Loss Harvesting Season Is All Year Long

Don't just wait for December to take advantage of great tax mitigation opportunities

Key Takeaways:

- Loss harvesting should be pursued throughout the year, not just in December.
- The tax benefits of such a strategy can be both meaningful and quantifiable.
- While some investors may have behavioral biases against realizing losses, they also are likely to have an aversion to paying taxes, so effective communication with your financial advisors is key.

For most investors in U.S. stocks and other risk assets, 2019 ended up being a surprisingly strong year, despite dire warnings about the inverted yield curve and potential recession early on. While I'm sure you enjoyed plenty of wins, not all sectors (and investment managers) thrived, Chances are you racked up a few losses—which are not necessarily bad for the financially savvy.

The term "loss harvesting" can have unpleasant connotations for investors, who may well have images of trying to salvage what one can from a financial shipwreck. The reality, of course, is that markets don't go only straight up, and any well-diversified portfolio will periodically have positions at a loss. Harvesting those losing positions helps mitigate their impact on the overall portfolio by providing a tangible tax benefit.

Behavioral research shows that many investors are reluctant to sell losing positions. Yet, investors also have a strong desire to minimize their tax bills. Loss harvesting opportunities increase with market volatility, such as has been experienced over the past few years. Markets have generally fallen this year, so there are many opportunities to harvest losses now, not just in December. The losses from positions sold below their cost basis can be used to offset gains from elsewhere in the portfolio, plus an additional $3,000 of remaining losses each year can be carried over to reduce income. Losses can be carried forward into future years, and having a large bank of losses can allow for the tax- free realization of subsequent gains, such as when rebalancing a portfolio or selling a highly appreciated position. Considering loss harvesting only at year end may cause clients to miss out on many opportunities to capture these valuable tax benefits.

Real-life example

Like 2018, the year 2012 was a prime example of why investors shouldn't wait just for year end to harvest losses. Unlike in 2016, markets started very strongly in 2012, and most positions closed the year with gains. However, there was a correction in the second quarter, with the S&P 500 falling 0.63 percent in April and 6.01 percent in May. While the S&P 500 was still up for the year at the end of May, money invested at the start of the second quarter was at a loss. Markets resumed their rise in June, and an investor who waited until December to harvest losses would have missed the opportunity. For individual securities, which tend to be more volatile than an index fund, opportunities for loss harvesting can arise even more frequently.

Tax lot accounting and the wash rule

This example also highlights the importance of tax lot accounting. An investor who periodically invests in a fund, say after a monthly paycheck, will have multiple positions at various cost bases. Following a market correction, the overall holding may still be at a gain, but some of the positions are at a loss. Designating those high cost basis lots for sale can increase the amount of loss harvesting. Investors need to be mindful of the wash rule, which disallows the recognition of the loss if the same or substantially similar security is purchased within 30 days before or after the sale.

When considering whether or not to loss harvest, see if you have a suitable substitute position to be sold. Typically a number of funds with similar investment styles can be found for reinvesting the proceeds of a loss harvesting sale. With individual securities the answer may not always be as straightforward, and one must weigh the tax benefits against the relative investment merits of a substitute. But often a security in the same industry can be found that has similar characteristics. Transaction costs are another consideration when weighing whether to do a trade.

Conclusion

Loss harvesting should be ongoing, rather than a once-a-year activity allowing you to take advantage of tax mitigation opportunities whenever they arise. However, each investor may have multiple securities, each with multiple tax lots. Monitoring all of these positions thus is a task ideally suited for automation and powerful software which many individual investors do not have. And I urge you to seek a professional advisor for this task.

You always want to err on the side of caution when it comes to aggressively mitigating taxes, but you don't need to leave money on the table. An underperforming investment is not really a loss until after all the tax implications have been factored. Keep this mind when the next wave of market volatility hits—you know it will—and don't hesitate to call your advisor any time throughout the year for guidance, reassurance and ideas during these uncertain times.