Morgan Stanley

Actively Pursuing Tax Alpha:

Tax Management Services for Select UMA®

While taxes are top of mind for all investors, active tax management of an investment portfolio as a wealth planning tool is typically a passive consideration for most. Asset allocation and product selection are the primary drivers of investment results on a pretax basis; however, after-tax results can vary greatly depending on the tax treatment of those investment decisions. A significant amount of work and analysis is involved in ultimately creating what we believe is one of the best investment solutions for our clients, yet taxes usually become a once-a-year discussion starting sometime after Labor Day. Opportunities for tax strategies ebb and flow with the fluctuations of the market and not with our fiscal calendars. Incorporating tax-sensitive investing into the daily trading activity of an account can capitalize on market fluctuations and potentially yield better after-tax results. This paper will attempt to demonstrate how.

Tax Drag and Tax Alpha

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It is important to understand how taxes can affect after-tax results on a basic level. It is widely understood that the realization of gains and payment of taxes will ultimately have an impact on the ending value of the investment portfolio, but by how much? The answer is complicated and unique to each account. Considering the complexities of the tax code in our progressive system, it may be presumptuous to paint with a broad brush in this regard. However, there are certain truths that mathematically bear out and are worth noting; the old adage "It's not what you earn, it's what you keep" comes to mind.

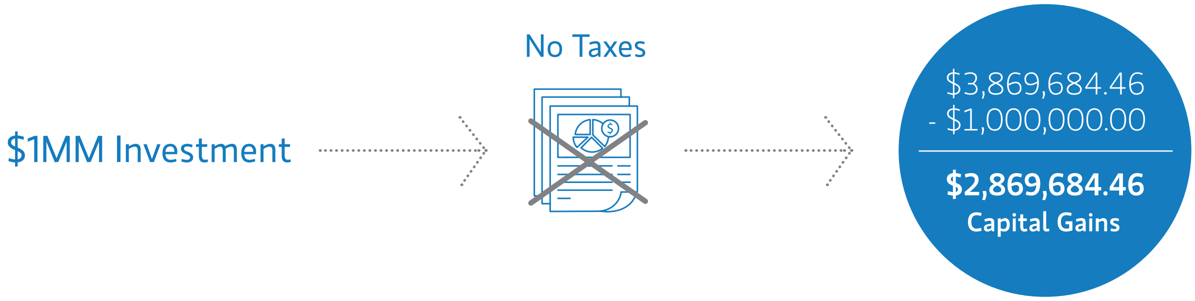
TAX DRAG can be defined as the reduction in after-tax returns that occurs as a result of realizing our gains and having to pay our taxes. Tax drag is largely unavoidable, as a growing taxable portfolio will ultimately have to pay taxes on those gains. However, due to the time value of money, the timing of those payments can have a material impact on the size of the drag effect of taxes. Short-term gains are taxed higher and create a higher tax drag relative to long-term gains, which are taxed less. Realizing gains frequently will also produce a higher tax drag than employing strategies that defer those gains out into the future. Reducing the amount of tax drag, thereby potentially increasing the ultimate ending value of the portfolio, is referred to as "tax alpha."

TAX ALPHA is the potential value created by the effective tax management of investments. Taxable investors have the ability to generate tax alpha through tax-deferral strategies such as tax-loss harvesting, IRS wash sale rule adherence, most efficient tax lot trading and others. The delay of the payment on taxable gains by utilizing these strategies allows for greater compounding of the potential growth of the portfolio. Compounding our returns on a larger investment amount for a longer period of time by delaying our taxes further into the future will reduce our tax drag and seeks to produce better compounded after-tax returns. Let's consider the simple math behind it:

