of TLH could be important, but this benefit depends on the expected performance of the deferred taxes over the investment period. Hence, the overall benefits of TLH depend on the investment goal of the portfolio (consumption or donation), the expected evolution of tax rates, and the expected return on the deferred taxes.

So far, we have discussed the potential benefits of TLH. What about the potential costs? Indeed, trading costs are an important consideration. While the major custodian platforms offer zero-transaction-fee trading for most stocks in SMAs, trading stocks to harvest losses can still generate implicit trading costs, such as bid-ask spreads. In addition, trading stocks to harvest losses requires trading **more** than the harvested losses. For example, $1 of harvested losses might require selling a position worth $100 and then buying another position with that $100. Hence, to harvest $1 of losses, one would have to trade $200. And this ignores the additional trading that might have to happen if you want to go back to your original position a month later (after the 30-day wash sale restriction period). In other words, blindly harvesting any losses in an SMA can require a lot of turnover and trading costs. To avoid that, Dimensional's Portfolio Management team focuses on meaningful TLH opportunities whose potential tax benefit is likely to be significantly larger than the expected trading costs.

Another important consideration is the impact of TLH on premium targeting. If performed naively, harvesting losses could make the portfolio reduce its focus on stocks with higher expected returns (for example, by consistently selling small value stocks). Lower pretax returns can lead to lower after-tax returns and defeat the purpose of TLH. Dimensional's portfolio management process, however, uses TLH as an opportunity to incrementally rebalance the portfolio towards its desired size, value, and profitability characteristics. The broadly diversified nature of our SMA strategies provides ample opportunities to replace a security sold at a loss with another one with similar or better expected return characteristics without violating the wash sale rule. Our daily portfolio management process evaluates all those tradeoffs in an integrated manner to provide investors with the best possible outcome.[3]

B. Minimizing Realized Gains

While TLH can be an important tool for pursuing tax efficiency, it is important to recognize that its potential benefits can decline over time as the portfolio ages. In the first year after buying stocks, some stocks will go up and some will go down. Up is better than down, but down creates opportunities for TLH. Ten years later, it is likely that most of the stocks the investor purchased will have appreciated and that the opportunities for TLH will be small. Therefore, it is important to have a multifaceted approach to tax management that can add value not only over the short term but also over the long term.

Another way in which we seek to improve after-tax returns on an ongoing basis is by taking into consideration expected capital gains along with return premiums, diversification, and trading costs in our daily evaluation of tradeoffs. This allows us to arrive at buy and sell orders that seek to improve expected returns while managing costs and risks. For highly tax-sensitive clients, we even go a step further and seek to balance estimated short-term capital gains and losses, as well as long-term capital gains and losses, at each portfolio rebalancing.

We also seek to improve the tax efficiency of investment outcomes by using a tax-advantaged lot relief methodology. Our robust portfolio management tools allow us to evaluate all tax lots for each held stock when deciding how to rebalance the portfolio toward higher expected returns and to identify the lots that would be most tax-efficient to sell.[4]

C. Avoiding Wash Sales

We also seek to add value by managing wash sales within and across linked accounts. A loss from the sale of a security below its cost basis cannot be recognized immediately if an investor buys the same or a substantially identical security within 30 days of the sale (before or after). The wash sale rule applies not only within an account but also across all of an investor's accounts (and their spouse's accounts if the couple is filing taxes jointly). Dimensional uses its portfolio management technology to monitor daily all SMAs linked to the same end investor to make sure there are no trades that trigger wash sales. And we monitor not only trades in the same security, but also in securities that could be defined as "substantially identical," such as other share classes of the same stock.

D. Monitoring for Gifting Opportunities

Another distinctive feature of the Dimensional SMA offering is our ability to monitor for taxable events in SMAs that could be transformed into meaningful gifting opportunities. For example, when company A decides to buy company B for cash and an investor's SMA holds company B, the investor might have a taxable gain if the price at which company A will buy company B is higher than the price the investor paid to acquire shares of company B. While the gain on the investment is welcome, the immediate tax bill might not be. Instead of just accepting the bill, the investor could donate stock B to a charity or a donor-advised fund.

