

Section VII. Wealth Cycle Management  
Chapter 16. Tactical adjustments to support wealth strategies

**Key Points**

- Tactics smooth out strategic portfolio return changes
- Tactics change with time horizons and risk tolerances
- Satellite asset tactics must often be more complex than core asset tactics
- Tactics include both change from and return to strategic wealth allocations and cashflows
- Tax management tactics smooth out returns

**Chapter Overview**

Tactics adjust investment returns variances. They preserve wealth and maintain household well being; especially during stressful periods. Wealth objectives, personal risk tolerances, time horizons, and strategies are key factors in selecting simple tactics suitable for a lifetime wealth process. Asset operational valuation and market psychology characteristics offer clues about expected price movements, liquidity, and appropriate tactics to smooth out portfolio valuations and cash flows. Wealth portfolios should be managed with tactics to adjust risks to tolerable levels during a wide range of considered scenarios. A qualitative person feels tactics as the difference between good and bad results. A quantitative being sees tactics as adjustments to favorable tilt the odds for success.

**Why tactics? Smooth out portfolio returns. Reduce Stress. Improve well being.**

Tactics are tools to keep wealth strategies in step with personal needs and a portfolio's ability to perform as expected. They should support a healthy well being by controlling portfolio value variations. Good tactics offer a household confidence to respond with plans to varied scenarios. Tactics are not guarantees. When applied with a good process, they improve peace of mind and the probabilities to attain objective cash flows or other forms of wealth.

No long time horizon wealth strategy should be chosen, forgotten, and expected to easily deliver precise desired cash flows. Most assets deliver unexpected distributions and their values change over time. Even Treasury Inflation Protected Securities (TIPS) after-tax returns vary slightly over their life time. TIPS are excellent wealth preservation assets; but they do not fully adjust for spending needs and specific tax issues.

A buy and hold strategy for a retirement spending objective may include a low risk all annuities portfolio, such as social security, pension, and annuity payments for life. If the strategy includes a buffer for possible added unexpected spending or gifts, then it may deliver stress free spending cash inflows without tactics. Yet, inflation may exceed the boundaries of inflation adjusted pension and annuity payments at some time over a long retirement period. For instance, many pension and annuity payments are capped at 3% or 4% annually and the U.S. government has changed the methodology for the SSA payment referenced Consumer Price Index in the past. There is no guarantee that U.S. currencies devaluations will be completely compensated for by even the low risk annuities buy and hold strategy. More importantly, there is no guarantee that personal spending needs will not exceed initial plans. Tactics offer flexibility to adjust for unexpected situations. They respond to bad scenarios by tilting portfolio asset weights to wealth preservation and return to wealth accumulation mode when appropriate.

Most people require a strategy that results in real returns or growth, as well as preservation, of wealth. Real (inflation adjusted after tax) returns require taking risks. Owning high quality investment bonds involve possibly a ½% default risk and a higher downgrade risk, when an entity is facing economic uncertainties. A longer period to maturity increases default risk, as well as interest rate risk. Equity investments offer opportunities to earn higher returns, as well as many types of risks. Active investment management also involves levels of added risk based on the consistency of processes used.

Portfolio assets and related active managers should be monitored, instead of blindly bought and held, and adjusted with tactics when they are not performing as expected. It is possible to hold equity asset portfolios without oversight during a long favorable period (e.g. 1982 – 1999) as they advance to extremely overvalued levels and sell all assets at their peak levels in February, 2000. Yet, that is a virtually unrepeatable lucky scenario. Somewhere lightning may strike twice and someone may win the lottery jackpot twice. Consider the probabilities. Households are better off with a few good tactics to attain expected strategic asset market returns than hoping to beat extreme odds of consistently outperforming market returns.

### **Life stages (time horizons) and appropriate tactical tools**

Human capital is potential wealth that can be converted into financial wealth. When human capital and time horizons are relatively long, then risky and illiquid assets can be held with acceptable wealth accumulation risks. At age 30 a healthy person may expect to work 30 or 35 more years prior to retirement. The planned working stage offers the period to convert human capital capabilities to financial income and savings. Small company stocks or private equity partnerships, which can not be sold for a defined period, may be appropriate. Some high risk investments will become very profitable and others will turn out to be worthless. The concurrent conversion of human capital during an early life period into new investments buffers risky held asset shortfalls and offsets financial capital losses. Yet, it is important to analyze and learn from losses. That is to develop appropriate tactics. At age 50, high risk portfolio setbacks can not normally be sizably offset with future human capital conversion (savings). The impact of setbacks on a significant financial capital portfolio is bigger and the capacity of human capital conversion is smaller during mid-life.