Hypothetical Example: Effect of Capital Gains Taxes and a $1,000,000 Investment

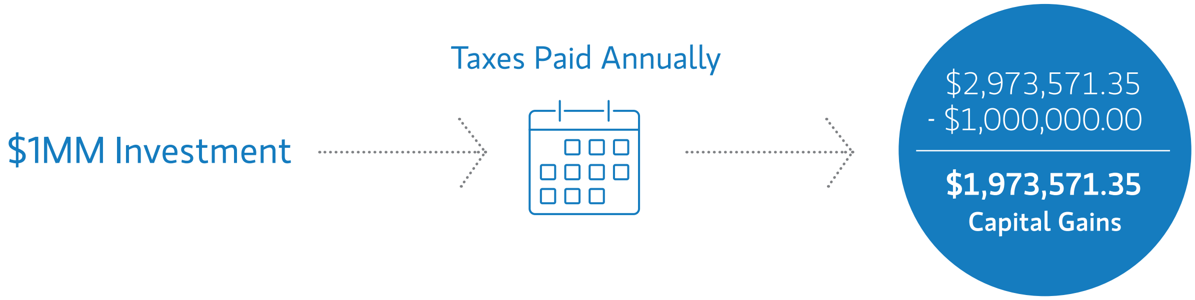
ASSUMPTIONS

Portfolio return at 7% per annum (20 yrs.) assuming no taxes:



ASSUMPTIONS

Portfolio return at 7% per annum (20 yrs.) less capital gains taxes (assuming 20% accrual taxes paid annually):



Clearly, taxes have a drastic impact on the portfolio relative to no taxes. We did not need to see a calculation to understand the negative effect of taxes, and since they are unavoidable, it may not be clear how active tax strategies can help produce better investment results. Our example on page 3 considers an active portfolio where all of the gains are realized on an annual basis and assumes a long-term capital gains rate of 20%. We use this unrealistic but simple illustration to demonstrate the concepts of tax drag and tax alpha. Continuing the example from page 3:

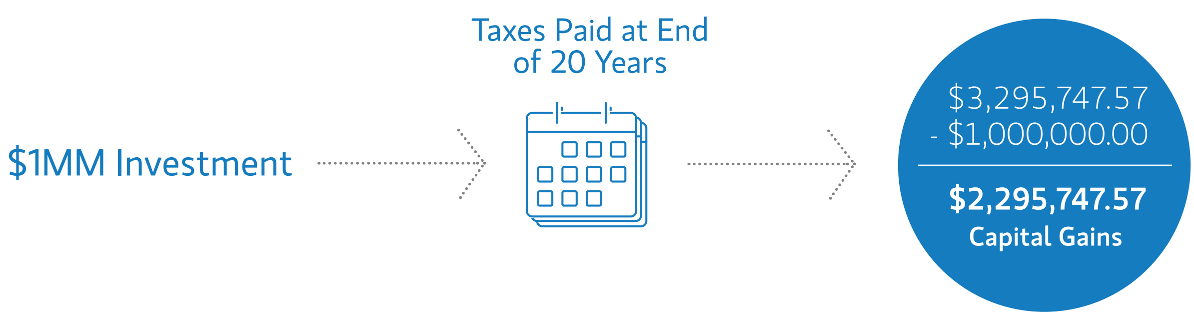
Opportunity Lost to Taxes (TAX DRAG $) = $2,869,684.46 - $1,973,571.35 = $896,113.11

Opportunity Lost to Taxes (TAX DRAG %) = $896,113.11 / $2,869,684.46 = 31.2%

Tax drag as a measure of the effect of paying taxes annually will always be greater than the tax rate when realizing gains frequently; it increases with the investment horizon and with the size of the return. Clearly, the effects of paying taxes annually are quite damaging to your after-tax result, and any attempt to reduce the tax drag on the portfolio is a worthwhile pursuit. While taxes must ultimately be paid, let’s examine the benefits of deferring taxes into the future:

