GREEN HARVEST
Asset Management

Benchmarking Managers That Offer Loss Capture

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There are a handful of asset managers and investment advisory firms that offer loss harvesting as a feature or benefit to their investment process. As most of these managers primary goal is to match the return of a broad index, measuring their relative success of that part of their process should be a simple exercise. If a manager provides close to the risk and return attributes of their selected benchmark index before fees, they have likely done that portion of their job effectively. But how would an investor measure a manager's ability to capture losses? We have created a benchmark that clearly illustrates a manager's ability to capture losses versus the opportunity to capture losses and versus other managers with a similar mandate.

Understanding the Loss Harvesting Opportunity

When a manager offers benchmark sampling, optimization or replication as well as systematic loss harvesting, the additional benefit is usually referred to as "tax alpha". The amount of net losses (realized losses versus realized gains) captured or harvested by the manager, assuming the manager provides the risk and return of the benchmark, is the amount of tax alpha the manager provides. This absolute measure does not, however address two relative measures of their loss capturing skill. First, an absolute tax alpha figure does not measure the amount of losses captured relative to the amount that were available. We call the amount of available losses the "loss capture opportunity". Additionally, it does not compare a manager's skill of capturing losses relative to other managers who have the same goal. A simple, fair and objective benchmark would allow an interested investor to compare all loss harvesting managers A) versus their loss capture opportunity provided by their selected benchmark, and B) versus other managers who feature loss capture as a benefit of their strategy and that have utilized the same benchmark.

Creating a Benchmark

Investment Alpha, traditionally viewed as the amount of risk adjusted return above a selected benchmark, is measured on an absolute basis. For example, if a manager seeking traditional Investment Alpha were to provide investors with the same amount of risk as their benchmark and provide 10% in additional return, the Investment Alpha would be likely about 10%.
A manager whose additional goal is loss harvesting is limited capturing to the weighted average losses of the securities in a selected benchmark. The Loss Capture Opportunity benchmark, is always a relative measure. As we are benchmarking the effectiveness of a manger to capture losses as a versus available losses, the tax alpha benchmark becomes a relative rate or a ratio. For example, if the manager's portfolio and their benchmark both owned the same two securities in equal weights and both were to fall 25% each during the same measured timeframe, the loss capture opportunity would be 25%. If, during this same timeframe, a manager had captured 12.5% in losses, the manager's relative loss capture rate, or amount of losses captured versus the loss capture opportunity, would be 50%.

Practical Index Benchmarks

The task of capturing the weighted average loss opportunity for a benchmark with 500, 1,000 or 3,000 components can be achieved given the availability of data, but given only the recent popularity of managers who seek to provide tax alpha and their non-traditional goals, this may be a complicated concept even for a savvy investor. We are therefore offering a simpler solution: measure the lowest value in the selected benchmark since the initial investment of the client's portfolio as the loss capture opportunity. For example, if a client invests $100,000 February 1 and their portfolio value on September 1 is $90,000, their loss capture opportunity would be 10%. This benchmarking concept makes it easy for any client who is looking to hire a loss harvesting manager to ask the following

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simple question: “If my portfolio is down 10% from its starting value, what amount of losses can you capture for me?”. The manager’s answer, if accurate and based on their past ability to capture losses, should be straightforward and easy to understand allowing the client to evaluate their effectiveness.

Benchmarking Past Performance

As with most other benchmarks, data showing past opportunities can be created and the skill of managers who captured losses over past time periods can be evaluated today. As the manager’s selected benchmark during past loss harvesting periods should be clearly stated and the loss capture opportunities are fixed, historical values, the risk of data-mining to create a desired result is highly unlikely. As with most investment strategies, a loss capture manager’s opportunity is always “start date dependent” and care must be used when benchmarking all time periods. Additional investment to the portfolio will have a unique effect on loss capture benchmarking as any new investment will likely introduce the same benchmark member securities but with a different cost basis than existing securities in the portfolio. In a rising market, the additional securities will likely have a higher cost basis creating new opportunities for the manager to capture losses. This a clearly a client benefit, but would invalidate the date of the initial benchmark and the client’s loss capture relative to that date.

A Word About Volatility’s Role in Loss Capture

As volatility is a key driver of available losses, a manager’s ability to capture losses relative to the amount of risk experienced by their strategies and benchmarks should also be considered. This is an additional way to measure risk-adjusted loss capture opportunities among different benchmarks. For example, a manager who is capturing losses in an emerging markets index, likely has a greater loss capture opportunity, but along with that additional opportunity come the risks experienced with investing in a traditionally more volatile asset class.

Selecting a Loss Capture Benchmark

As with many active managers who compare their returns to a benchmark, misbenchmarking or choosing the incorrect benchmark may occur. For example, if you are benchmarking loss capture versus the S&P 500 index, the manager should not own securities from external asset classes such as small cap securities or members of the historically more volatile emerging markets index. Including these types of securities in a client’s portfolio and not in their loss capture opportunity benchmark misrepresents the client experiences and may violate their risk tolerance.

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