Insights
Tax-Loss Harvesting

October 2020

2020 Tax-Loss Harvesting

Investors have been on a wild ride in 2020. First a 30% drawdown in equities, then a furious rally — all set against a backdrop of a global pandemic that has upended economies and daily routines. While headlines remain focused on the S&P 500's rally back above pre-crisis highs, not all markets and strategies have rallied. This creates opportunities for investors to sell investments in taxable accounts that have lost value to offset capital gains — and help reduce taxes.

To understand where losses may reside in portfolios, we analyzed the year-to-date returns for every US-listed ETF and mutual fund, grouping them by their Morningstar Category. Our analysis included calculating the average return for each fund category to assess the severity of losses; determining the percentage of funds with losses to see the breadth of the declines; and totaling the assets in a loss position to gauge the size of the opportunity. We identified a $2 trillion crop of assets with current losses now ripe for harvesting.

Figure 1
Market Segments with Tax-Loss Harvesting Opportunities

Investment Theme	Setting the Stage	Average Fund Return YTD/% with Losses	Average Net Expense Ratio (%)	Total Assets in Category ($B)	SPDR ETF Potential Swap Solutions	SPDR Net Expense Ratio (%)
Value (All Market Caps and Geographies)	Value's underperformance has been widely discussed this year, as the S&P 500 Value Index is down 11% and lagging broader US equities by 15.8% in 2020. This poor performance is exacerbated within small-cap value strategies and outside the US.	Large-Cap Value -10.5%/95.1%	0.73	1,098	SPDR Portfolio S&P 500 Value ETF [SPYV]	0.04
		Mid-Cap Value -15.5%/98.6%	0.81	214	SPDR S&P 400 Mid Cap Value ETF [MDYV]	0.15
	Beyond the negative performance, 65.9% of the active funds in these categories paid capital gains dividends last year. Given that those funds have had $60 billion of outflows in 2020,* the probability of another large-cap gains dividend is high.	Small-Cap Value -19.3%/95.9%	0.97	115	SPDR S&P 600 Small Cap Value ETF [SLYV]	0.15
		Foreign Large-Cap Value -11.4%/93.1%	0.76	168	SPDR MSCI EAFE StrategicFactors ETF [QEFA]	0.30
				Total 1,594		
Small-Size Strategies	Small-size funds lagged considerably during the COVID-19 correction and have yet to rally all the way back. On average, mid caps have held up better than small caps, but they are still in the red on the year.	US Small-Cap Blend -13.3%/94.5%	0.84	299	SPDR Portfolio S&P 600 Small Cap ETF [SPSM]	0.05
		US Mid-Cap Blend -7.5%/86.6%	0.74	272	SPDR Portfolio S&P 400 Mid Cap ETF [SPMD]	0.05
	Beyond the negative performance, 66.4% of the active funds in these categories paid capital gains dividends last year. Given that those funds have had $13 billion of outflows in 2020,* the probability of another large-cap gains dividend is high.	Foreign Small/Mid-Cap Blend -5.8%/86.8%	0.96	47		
				Total 619	SPDR S&P International Small Cap ETF [GWX]	0.40
US Real Estate	The real estate sector has experienced extreme pandemic headwinds, as local economies have been slow to reopen, leading to broad-based losses for funds focused on this segment.	-13.4%/91.2%	0.79	119	Real Estate Select Sector SPDR ETF [XLRE]	0.13
					SPDR Dow Jones REIT ETF [RWR]	0.25
Below-Investment-Grade Credit	As COVID-19 fears swept across the US, credit markets fell and spreads widened. Since then, prices have stabilized, but some funds have yet to rally back to gains.	High Yield -0.3%/45.3%	0.76	367	SPDR Portfolio High Yield Bond ETF [SPHY]	0.15
		Senior Loans -1.6%/74.6%	0.84	88	SPDR Blackstone / GSO Senior Loan ETF [SRLN]	0.70
				Total 455		

Source: Morningstar, SPDR Americas Research, as of 09/11/2020. **Past performance is not a reliable indicator of future performance**. *Flow statistics are year-to-date through 08/31/2020.

Tax-Loss Harvesting Rules

In taxable accounts, when you sell a position that has lost value, you can use the loss to offset capital gains that result from selling securities at a profit during the year. Your booked losses can also offset mutual funds' annual capital gain distributions.

At year-end, if your capital losses exceed your gains (or if you don't have any gains), your losses can offset up to $3,000 in noninvestment income, even though that is often taxed at a higher rate than capital gains are. Losses greater than that carry forward to offset capital gains and ordinary income over your lifetime.

Importantly, when reinvesting the sale proceeds, you must abide by the Internal Revenue Service's Wash-Sale Rule, which prohibits claiming a loss on the sale of an investment if the same or "substantially identical" investment is purchased either 30 days before or after the sale date.

Harvest to Swap or Refine Exposures

Traditionally, investors have used a "tax swap" — a similar but not identical security — as a placeholder to maintain exposure to the asset class for 30 days. After 30 days, they choose whether to switch back to the original holding or not. Keep in mind that if the new investment appreciates and you sell it within a year, those gains will be taxed at the short-term capital gains tax rate, which is higher than the long-term rate. For that reason, it may be advantageous to choose a swap that could become a long-term holding.

You also could decide to invest your sale proceeds in a way that repositions your portfolio to:

- **Lower Costs** ETFs generally have lower expense ratios than mutual funds do. As seen in the table on page one, all SPDR ETFs referenced have lower management fees than the category average.

- **Pursue "Tax Alpha"** By nature of their unique create and redeem functions, ETFs are inherently more tax-efficient vehicles than mutual funds are. In nonqualified accounts, ETFs offer a potential tax advantage for investors, as they typically do not distribute capital gains as often as mutual funds do.

- **Replace an Underperforming Active Manager** Active managers have come under fire over the past few years for charging high fees and delivering subpar performance. According to S&P Dow Jones, "70% of domestic equity funds lagged the S&P Composite 1500 during the one-year period ending Dec. 31, 2019, making it the fourth-worst performance since 2001."[1] Investing in a low-cost index fund eliminates the risk of choosing an active manager who underperforms the market.

Research Methodology

US-Listed ETFs and oldest share class mutual funds were analyzed. "Value" defined as all funds in the Large-Cap Value (429 funds), Mid-Cap Value (139 funds), Small-Cap Value (145 funds), and Foreign Large-Cap Value (130 funds) Morningstar Categories. "Small-Size Strategies" defined as all funds in the Small-Cap Blend (255 funds), Mid-Cap Blend (172 funds), and Foreign Small/Mid-Cap Blend (38 funds) Morningstar Categories. "US Real Estate defined as all funds in the Real Estate Morningstar Category (91 funds). "Below-Investment-Grade Credit" defined as Senior Loans and High Yield. "Senior Loans" are all funds in the Bank Loan Morningstar Category (67 funds). "High Yield" defined as all funds in the High Yield Bond Morningstar Category (232 funds).

Endnotes

1 S&P Dow Jones SPIVA U.S. Scorecard Year-End 2019.

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Glossary

Basis Point (bp) A unit of measure for interest rates, investment performance, pricing of investment services and other percentages in finance. One basis point is equal to one-hundredth of one percent, or 0.01%.

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Bonds generally present less short-term risk and volatility than stocks, but they contain interest rate risk (as interest rates rise, bond prices usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities.

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Equity securities may fluctuate in value in response to the activities of individual companies and general market and economic conditions.

Value stocks can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time. Investments in **small-size companies** may involve greater risks than in those of larger, better-known companies. Returns on investments in stocks of small companies could trail the returns on investments in stocks of larger companies.

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