### **Early stage simple wealth building tactics**

At a new household stage (e.g. age 30) with limited experience, the primary focus should be on constructing a diversified portfolio of predominantly equity assets. That is a strategic focus to accumulate wealth. Selected tactics are encouraged to be limited, compatible with personal risk tolerance, and focused on total portfolio risk.

A non-business owner household usually holds security assets. The mix of investment portfolio equity and debt assets at any life cycle stage should be determined by personal risk tolerance. The **inexperienced** household is wise to **select simple** asset classes. An equity asset class can be held with limited specific company risk by purchasing a passive **stock index mutual fund** (e.g. Vanguard S&P 500 Large Company Stocks – VFINX) or an Exchange Traded Fund (e.g. Russell 2000 Small Company Stocks – RUT.) An investment grade intermediate term (5 yr. to maturity) **bond index mutual fund** (e.g. Vanguard Investment Grade bonds – VFICX) can similarly be held. A conservative risk tolerant household would naturally select a smaller portion of equity to debt funds than a pension fund would choose. An aggressive risk

tolerant household may select a larger proportion of equity assets. A model portfolio is expected to include about ten equally weighted (10%) assets, although an initial portfolio may hold equal portions of as few as 4 assets (two equity, one bond, and one money market fund). A thoughtful ten asset portfolio offers a good balance between flexibility and significant asset decision impact.

### **Anticipated Uncertainty Tactic**

Equity holdings are generally more risky and require more monitoring of possible overvaluation factors. The simplest tactic is to **sell ½ of an asset holding**, if future **economic uncertainty is expected** to cause the holding to be **20% overvalued** in terms of cash flows. Historical perspective and a future scenario analysis are needed to develop a process for study and decision making instead of gut feelings. Asset overvaluation catalysts include regulation, competition, credit, tax, and speculative asset buying uncertainties. Consider a small cap index mutual fund may become overvalued when macroeconomic or geopolitical conditions imply an economic recession. Be aware, professional economists rarely forecast recessions accurately. Remain humble, since half the predicted recessions do not actually occur. There is normally some valid scenario that an asset class will continue to rise to an added overvaluation. Earnings expectations are the primary reasons for asset valuation changes as investors weigh intermediate and long term outlooks. An approach to develop a **reciprocal** buy back tactic is to monitor security analyst earnings forecast revisions. Their forecasts are often as randomly accurate as economic forecasts. They tend to be slow to forecast corporate earnings declines during an economic recession. Yet, when **analysts** switch back to greater than **1.5 upgrades / 1.0 downgraded** corporate forecast, **uncertainty** has **declined** and investors tend to buy stocks again. **Buying back broad equity positions** as the uncertainty declines is a suggested reciprocal tactic. Zacks Research is a data source. Historically, a sharp unexpected 20% equity market downturn occurs every 5 years. Overall returns may be smoother if normal equity assets are in cash during both the last 10% of an equity market advance and 10% of a subsequent market decline. The overall tactic is not expected to perform better than a simple buy and hold approach during mild recessions. However, during severe recessions (1958, 1974, 1982, 2008), the tactic will preserve wealth.

Recall that the suggested annual portfolio **rebalancing** of asset holdings, if they move notably away from desired portfolio weights, is a **strategic** (not tactical) **decision**. If a portfolio is in strategic balance, then it will be less impacted by a sharp overvalued asset class downturn.

#### **Interest Rate Trouble Tactic**

Short term interest rate changes have had limited equity market direction predictive value in the current global economy. However, a **negative yield curve** (short term 3 month or 2 year Treasury security interest rates higher than long term 10 year bond interest rates) is a factor to be aware of. It is a key leading economic indicator. Relatively high short term interest rates directly guided by FRB fed fund bank rates are meant to slow down an economy to address an unsustainable factor (inflation, asset price bubble, weak dollar, etc.) Higher finance costs slow down an economy. Many cyclical sectors are impacted and earnings invariably fall below previous forecasts. The relationship is imperfect. Negative yield curves, such as Feb. 2006 may occur long before an equity market peak (Oct. 2007). Yet, a wealth preservation tactic is to **consider selling 10%** portfolio cyclical equity increments on a **quarterly basis** while the yield curve remains negative. Tax deferred (IRAs, 401K, etc.) are ideal asset locations from which to sell. Since yield curves during the past 40 years have not remained negative for 3 consecutive quarters, a **maximum of 30% reduced portfolio holdings** would likely be sold due to **negative yield curve** conditions.

