

## **Differences Between Parametric’s and Efficient Tax’s Approaches to Tax Loss Harvesting**

This paper provides a detailed comparison between Parametric Portfolio Associates LLC’s (“Parametric’s”) approach to tax management and tax-loss harvesting and that of Efficient Tax (“ET”) as effected via ET’s product, the Efficient Tax Portfolio Optimizer (“ETPO”).

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## **I. Executive Summary**

The financial services industry's approach to tax sensitivity diverges from the goals of the investor.

While the industry manages portfolios to minimize in-year taxes, Efficient Tax's ETPO manages portfolios to maximize the accumulation of after-tax wealth. This is accomplished through higher levels of after-tax capital efficiency using ET's patent-pending processes.

The industry has been mired in tax minimization strategies that don't serve the best interest of investors for three very important reasons: the erroneous belief that saving taxes equates to wealth accumulation; legacy portfolio systems that support this belief; and the inadequate approach to after-tax performance calculations.

Only through the illumination of after-tax alpha opportunities generated through the ETPO and the correct calculation of after-tax performance, can managers focus on what is most important to investors: creating greater after-tax wealth.

The ETPO approach to tax loss harvesting ("TLH") provides a superior approach when compared to all others available in the marketplace.

Using its patent-pending software, ET helps investors and wealth managers find those assets in the portfolio where it makes sense to sell the asset, pay the tax, and reinvest for higher after-tax returns moving forward.

Parametric's approach to TLH predates the use of the internet for managing financial processes and portfolios.

Since 1993, Parametric has built a very profitable practice around its passive investing and active tax-management TLH practice, however its processes and calculations are rooted in outdated technology. Passive strategies miss the ability to maximize the opportunities to measure and achieve after-tax alpha.

The ETPO provides a vastly improved and demonstrably more successful approach to growing after-tax wealth for investors. There are six important and salient differences between the approaches to wealth management for Efficient Tax and Parametric:

1. The ETPO is the only risk management tool for taxable equities that focuses on what is important to investors: After-tax wealth accumulation, within risk tolerances, net of fees.

Parametric's offering focuses on its active TLH software to minimize taxes each year for investors.

2. Efficient Tax uses the correct after-tax performance measurement – balance sheet wealth accumulation - while Parametric’s cash-flow methodology is a legacy approach which doesn’t reflect true after-tax performance.

3. As a result of ET’s accrual accounting methodology versus Parametric’s cash accounting methodology, Parametric’s benchmarking on after-tax performance is inherently flawed and off-point.

Efficient Tax’s benchmarking is calculated using actual after-tax performance for an existing discipline.

Results are then compared with a side-by-side investment discipline, one using the ETPO, and one not, comparing the after-tax value at time “A” versus time “B” for each portfolio.

4. The ETPO offers the ability to evaluate concentrated positions, achieving greater returns with materially less risk via its proprietary diversification algorithms.

Parametric offers no such capability on an automated basis.

5. The ETPO’s active proprietary portfolio management algorithms allow the portfolio manager to make daily decisions on diversification, re-balancing, and TLH opportunities.

Parametric’s passive investment strategy makes it incumbent on the portfolio manager to be actively involved in running scenarios to test for opportunities to diversify or re-balance.

Additionally, TLH opportunities are presented actively, but only in the context of minimizing in-year taxes, not on maximizing after-tax alpha.

6. Parametric, like the rest of the wealth management community, is handicapped in its tax management, lacking the tools to properly evaluate risk on an after-tax basis.

ETPO makes its decisions on diversification, re-balancing, and TLH opportunities with proprietary tools that account for the evaluation of risk on an after-tax basis.

Efficient Tax’s approach to wealth management is a catalyst for change in the financial services industry, moving from passive investment strategies and legacy processes to an active investment strategy that gives the wealth manager the tools needed to create greater after-tax wealth, net of fees and within risk tolerances.

As investors begin to see the materially better results in their portfolios, they’ll begin to ask themselves, “*How much have my managers been costing me?*”

## II. Parametric and Efficient Tax Primary TLH Principles

1. Parametric's tax management goal is to minimize the tax drag associated with a passive investment strategy that attempts to minimize before-tax performance tracking error as compared to a chosen benchmark.

It does so by recommending the realizing of losses on ETFs when certain loss triggers are met, replacing the sales with substitute investments designed to mirror what was replaced in terms of performance; without running afoul of the "wash sale" rule.

2. Parametric selects a custom benchmark depending upon a client's tracking error risk tolerances, and deducts the tax on realized gains to calculate an after-tax return in a "pre-liquidation" after-tax performance calculation.

This after-tax performance measurement conforms with industry standards (deducting the tax liability associated with any net realized gains incurred during a tax year from a before-tax rate of return made up of the difference in market value, plus any dividend distributions), but does not conform with the SEC's preference to add a post-liquidation method.

3. Efficient Tax uses a "post-liquidation" performance measurement, as recommended by the SEC, that is based upon the accrual method of accounting, or balance sheet approach.

This method calculates after-tax performance by using a market asset value less accrued tax liability: comparing the after-tax value of a portfolio at time "A" with time "B", inclusive of dividends, for a true measure of increase or decrease in spendable wealth.

4. Efficient Tax creates greater after-tax wealth through the ETPO by calculating when existing superior investment return opportunities, adjusted for risk, will generate materially greater return beyond the tax cost of selling a profitable tax-lot.

The ETPO realizes losses on the most over-valued stocks, and offsets those losses against the most over-valued stocks with a gain, but not at the expense of future after-tax wealth accumulation.

This achieves the greatest increase in after-tax return potential of the portfolio upon a sale and reinvestment.

