Morgan Stanley

Tax Loss Harvesting: A Way to Mitigate the Effect of Capital Gains

By Ben Mihalik

Tax loss harvesting is a full year endeavor. Generally, individual investors address losses at the end of the year, but for our team, we take a more active approach based on the regular fluctuations of the market.

Tax loss harvesting is a tactical strategy of realizing losses to offset current year capital gains and/or up to $3,000 of your current year taxable income (compensation, private investments, etc.).[i] Additionally, these losses can be "banked" to be used to offset future year's capital gains.
The strategy has four stages[ii]

1. Identify and sell investments with unrealized losses
2. Select replacement securities
3. Portfolio continues to deliver client-specific exposure
4. Manage sector, industry, and security risks relative to benchmark

The result is creating a potential tax benefit while maintaining your long-term asset allocation.

While most investors execute tax loss harvesting at the end of the year, we advocate for year-long awareness.

- Historically, the average S&P500 intra-year correction is 10%
- Breaking down index returns[iii]:
    - 2023: S&P returned 26.29%
        - ~72% of stocks had a maximum drawdown of more than 15%
        - 171 stocks had negative returns for the year
    - 2024: S&P returned 25.02%
        - ~69% of stocks had a maximum drawdown of more than 15%
        - 172 Stocks had negative returns for the year

In 2020, investors who addressed tax losses in November and December would have missed one of the greatest opportunities to capture losses and reallocate accounts while staying invested and potentially capitalizing on stock appreciation. Each dollar of tax loss harvesting realized during the year could help reduce taxes and allow us to re-allocate your investments with a reduced tax burden.

To bring this full circle to today – we are currently going through a period of increased volatility and both individual names and the indexes are experiencing declines. This presents several opportunities:

- Capture losses where possible
- Reallocate accounts if necessary
- If there is excess cash waiting for investment, begin a more tactical dollar cost averaging strategy to possibly take advantage of attractive prices

Just like investing, managing a tax efficient portfolio is a full-time job.

SoundView Wealth Management at Morgan Stanley
Two Jericho Plaza, Jericho, NY 11753
(516) 336-0890

Frank Lourenso, CFP®, CIMA®
Managing Director
Financial Advisor
NMLS: 1288184

Dan Griesmeyer, CIMA®
Executive Director
Financial Advisor
NMLS: 1279212

Michael Simon, CRPS®
Senior Vice President
Financial Advisor
Family Wealth Director
Corporate Retirement Director
NMLS: 1279535

Benjamin Mihalik, CPWA®, CIMA®, CFP®
Senior Vice President
Financial Advisor
NMLS: 1407644

Brad Schatz, CFP®, CIMA®
Senior Vice President
Financial Advisor
NMLS: 1275593

Allison Giffuni, CFP®
Senior Vice President
Financial Advisor
NMLS: 1255292

Nick Mangia, CFP®
Assistant Vice President
Investment Consultant – Relationship Manager
NMLS: 2698971

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[i] Investopedia: https://www.investopedia.com/terms/t/taxgainlossharvesting.asp#:~:text=The%20Bottom%20Line-,Tax%2Dloss%20harvesting%20is%20the%20timely%20selling%20of%20securities%20at,%243%2C000%20in%20net%20losses%20annually.
[ii] Parametric Custom Core Equity – First Quarter 2023 – Page 12
[iii] Factset, as cited in Parametric Custom Core Equity – Fourth Quarter 2024 – Page 12, 14, 16