A **reciprocal** yield curve tactic is to **buy equities back** when conditions are stable. The buy decision process is far more difficult because global currency and economic conditions may be more critical than FRB rate changes. The FRB may significantly reduce interest rates and cause a positive yield condition prior to an equity market peak (Oct. 2007) and continue to cause a more stimulative positive yield curve prior to a final stage equity market decline (Sept. 2008 through Feb. 2009). Monitoring the overall **macroeconomic** picture (i.e. the **earnings related GDP**) is suggested as defined by the Conference Board monthly **Leading Economic Indicator** or other similar broad LEI with a good track record. It includes the yield curve and has a reasonable record of signaling the end of an economic downturn. A process of **buying 10%** portfolio equity monthly increments near the **approximate bottom** (1<sup>st</sup> two consecutive

months where **LEI > +0.5%**) and **first quarter** of an economic recovery (**GDP > 0%**) usually coincides with an improved general company earnings outlook and advancing equity prices.

#### **Mid Wealth Accumulation Stage Tools**

As a household approaches the mid earning period stage (45 to 50 yrs. old) experience and reduced potential human capital will likely change the wealth accumulation tactical approach. Life stage related tactics should consistently reduce risk levels (smooth out lower annual returns) with age. Generally they support the overall strategy of expected smoother returns prior to and during retirement. Specifically, the tactics avoid high risk scenarios by applying safe outlets to cut or inoculate equity risk. They support the strategic decision to annually reduce risk by adjusting for other tactics to preserve wealth during the previously discussed overvaluation and interest rate uncertain periods. For example, after a portfolio is 10% underweighted in equities for a year, a reciprocal signal to return to full equity weight may occur. But household spouses may note that they are a year older and their personal savings outlook is cloudy. They may select to only buy back 7% equity assets for their portfolio or to purchase a balanced fund, which nominally holds 60% equities and 40% debt. The adjustment tactical process recognizes new conditions, documents the analysis, and make a suitable change.

Knowledge and experience allow an investor to understand and use different types of tactics. Non-controlling asset tactics should usually focus on market valuation factors. Remember that non-controlling owners can not change the operating cash flows of an equity asset to increase fundamental value. A controlling asset holder, such as a residential apartment building owner, can upgrade units, charge higher market related unit rents, and change operating cash flows. Non-controlling share holders must simply respond (hold/buy/sell) to market valuations (over/under analyzed value) and sentiment (supply/demand sentiment).

#### **Active Management Mutual Fund Tactics X**

Core portfolio holdings of asset index mutual funds are meant to match specific asset market returns. Many people naturally desire to try to beat (exceed) market returns with additional or satellite assets. The analysis process for selecting active management funds was previously discussed. Tactics help decide when

to buy and sell added risk active assets. If a stock fund is expected to be held for at least 7 years with a best case scenario of doubling, then a 10.4% annual return is expected. To achieve a superior return the fund should be purchased when it is undervalued. That requires not following the crowd (purchasing last year's top performing fund). In fact a good tactical approach is to understand a fund manager's process, recognize when his or her general strategy has been out of favor, and notice if the asset class is also undervalued. The long term (greater than 10 years) profitable manager may still have a good process and be extra focused to regain a more competitive position among peers. The manager's performance should be checked relative to a comparable index fund. If the sub par active fund returns exceed the comparable index fund returns and the general market is not in a free fall (greater than 8% monthly loss), a tactic would be to buy a ½ position (5% of portfolio assets). If the fund returns continue to out perform the index fund returns during the next month, then the final ½ position may be purchased. A benefit of the tactic is that the fund likely will not have unrealized stock gains. That should be monitored because the fund's sale of profitable stock holdings could result in an unexpected taxable year end distribution.

The tactic is simply a way to purchase superior active manager expertise, when it is on sale, and boost the chances of achieving best case returns. It is suggested to limit mutual fund sell tactics. Funds should generally be held for the long term unless the manager is replaced by someone without an acceptable performance record. When a mutual fund has performed far above peers for a year or two and it is time for periodic rebalancing, consider selling a large portion of the top fund holdings. Take the profits to purchase more out of favor asset funds in your portfolio or on your watch list.