### III.Pre-liquidation vs. Post-liquidation Performance Comparisons

#### Portfolio Assumptions

<b>Market Value January 1</b>	<b>\$100.00</b>	
Accrued Tax Liability January 1	\$10.00	
Capital Appreciation	\$8.00	
Dividend Income	\$2.00	
<b>Total Before Tax Return</b>	<b>\$10.00</b>	<b>10.00%</b>
Short-Term Realized Gains	\$5.00	
Long-Term Realized Gains	\$10.00	
Short-Term Tax Rate	40.00%	
Long Term Tax Rate	20.00%	

<b>PERFORMANCE MEASUREMENT</b>	<b>TRADITIONAL TAX EFFICIENCY Pre-Liquidation Basis</b>	<b>ACCURAL METHOD Post-Liquidation Basis</b>
Total Before-Tax Dollar Return	\$10.00	<b>\$10.00</b>
	Minus Short-Term Tax (\$2.00) 40% x \$5.00	<b>After-Tax Value Time A</b> \$90.00  \$100/Market Value - \$10/Accrued Tax Liability = \$90.00
	Minus Long-Term Tax (\$2.00) 20% x \$10.00	<b>After-Tax Value Time B</b> \$97.60  \$90/Market Value + \$8/Capital Appreciation - \$1.60/Capital Appreciation Accrued Tax Liability Alpha + \$2/Dividend - \$0.80 Dividend Tax = \$97.60
Net After-Tax Dollar Return	\$6.00	<b>\$7.60</b>
Net After-Tax Percentage Return	6.00% \$6.00/\$100	<b>8.44%</b> <b>\$7.60/\$90.00</b>

## IV. Side-By-Side Comparisons

	PARAMETRIC	EFFICIENT TAX	PRIMARY DIFFERENCES
STRETEGIC INVESTMENT GOAL	Minimize the tax drag on benchmark performance through the realization of losses when amount triggers are met, with the reinvestment in like substitutes.	Maximizing after-tax wealth within risk tolerances, net of fees, by calculating when superior investment opportunities are forecasted to more than pay for the tax costs of selling a profitable tax-lot, generating additional after-tax wealth over time.	Only Efficient Tax seeks to generate true after-tax alpha.
PERFORMANCE MEASUREMENT	Parametric embraces the USIPC industry-standard measurement that deducts accrued realized tax liability against a tax year's pre-tax performance.	Efficient Tax postulates that the correct approach to after-tax performance measurement is through the accrual accounting method or the post-liquidation method, comparing after-tax values at time "A" vs. time "B".	<p>Parametric's approach violates the accounting principle of matching revenues and expenses, by offsetting prior years accrued but deferred tax liability against a current year's performance.</p> <p>It doesn't measure after-tax performance correctly, and therefore all of its writings regarding performance measurement and benchmarking are equally flawed.</p> <p>One can create wealth without generating cash-flow.</p> <p>Conversely, generating cash-flow does not guarantee wealth creation.</p>

	PARAMETRIC	EFFICIENT TAX	PRIMARY DIFFERENCES
TAX-LOSS HARVESTING	<p>Parametric realizes losses to reduce the tax liability on current pre-tax returns.</p> <p>It invests in tracking error risk to realize losses that can be used against otherwise benchmark gains.</p> <p>It suggests a 1% tracking error is adequate to achieve some material tax alpha.</p>	<p>ET's TLH approach is to achieve the greatest step-up of after-tax return alpha potential by selling stocks at a loss with the least return potential remaining, on a risk-adjusted basis, harvesting those losses against the most over-valued profitable tax-lots, and reinvesting the after-tax proceeds in higher return opportunities.</p> <p>This approach, coupled with understanding when to sell a stock at a profit without the benefit of losses to offset the profit, because superior investment opportunities will more likely than not eclipse the tax cost associated with selling a profitable tax-lot.</p> <p>These are two of the key drivers in the after-tax portfolio optimization process that leads to minimizing taxes without jeopardizing future after-tax wealth accumulation.</p> <p>A 1% after-tax increase in return or wealth generation on a million dollars over twenty years will yield an extra \$385,000 in after-tax spendable wealth.</p> <p>On a billion dollars invested, that translates into an extra 385 million dollars of after-tax spendable wealth.</p>	<p>The easiest way to pay "no more" in taxes is to make "no more" money.</p> <p>ET achieves alpha returns in excess of tax costs, whereas Parametric has no alpha goals or tactics.</p> <p>ET maximizes the hidden tax savings value of a loss through the combination of tax avoidance and alpha achievements by investing the tax savings at or above benchmark returns.</p>

	PARAMETRIC	EFFICIENT TAX	PRIMARY DIFFERENCES
PASSIVE VS. ACTIVE INVESTING	Parametric limits investing to passive strategies.	ET embraces active investing as the optimal path to achieve maximum excess returns on an after-tax basis.	<p>Parametric’s self-awareness that they have no active management skill set and their focus on minimizing tax drag limits them to a non-alpha achieving tax management discipline.</p> <p>Active management can more than cover the cost of fees, while a passive strategy underperforms its benchmark by the amount of its fees.</p>
BENCHMARKING	Parametric creates custom benchmarking portfolios for a client and uses the traditional after-tax performance measurement approach that offsets past accrued but deferred tax liability that comes due as a result of a sale abasing the most recent calendar year’s pre-tax market value and dividend performance.	The ETPO empirically develops after-tax alpha over time as it is a force multiplier add-on to varied wealth management internal disciplines	Efficient Tax benchmarks measure how an existing, managed portfolio performs on an after-tax basis using the correct accrual method wealth-generation measures instead of Parametric’s industry standard tax minimization strategies.