Say the investor holds 10 shares of company B with a cost basis of $100 per share, and the acquisition price is $125 per share. As our research shows, acquisition targets typically trade near the acquisition price in the days prior to an announced cash merger,[5] so we can assume that the current traded price of company B is $125. By donating those 10 shares of company B, the investor can make a charitable gift of $1,250 and likely deduct the full amount when assessing taxable income for that year. Assuming a marginal tax rate of 40%, that would be $500 in tax savings.

By not taking advantage of this opportunity, the investor will end up with realized gains of $250 ($25 gain per share on 10 shares), or a tax bill of about $100. If the investor still decides to donate $1,250 to a charity that year, the net tax savings will be only $400 ($500 tax savings from the donation minus $100 for the tax bill due to the corporate action). Hence, our daily portfolio monitoring and active coordination with financial advisors around taxable events can generate better tax outcomes for the investor.

E. Emphasizing the QDI Portion of Dividend Income

Dimensional's tax management focuses not only on capital gains and losses, but also on dividend income. Dividend income gets taxed at a lower rate (the long-term capital gains rate) if it is "qualified dividend income" (QDI). Nonqualified dividend income gets taxed at the higher ordinary income tax rate. To maximize the QDI portion of dividend income, Dimensional excludes securities whose dividends tend to be non-QDI (e.g., REITs and PFICs) from its SMA starting strategies and ensures that live SMAs hold stocks for more than 60 days in the 121-day period around the ex-date of a dividend payment so that dividends get QDI treatment. In addition, we seek to delay the purchase of eligible stocks about to pay dividends.

IV. Applying Tax Management Expertise to Special Client Requests

At Dimensional, we aim to provide tax-efficient outcomes to investors not only in the day-to-day management of their SMAs, but also when fulfilling special requests. For example, when an advisor asks us to harvest a certain amount of gains or losses for a client, we will evaluate different ways to achieve that through multiple data lenses (e.g., changes in portfolio characteristics, changes in overlap with customized strategy, expected turnover and trading costs) and will implement the most beneficial option for the portfolio. We apply the same thoughtful approach to requests for gifting suggestions and withdrawals. Finally, we offer tax transition analysis not only for onboarding but also for potential changes in investment strategy, environmental, social, and governance (ESG) considerations, industry or country exclusions, and security restrictions.

V. Dimensional's Tax Management Approaches for SMAs

To meet the needs of different types of SMA clients, we offer four tax management approaches: None, Light, Standard, and Aggressive. Each approach is designed to incorporate elements of our multifaceted approach to tax management in order to help clients achieve their financial goals. Standard and Aggressive tax management both actively harvest losses while systematically pursuing reliable equity premiums, managing risks, and controlling costs. Where the approaches differ is their relative emphasis on tax management versus targeting premiums and diversification. Exhibit 3 illustrates how the four approaches strike a different balance between pretax and after-tax returns.