#### **Individual Traded Asset Tactics**

Public securities (stocks/bonds) include specific corporate or governmental issues that require added operational and market analysis prior to useful risk control tactics.

- Is the stock P/E ratio above its economic sector average and above its historical recent 10 year average?
- Is the stock price more than 20% higher than a discounted cash flow analysis price?

- Has the bond rating of a major credit rating service (Moody's, Standard & Poors, Fitch) been cut?

Determining over valuation is the thorough way to judge an asset's value prior to purchase. However, market psychology and pricing are critical before and after purchase. The majority of asset (equities and debts) prices follow the direction of the market.

An overpriced growth type stock may fall 20% in response to a quarterly earnings report 20% below forecasts. Even a slightly under valued asset may fall 10% due to a missed earnings forecast in a weak market. If an asset price falls more than 20% and a financial statement review does not indicate a next quarter earnings recovery above analysts' consensus forecasts, then some action is suggested. (As will be repeated, charts are suggested approaches to monitor exchange traded asset absolute or relative price changes.) For tax deferred accounts selling ½ the asset position should be considered. For taxable accounts with a large unrealized asset gain a put (right to sell) option will be discussed later to insure against further loss. Be aware the market place of sellers may know something that really makes the risk higher than the lower price indicates. (Recall a 20% loss requires a 25% gain to recover to breakeven, but a 50% loss requires a 100% gain to get back to even.)

Tactics for selling an overpriced asset in a strong or neutral market often lead to different results. In a strong market, holding the overpriced asset is normally wise. Its price may go much higher. However, in a neutral market which usually occurs when assets are generally fairly or over priced, it is wise to follow the adage: "Sell on Good News". That is: sell ½ of a position in an overvalued asset that recently reported forecasted good earnings in a neutral market.

#### **Individual stock tactics**

As a household ages gracefully, it is wise to hold less risky individual equities. A business person may hold an apartment rental building with no mortgage loans and finance upgrades through cash flows. A passive investor may own dividend paying stocks. Long term growing steady dividends are an excellent source of derived equity cash flows. They offer a buffer against asset price declines during broad market downturns, because investors generally pay more

for more certain cash flows. Therefore, blue chip consumer staples dividend paying stocks are referred to as defensive stocks. Weak markets impact defensive dividend paying stocks to an extent. A good tactic is to buy dividend paying stocks after a significant broad market decline. They will not rise or fall as much as a cyclical non-dividend paying stock. Yet, the lack of gyrations may be good for your peace of mind.

### **Emotionally compatible tactics**

Emotional behavioral biases have been discussed at length because knowing and adjusting for one's personal behavior risks are necessary for household well being. Peace of mind and security characterize well being and are a form of wealth. Large greed and fear emotional changes and an inability to accept the prospect of taking losses on the one hand are problematic biases. Taking rational short cuts and blissfully following the crowd on the other hand makes consistent investment gains unlikely. If negative behavior biases can not be corrected after about 5 years of good attempts and self analysis, it is wise to select a trustworthy advisor and direct he or she to implement appropriate strategies and risk control tactics to achieve agreed to wealth flow goals.

An emotional person is disadvantaged in both negotiations and decision making. A counterparty in a negotiation can spot what is important to an emotional person and make small concessions in the process of unexpected benefits. An emotional person should either hire an agent to negotiate face to face or negotiate through formal written offers and counteroffers to reduce behavior risks until an agreement is approved. Those with negative behavioral biases often amplify feelings and make poor decisions under stress.

Noise or conflicting information is a source of stress that can be reduced by all, including those who quickly change moods from greed to fear to apathy. Television news, newspapers, and the internet are sources of conflicting and cleverly biased views. Their goals are to sell a service that is perceived to be objective, while omitting key facts and not presenting both sides of a story. That is to catch people's attention with a provocative 10 second sound bite or flashy headline. A good tactic to reduce noise and stress is to select a limited number of sources that provide relevant investment related current facts. The big business biased *Wall Street*

*Journal* and big political government biased *Washington Post* are examples of a limited number of printed sources. *Finance.Yahoo* is a source of internet business day data.