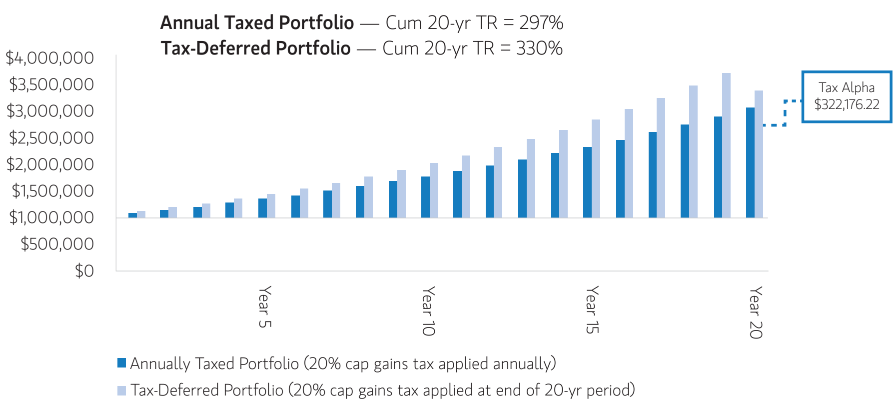
ASSUMPTIONS

Portfolio return at 7% per annum, deferring taxes until the end of the investment period (20 yrs.):



Through deferral of the taxes until the end of the investment period, we were able to produce an additional $322,176.22 ending period value, or an additional 32.2% cumulative return over the period. We reduced tax drag dollars from $896,113.11 to $573,936.89, and in percentage terms, we were able to reduce it from 31.2% to 20%. The added value through employment of tax-deferral strategies is our tax alpha.

Ending Period Cumulative Returns $1,000,000 Taxable Portfolio



Hypothetical Illustration

How Can You Pursue Tax Alpha?

The simple example above will differ from your actual tax situation, but it illustrates the ongoing need for "tax management" of an investment portfolio. Higher tax brackets, short-term gains, passive or active trading, noninvestment-related income or losses; all will have an impact and in many cases can worsen the effects described above. Imagine the after-tax result if we assumed the ordinary income tax rate for a portion or all of the gains.

PRUDENT TAX-LOSS HARVESTING: At the very least, you, your Morgan Stanley Financial Advisor and your tax advisor should consider reviewing your taxable accounts regularly to identify opportunities to mitigate capital gains before year-end. The simple process of selling losses to offset these realized capital gains may be critical to mitigate possible tax liabilities over time. While this concept is not new, it is often overlooked during the course of the year.

