First Ascent Asset Management

UNDERSTANDING TAX ALPHA

What is Tax Alpha?

Tax alpha measures the benefits of decisions made by a portfolio manager that are designed to improve the after-tax return of a portfolio.

These decisions come in two forms: tax-loss harvesting and tax deferral.

Tax loss harvesting involves intentionally selling a security at a loss, which can then be offset against taxable gains from other sources to reduce current taxes.

Tax deferral involves delaying a transaction to achieve a tax benefit.

Calculating Tax Alpha

To calculate tax alpha, we isolate the benefits of portfolio management decisions designed to achieve a tax benefit from the impact of other portfolio management decisions. Here's how it works.

Step 1. Calculate the difference in returns between the portfolio and its benchmark before taking taxes into account. Let's say the portfolio returned 10.4% for the year and the benchmark returned 10%. These are pre-tax returns. Their difference is 0.40%.

The difference in pre-tax returns of 0.40% primarily reflects the benefits of portfolio management decisions that were not directly made to achieve a tax benefit.

Step 2. Now, using the client's assumed tax rate, calculate the difference in returns between the portfolio and its benchmark taking the client's taxes into account. This involves considering the tax impact of all gains and losses generated during the year.

Let's say that after taking taxes into account the portfolio generated a return of 9.7% and the benchmark generated a return of 9%. The difference in after-tax returns is 0.70%.

The after-tax returns are lower than the pre-tax returns because the client paid taxes on gains that were generated during the year and didn't have enough losses to offset all of them. The taxes paid reduce the true net return to the client.

Step 3. Now subtract the difference in pre-tax returns (0.40%) from the difference in after-tax returns (0.70%). This reduces the difference in the after-tax returns of the portfolio and the benchmark by the amount of the benefit generated by non-tax-related decisions.

The remainder, 0.30%, is the tax alpha. That is, the amount of the benefit realized by the client, after taxes, from the portfolio manager's tax management decisions.