Opinion shows are dangers to level headed thinking. They must recommend speculative assets to keep people's attention and hold TV ratings by randomly picking a big winner (coincident with many big losers.) Some people consider business shows to be entertainment. Yet the shows confidently present so many amplified half truths that they are a hindrance to clear thinking. An alternative tactic is to read one monthly or quarterly newsletter that has a good record of forecasting interest rates backed by economic charts and graphs. The information should support actions related to the Interest Rate Trouble Tactic. A second tactic is to read a good source of geopolitical commentaries. That should offer good logic concerning international trade, regulations, and regions of stress. The information may be helpful in identifying catalysts related to the Anticipated Uncertainty Tactic. Analyzing the previously discussed regulator (S.E.C., other national and state regulators) asset related submittals is considered necessary investor research and monitoring. That is not tactical, but it does reduce the amount of noise that triggers negative behavior biases.

### **Thorough tactics overcome rational weaknesses**

A few people with balanced emotions take the prospects of losses and gains equally, and persevere instead of being overwhelmed by the regrets and apathy. Their attitudes and habits are naturally positive emotional behaviors. Yet their challenge is to improve rational biases.

Following the crowd, becoming overconfident during a profitable period, and taking short cuts that simply focus on a single critical factor, such as new goods orders, are rational weaknesses. All momentum trends as defined by excessive demand eventually lead to overvalued assets. If the overvaluation continues with the help of momentum speculators, then an unstable asset price bubble will likely occur and burst. That is the challenge for a rational momentum focused investor. At the beginning of 2008 with crude oil selling at about \$96 per barrel, did the rational speculator expect \$120, \$140, or \$50 per barrel? The price of oil, in fact, traded sequentially at all those prices. However, many rational speculators did not have a process to profit from extreme volatility. Few people with a thorough

process understand that occasional big profits are due to good luck in addition to a skillful process. It is natural to become over confident, when profits accumulate effortlessly. Humility is not a tactic; but it is a virtue that tones down the overconfidence when risky objectives are realized with a nice push from good luck.

The key tactic to overcome the rational short cut bias is to think like a social scientist. If a significant number of past data samples are linked together as a primary cause and effect, then an economic reason may be hypothesized for an expected market price trend. In other words, a catalyst may be found for an undervalued asset to be demanded by market participants. Three unique factors should be combined. The catalyst must impact the asset operational (cash flows) valuation in the intermediate term (<1 year.) The asset should have the characteristics that interest big money demand. Finally, the probability of expected gain should exceed the probability of potential loss by a factor related to the asset market price volatility. The thorough rational investigation involves both the qualitative art of finding a catalyst and the quantitative science of estimating the gains of correct statistical analysis and losses of an incorrect hypothesis. That is the rational tactic or process needed to beat (exceed) overall market asset returns<sup>1</sup>. It is not easy.

### **Wealth Portfolio Tactical Adjustments**

Portfolios of assets are constructed with a strategy to earn required long term returns at a minimum risk level. The minimum risk level should be with one's worst case risk tolerance. Diversification of asset holding characteristics is the ideal way to minimize risk. The characteristics between various types of equity (including real estate), debt, alternative, and money market assets should be monitored quarterly. The key characteristics are three year asset volatility ( $\sigma$ ) and inter asset correlation ( $\rho$ ). During extreme credit uncertainty (1981/82, 2008/09),  $\sigma$  and  $\rho$  increase dramatically. Equity, debt, and alternative asset holdings can not be newly financed, and speculators must sell assets to raise cash and pay existing financing calls. In those panic conditions, cash is the only safe asset to preserve wealth. There is no perfect portfolio tactic to estimate what part of the portfolio should be sold to raise cash. Watching near runaway inflation broken or the government take over of the financial and other economic sectors causes portfolio valuation uncertainties.

Generally selling the most volatile assets until your risk tolerance is reached (sleeping soundly) is a reasonable approach.

In a non-credit induced recession, asset  $\sigma$ 's and inter asset  $\rho$ 's do not change extremely, although equity  $\rho$ 's do increase. Tactics can be used to focus on the portfolio assets with the highest  $\sigma$ 's. Those are usually equity assets and non-investment grade bonds. Uncertainty (high  $\sigma$ ) usually relates to earnings or more generally cash flows. When asset forecasted cash flows are downgraded, they become overvalued in the intermediate term. Consider selling  $\frac{1}{2}$  positions in assets that are overvalued by 20%. The overvaluation may be estimated by a forecasted 20% drop in next year's asset cash flows. The point is to initially sell only  $\frac{1}{2}$  overvalued asset positions. For example, if a portfolio core consists of 6 equity assets and 4 are analyzed to be overvalued, then  $\frac{1}{2}$  positions in each asset may be sold. A 10 asset portfolio would then move 20% of normally equity assets to cash. The tactic dramatically reduces overall portfolio  $\sigma$ . No one knows how to consistently time the market. And there is a potential loss of opportunity, if uncertainty quickly subsides (Nov. 1987) and equities quickly recover. However, the corrective phase of the previously discussed Interest Rate Trouble Tactic is helpful to decide when to return to each asset's full invested strategic position.