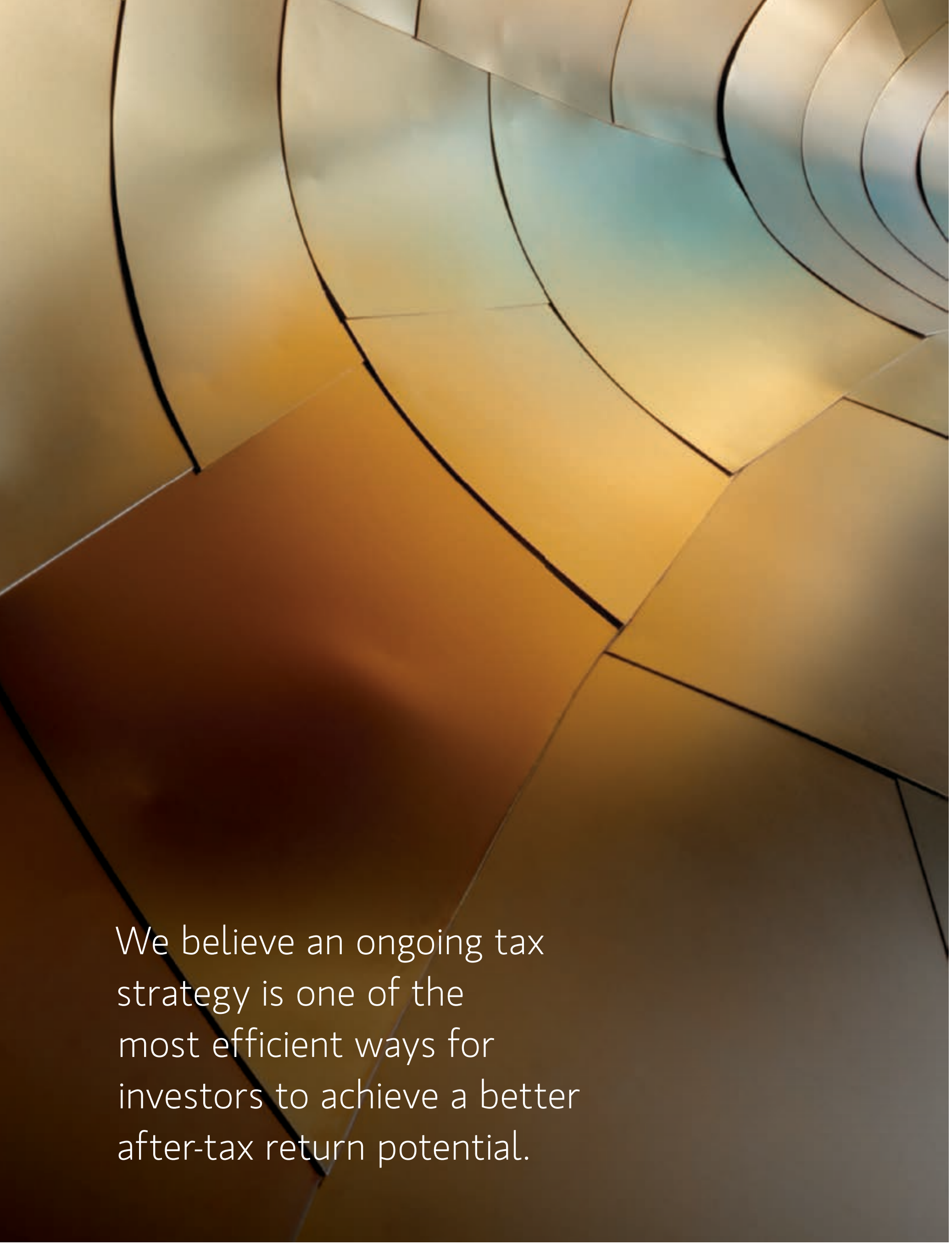
Active Tax Management: Tax Management Services for Select UMA[1]

Morgan Stanley has developed and offers a proprietary "tax management" overlay process for taxable Select UMA® accounts designed to actively seek out tax alpha. The service can be added or removed at any time and employs an active approach to deferring taxes and minimizing tax drag. Here is a description of the program's features:

Simplicity — The Power of One

Select UMA offers a simplicity that can help you build your financial future. You will be able to combine a robust, risk-based asset allocation strategy with multiple investment products within a single account.[1] By including an asset allocation tailored to your needs, a comprehensive process for manager analysis, portfolios developed and constructed specifically to your asset allocation, and ongoing account management and oversight, we help you simplify your financial life.

TAX-EFFICIENT TRADING: Typically, investment managers will only be concerned with delivering the best performance possible, disregarding tax consequences to the individual investor.



We believe an ongoing tax strategy is one of the most efficient ways for investors to achieve a better after-tax return potential.

This means many managed account programs will sell according to the FIFO method (the first lot in will be the first lot out when partially selling from positions) in positions with multiple versus purchase tax lots, unless directed to do otherwise. This can result in higher gains (lower losses) from a sale if higher cost-basis tax lots exist. With Select UMA Tax Managed accounts, our Tax Management Services overlay manager uses a best tax outcome methodology instead of FIFO; this allows clients to keep lower cost holdings in their accounts. When a portfolio manager makes changes, or if clients submit a service request, the overlay manager will look to sell lots at a loss first.