EXHIBIT 3: Customized Levels of Tax Management

EMPHASIZE PRETAX RETURNS ←→ EMPHASIZE AFTER-TAX RETURNS

No Tax Management	Light Tax Management	Standard Tax Management	Aggressive Tax Management
Broadly diversified strategy focused on drivers of expected returns with low turnover	Broadly diversified strategy focused on drivers of expected returns with low turnover	Broadly diversified strategy focused on drivers of expected returns with low turnover	Broadly diversified strategy focused on drivers of expected returns with low turnover
Apply a tax-advantaged lot relief methodology	Apply a tax-advantaged lot relief methodology	Apply a tax-advantaged lot relief methodology	Apply a tax-advantaged lot relief methodology
Exclude REITs and PFICs	Exclude REITs and PFICs	Exclude REITs and PFICs	Exclude REITs and PFICs
Manage wash sale rule within and across linked accounts	Manage wash sale rule within and across linked accounts	Manage wash sale rule within and across linked accounts	Manage wash sale rule within and across linked accounts
	Balance short-term capital gains with losses in rebalancing	Balance short-term capital gains with losses in rebalancing	Balance short-term capital gains with losses in rebalancing
	Maximize QDI portion of income	Maximize QDI portion of income	Maximize QDI portion of income
	Conduct client-specific gain and loss harvesting	Conduct client-specific gain and loss harvesting	Conduct client-specific gain and loss harvesting
	Provide tax analysis for account changes	Provide tax analysis for account changes	Provide tax analysis for account changes
	Identify securities for gifting opportunities	Identify securities for gifting opportunities	Identify securities for gifting opportunities
	Place **modest** emphasis on minimizing gains while balancing tradeoffs among premiums, costs, and diversification	Place **moderate** emphasis on minimizing gains while balancing tradeoffs among premiums, costs, and diversification	Place **strong** emphasis on minimizing gains while balancing tradeoffs among premiums, costs, and diversification
		Harvest meaningful losses **moderately** throughout the year.	Harvest meaningful losses **aggressively** throughout the year.
		Balance long-term capital gains with losses in rebalancing	Balance long-term capital gains with losses in rebalancing
		Analyze ongoing opportunities for charitable giving	Analyze ongoing opportunities for charitable giving

Conclusion

Dimensional has over 20 years of experience in tax management. What this experience has taught us is the importance of having a multifaceted approach to tax efficiency that considers capital gains, capital losses, and income at every step of the investment process, from portfolio design to portfolio management and trading. A multifaceted approach to tax management can be difficult to achieve for direct indexing. Dimensional's investment approach goes beyond indexing. We apply a systematic yet flexible daily implementation process informed by decades of research and experience. As a result, our SMAs can seek higher expected returns while minimizing tax costs.

GLOSSARY

Relative price: Refers to a company's price, or the market value of its equity, in relation to another measure of economic value, such as book value.

Expected return: The percentage increase in value a person may anticipate from an investment based on the level of risk associated with the investment, calculated as the mean value of the probability distribution of possible returns.

Market capitalization: The total market value of a company's outstanding shares, computed as price times shares outstanding.

Nonqualified dividend income: Income that doesn't meet IRS requirements to qualify for a lower tax rate, also known as ordinary income.

Profitability: A company's operating income before depreciation and amortization minus interest expense scaled by book equity.

Qualified dividend income: Ordinary dividends that meet specific criteria to be taxed at the lower long-term capital gains tax rate rather than at the higher tax rate for an individual's ordinary income. The rates on qualified dividends range from 0 to 23.8%.

Separately managed account: An investment vehicle in which investors directly own the securities held in individual custody accounts.

Wash sale rule: A tax rule stating that, if an investment is sold at a loss and then repurchased within 30 days, the initial loss cannot be claimed for tax purposes.

Donor-advised fund: A charitable giving vehicle administered by a public charity created to manage charitable donations on behalf of organizations, families, or individuals.

1. Kaitlin Hendrix, "*SMAs: Quantifying the Tradeoffs between Taxes and Diversification*" (white paper, Dimensional Fund Advisors, 2021).
2. If you're wondering why we focus on overlap rather than ex-ante tracking error, please see "*SMAs: Measuring the Impact of Personalization*" (research paper, Dimensional Fund Advisors, June 2021).
3. For an example of Dimensional's approach to tax loss harvesting at work, see: "*SMAs at Work: A Smarter Approach to Tax Loss Harvesting*" (Dimensional Fund Advisors, 2021).
4. The tax lot relief methodology that we use is the highest-cost method. It provides similar tax efficiency with less operational complexity than tax lot relief methods called "least tax liability" or "tax sensitive." For more information on this, please see the response on this topic in "*Dimensional SMAs: Frequently Asked Questions*."
5. Kaitlin Hendrix, "*Cash by Any Other Name*" (white paper, Dimensional Fund Advisors, 2020)

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