### **Satellite tactics differ from Core Adjustments**

Portfolio satellite asset tactics differ in repurchase criteria. Since they represent a more narrow focus (e.g. exchange traded sector fund, stock, commodity) added risk factors make the overvaluation and market sentiment analysis more complex.

The market price relative strength (RS) is a good momentum/sentiment indicator for satellite asset buy/hold/sell decisions. If a portfolio includes 50% satellite assets (e.g. 3 actively managed equity funds, one commodity fund, and one foreign bond fund), then the absolute asset price movement trends, as well as RS versus benchmark asset classes, should be monitored. It is useful to also have alternative assets on a watchlist to replace the held asset at the appropriate time. Maintaining a watch list of portfolio satellite alternative assets provides flexibility to rotate toward under valued potentially market favored assets (away from

unfavored assets.) The idea is to avoid holding weak RS assets for long periods, even if they are under valued. Holding risk free cash is better for smoothing portfolio total returns, than holding moderately risky under valued assets that are trending lower in RS, as well as market price.

The process tactic of rotation of portfolio satellite assets into stronger, potentially more profitable assets follows. Assume during market uncertainty, two actively managed equity funds (Large Growth and Energy Sector companies) and one commodity ETF (industrial metals) was sold. After 6 months (ideally near the trough of a moderate recession), the previously discussed interest rate curve and leading indicator factors turn favorable. A watch list includes Mid Size Value, Small Size Growth, and Health Sector companies mutual funds, an Emerging Markets equities mutual fund, and currencies ETF that are calculated to be fundamentally under valued. The Mid Sized Value, Health Sector, and Emerging Markets equity mutual funds are measured to have neutral intermediate term price trends and positive RS to their market benchmarks and the funds that were previously sold. The tactic would proceed to buy ½ positions in the 3 funds over a 2 month period and buy the final ½ positions over the next 2 months. Ideally 2 of the 3 assets will perform better than benchmarks (and the sold funds) and will be held for a normal business cycle (3 to 4 years).

Since satellite assets are usually more concentrated and risky than broad core assets, more price movements should be expected. The risk controls for held satellite assets should be more market price focused than fundamental valuation focused. Market sentiment anticipates and often leads meaningful operational asset cash flow changes. Market price and volume technicians use a full set of monitoring tool; PnF, candle stick, moving average charts, etc; to identify where support (demand) and resistance (supply) of shares should statistically occur. Developing a set of technical tools that fit your situation is a suggested sound approach to monitor price and RS trends. That requires research on how tactics should work and when they don't work. Set stop loss and cash out gain sell prices based on your tools. For most people with moderately risky assets, a 20% loss (decline) threshold based on your selected tools is a good indicator that something is wrong and at least ½ of the asset position should be sold.

### **Illiquid assets and unrealized taxable gains (losses) offer unique tactical challenges**

Illiquid assets, such as restricted holding period stocks or real estate, offer special challenges. In a broad economic and market decline, most related asset values are affected. The simplest risk reduction tactic is to sell part or the entire asset and limit potential losses by reducing risks.

However, the illiquid asset potential decline may sometimes be adjusted by transferring risk. An option to sell (put) the asset to a counter party may be purchased for a premium. It offsets an asset market price decline during the exercise period. The option is a derivative and therefore is an approximate insurance against loss. Yet prior to expiration, the right to sell an asset at a higher than market price can be exercised to earn a gain that offsets the protected asset market value loss (less transaction and tax on gain costs.)

A middle level technology company manager may accumulate \$250,000 market price of overvalued restricted sale stock, which can be sold in two years. He is 60 years old and has a total portfolio valued at \$2,000,000. Historically, the stock has declined about 25% in line with its benchmark during an economic recession. He can not sell the stock during an expected potential recession. If derivative stock put options trade, he may consider purchasing at-the-money (about the same exercise price as the current stock price) options that expire near the end of the uncertainty period (e.g. 6 months). The put options neutralize or inoculate against a stock price decline and transfer risk for an option premium price. The concept is simple, but the execution requires forethought and scenario analysis. During the option exercise period, the price of the restricted stock may decline, remain the same, or rise in price.