WASH SALE RULE: In a multi manager account structure, there is the potential for conflicting trades in substantially similar securities throughout the year. This is especially true if multiple Separately Managed Account (SMA) managers are used to represent a single asset class or when using separate accounts across different advisory platforms. Within a Select UMA Tax Managed account, Tax Management Services takes precautions to help you avoid this all-too-common scenario. If a security is sold for a loss, the loss will be preserved and the security will be restricted from purchase for the duration of the wash sale period. This practice seeks to adhere to the IRS Wash Sale Rules,[1] which the team observes when trading securities and rebalancing allocations. Adhering to the rule in certain circumstances will preserve your ability to utilize losses against realized gains in the current tax year. If you have more than one equity SMA investment manager in your UMA account, Tax Management Services will block that security for all managers. Except in the case of tax-loss harvesting, a disallowed loss is possible when a security is purchased by one manager and subsequently sold by another within a 31-day period.

ACTIVE TAX-LOSS HARVESTING: If you choose to select Tax Management Services for your Select UMA account, active tax-loss harvesting is part of the management process. With a Select UMA Tax Managed account, if an account has a net realized gain at the time of the quarterly tax harvesting (once per quarter), Tax Management Services will attempt to offset the gain by selling positions that are currently held at a loss. This allows the account to take advantage of market movement throughout the year and not just at year-end like a non-Tax Managed account.

Where a tax loss is realized as a result of the foregoing process, an ETF is purchased with the proceeds to maintain

LEARN MORE ABOUT TAX MANAGEMENT SERVICES:

Speak to your Financial Advisor today to learn more about how you may be able to benefit from Tax Management Services from within your Select UMA account.

market exposure and held for thirty (30) days to adhere to the IRS wash sale rule. This process attempts to reduce or, if possible, eliminate realized capital gains within the account and the taxes associated with them.

OPTIONAL CLIENT-SPECIFIC TAX OR GAIN MANDATES: Our Tax Management Services allows the client and Financial Advisor to set a realized gain limit in a managed portfolio, otherwise known as a “tax mandate” (e.g., no more than $50,000 net realized gains per year in the client’s account). The PPG Tax Management Services team will seek to adhere to these limits and prevent trades in securities that will drive the realized gain amount above that of the specified mandate.

These active techniques are applied throughout the year and in the normal course of trading, which better enables a portfolio to take advantage of market fluctuation rather than the typical annual look-back approach. We believe an ongoing tax strategy is one of the most efficient ways for investors to achieve a better after-tax return potential. To learn more about Tax Management Services at Morgan Stanley and how they may benefit your portfolio, speak with your Financial Advisor today.

All information as of June 2021.

[1] A client may elect Tax Management Services for the account by notifying their Financial Advisor, and indicate what Maximum Tax or Realized Capital Gain Instruction is desired for the account, if any. The Tax Management Services Terms and Conditions attached to the Morgan Stanley Smith Barney LLC Select UMA ADV brochure as Exhibit A will govern Tax Management Services in the account. Review the Morgan Stanley Smith Barney LLC Select UMA ADV brochure carefully with your tax advisor. Tax Management Services are not available for all accounts or clients and may adversely impact account performance. Tax Management Services do not constitute tax advice or a complete tax-sensitive investment management program. There is no guarantee that Tax Management Services will produce the desired tax results.

A client must have a Taxable Select UMA account in order to be eligible for Tax Management Services.

Tax laws are complex and subject to change. Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates, and Morgan Stanley Financial Advisors and private Wealth Advisors do not provide tax or legal advice and are not "fiduciaries" (under ERISA, the Internal Revenue Code or otherwise) with respect to the services or activities described herein except as otherwise provided in writing by Morgan Stanley. Individuals are encouraged to consult their tax and legal advisors (a) before establishing a retirement plan or account, and (b) regarding any potential tax, ERISA and related consequences of any investments made under such plan or account.

Diversification and asset allocation do not assure a profit or protect against loss. Past performance is not a guarantee of future results.

Rebalancing does not protect against a loss in declining financial markets. There may be a potential tax implication with a rebalancing strategy. Please consult your tax advisor before implementing such a strategy.

Please see the Morgan Stanley Smith Barney LLC Select UMA Form ADV Wrap Fee Brochure (the "Morgan Stanley ADV") for more information on the Select UMA Investment Advisory Program. The Morgan Stanley ADV is online at www.morganstanley.com/ADV.

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