Selling immediately prior to the expiration date is the simplest tactic. If the stock price is higher or at the option exercise price at that time, then the option will be worthless and the net cost of the insurance will be option premium cost less any tax loss credit. If, for example, the underlying stock declines 15% during the exercise period, then the comparable amount of options may be sold for about \$37,500. The net gain after transaction costs may be \$27,500. At the time of option sale, the net position could be the stock value (\$212,500) + after-tax gain (\$21,500); that is \$233,000, instead of \$212,500

if the stock was held without the put option. In many cases, a solid company stock trades at fair value based on a cash flow analysis after a 15% decline. Then purchasing another put option is an unnecessary insurance cost. For cases where the cash flow is questionable and the stock price reached a 25% historical worst case cyclical decline, purchasing another option may be considered. Yet, be aware for most good companies in normal recessions (about 9 months), the recovery bounce is usually very quick and the second at-the-money option will likely expire worthless.

Satellite real estate investment illiquidity is a different situation. Shorting an REIT security is an indirect way to try to inoculate a specific property risk with a broad asset security. A directly owned property does have the benefit of operational control. If current mortgage rates are below existing property mortgage rates, then refinancing may reduce operating costs. However, real estate should be viewed as a long term investment with an opportunity for steady income. When property values fall, it is usually best to focus on maintaining the cash flow. That is, wait, if possible, until market valuations recover to acceptable price levels prior to sale.

#### **Broad Market Insurance Tactics are Tricky**

Some investors feel confident with their long term active fund manager, but fear a sizeable broad stock market correction. They would like to hold mutual funds with sizeable unrealized capital gains. Yet they seek to safeguard against potential loss of fund value in an expected declining market. Broad market inverse ETFs essentially hold short (sell) positions in the market universe of stocks either directly or synthetically through derivative securities. Purchasing an inverse ETF is a non specific hedge against a fall in the value of the held primary fund. The decision to remove the protective hedge is complex. It is essentially a market timing tactic that must select a target best case expected scenario exit, as well as a lost opportunity exit strategy. The hedge is approximate because the inverse market fund will not exactly track an opposite trend to the protected active fund. The inverse fund will also track at premiums and discounts to its benchmark universe and require transaction costs. Hedging is a game of speculative probabilities. For most broad active funds with near normal volatility ( $\sigma$ ), a  $1\sigma$  target price protection includes about 17% of potential

movements in a year and is a possible limit. If  $\sigma = 12\%$ , then 12% may be a reasonable target best case target. After taxes and inexact price movements, 9% of a 12% primary fund decline may be offset. A lost opportunity exit target may be a decline in inverse fund value of 8%, while the primary fund increases in value. Hedging with broad inverse market funds is a tricky tactic that is **only suggested for experienced speculators**, who are trying to protect a single satellite asset in a taxable account. In tax deferred accounts, full or  $\frac{1}{2}$  asset positions should simply be sold if they become overvalued or high uncertainty is determined.

#### **Tax management helps smooth out returns**

Since the U.S. Constitutional 16<sup>th</sup> Amendment granted Congress the power on February 3, 1913 to levy and collect individual income taxes, the tax code has changed often to its current level of extraordinary complexity. Generally, the key U.S. code principles are that progressively higher income tax rates are levied on higher levels of income. Capital gains are usually taxed at a lower rate than normal income tax rates to encourage capital purchases and employment prospects. A dividend tax rate lower than other income tax rates is a relatively recent 2003 code revision focused on equity ownership and savings. It may be a minor issue in long term tax management. Finally, high income tax states affect individual tax management and many mobile citizens respond by moving from them.

Key tax management tactics attempt to smooth out total annual taxable income, the flow of low taxed gains and dividends, and tax deferred account distributions; finally tactics try to distribute accumulated net worth (an estate) prior to death. The idea is to pay governments legal taxes efficiently with limited stress.

Business owners, established professionals, and retired individuals with adequate economic resources can control total annual income better than wage earners. Long term (5 to 10 year) transaction planning is very useful to setup flexible scenarios and stabilize wealth distributions. As tax laws change unpredictably, planning must adjusted. In any case, a knowledgeable tax accountant and a good attorney for property issues are worth their fees.

Tactics include locating high distribution (bonds, REITs, etc.) income sources in tax deferred

accounts (IRAs, etc.) and low distribution growth equity assets (core index stock funds) in regular tax accounts. Fixed annuity payments are regularly taxed income. Exceptions are sometimes made to the location tactic for flexibility. Money market funds or short term bond funds may be held in taxable accounts by those, who are not required or do not want to take IRA distributions. Active equity funds with unpredictable or high distributions are sometimes held in tax deferred accounts.

Time horizons relate to long term planning, assuming a household or individual has the resources to make rational adjustments. A 65 year old retiree, who plans to live to age 95, may use different tax management tactics than a person, who plans to live to age 80. He or she may effectively receive relatively higher risk cash flows by transferring longevity risk to an issuer of an irrevocable annuity. The issuers offer annuities anchored to current mortality statistics. Based on a large number of originated contracts and matched time horizons, they can earn a profit and stay in business by prudently investing in higher risk assets than an individual. Hence if one expects to live longer than normal, a tactic for smoothing out low risk taxable income is to purchase an annuity or donate to a non profit organization that returns income through a gift annuity. Annuity purchases may be incremental. That is to purchase an annuity to provide perhaps 35% of planned annual spending. Yet, as previously stated, the annuity decision is irrevocable and normal human behavior declines the opportunity.

Another tax management tactic is capital gain/loss matching. That is trying to match or harvest losses with gains each year. The issue is most important, when individual net capital losses would exceed \$3,000 in a year and must be carried over to following years. The carryovers are effectively interest free loans to the U.S. (and where applicable state) government. For example, if \$13,000 capital losses were recorded in 2008, only \$3,000 could be applied as U.S. income tax statement losses. It is sensible to review the cost basis and current valuation of taxable account assets and consider selling over-valued profitable assets to match losses. That is a tactic to harvest (share with governments) losses efficiently.

Tax accountants and planners spend a substantial amount of effort weighing IRA distributions and

regular to Roth IRA conversions. The tax tactic is complex. The U.S. IRS (and applicable states) offers the conversion opportunity in order to accelerate the payment of taxes on deferred account distributions. The taxpayer considers whether the deferred account has enough assets to pay for lifetime spending needs, as well as how much future tax rates are expected to increase. If taxpayer longevity estimates are fairly accurate and annual deferred account distributions are somewhat smooth, a Roth IRA conversion may not be an efficient tactic. On the other hand, at death the non-taxable Roth IRA can be transferred directly to a beneficiary with a long life expectancy. Discuss this complex tactic with your tax specialist to find if it makes sense.

Gift related tax tactics are worth contemplating. Non profit organizations accept many types of gifts. Shares of stocks and property are often accepted, as well as cash. Their valuation for individual income charitable itemized deductions is the current market value. If for example, shares of stock were purchased for \$20 per share 25 years ago and are effectively worth \$120 per share today, their total market value increased 500% and the increase is taxable upon sale. A combined IRS capital gains and state straight tax rate may be 24%. It is more effective to donate the shares of stock directly to the charitable institution, instead of selling the stock, paying the taxes, and donating the remainder to the charity. Check with your tax advisor concerning 20% adjusted gross income or other limitation on appreciated charitable gift deductions.

Your tax advisor will no doubt have many more detailed tax efficiency tactics to consider. They are important because taxes are certain, whereas other than risk-free items, asset returns are risky and uncertain. Good planning avoids over paying IRS and state taxes. Over long periods, the retiree or small business owner, who adjusts income distribution flows, may preclude unnecessarily paying 1% to 3% annual taxes. It is much harder to consistently earn 1% to 3% annual returns to compensate for the normal over payment of taxes due to lack of long term planning.

#### **Summary**

- Tactics play a supportive role for lifetime wealth management strategies.
- Tactics should be used less frequently with time as risk taking is reduced.
- Better strategies need fewer adjustments.

- Superior tactics use specific scenario analysis.
- Better tactics account for the unexpected outcomes and take minimum losses when necessary.
- They present prospect (outcome) tilted benefits in risky situations.
- If tactics are incorrect, they add risk.
- Thus, tactics should be used thoughtfully and sparingly.

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References

<sup>1</sup>Fisher, Ken, *The Only Three Questions That Count*, 2007