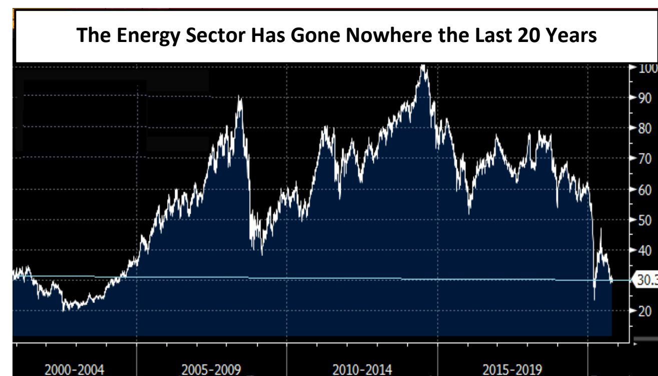
October 26, 2020

Harvesting Strategy

How Sectors are a Sweet Spot to Powering Tax Benefit Capture

The Energy sector did it again. Last week, despite gaining almost 1%, Energy was the sector with the largest drawdown and was the dominant place for Tax Benefit Capture (TBC) in Green Harvest's U.S. Equity Strategy.[1] We've discussed many times how this sector has been a continued source of TBC. Energy has indeed dramatically underperformed for many years now and especially in 2020, leading to the largest disparity among sectors since the Great Depression. In terms of performance, the sector has gone nowhere for 20 years - see chart below.[2]



Of course, for U.S. equity investors to be able to consistently capture tax benefits, they must have an effective mechanism in place. Green Harvest's approach is to build U.S. Equity portfolios using sector specific Exchange Traded Funds (ETFs). Green Harvest monitors positions intraday day everyday and, when opportunities arise, simultaneously substitutes one sector ETF for a similar sector ETF in order to be able to capture tax benefits and maintain market exposure.

Contrast our approach with portfolio construction alternatives at either end of the exposure spectrum:

A) **Broad-based ETFs**, such as the SPDR S&P500 (SPY), combine all 11 sectors into one vehicle thus averaging the investors' returns. With such ETFs, the opportunity for isolating and targeting TBC in any particular sector is therefore limited. For instance, in 2017, the Energy Sector fell steadily for nearly the first eight months of the year, losing over 17%, but InfoTech and other sectors made up the difference, leaving SPY with scarcely any drawdowns. Buying SPY at the beginning of 2017 would have left investors with zero opportunities for TBC.

B) **Direct Indexing**, or owning individual equities, does offer the means to target specific sector positions. However, individual equities may not allow for the type of substitution among similar exposures that ETFs enable. For instance, in the S&P 500 Energy sector, Exxon Mobile (XOM) and Chevron (CVX) dominate, holding a combined 46% weight as of Friday. Investors could sell one stock to buy the other to capture a tax benefit while maintaining sector exposure but in doing so would be exposed to dramatic single security risk. Likewise, simply selling such securities and holding cash-like instruments for the required 31-day "wash sale" period could mean missing a rebound.[3] Substituting among ETFs, on the other hand, enables both of these positions to be simultaneously swapped with minimal variation in exposure. For instance, the top 3 Energy ETFs that Green Harvest currently employs all maintain between a 42% and 46% combined weighting in XOM and CVX. Similar enough to be

[1] Tax Benefit Capture (TBC) in this context refers to the practice of purposely selling positions with unrealized losses to minimize taxes by offsetting realized gains. Green Harvest typically implements a simultaneous purchase in conjunction with each sale to maintain the desired investment exposure.
[2] Energy Sector performance as measured by SPDR Energy Select (XLE) from 10/23/2000 to 10/23/2020.
[3] Per the "wash sale rule," 31 days is the requisite period which substantially identical securities can not be repurchased after having been sold for a tax loss benefit. See https://www.investopedia.com/terms/w/washsalerule.asp

effective substitutes, but different enough not to be substantially identical for purposes of the wash sale rule.

With perfect foresight, investors could have avoided Energy altogether as well as any underperforming sector. Of course, no one can predict which sectors will rise while others languish, and therein lies one of the many arguments for diversification and indexing. What we can say is that the classification of companies into sectors has explained divergent returns better than most other factors. Index investors who capitalize on this as part of a robust ongoing TBC approach can be well positioned for opportunities that can drive their after-tax returns.

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Download Our White Paper: Future Value of Tax Benefits

Market Data Heat Map Summary for week of October 19 – October 23, 2020:

Market Exposure	Sectors/Regions with GHAM Tax Benefit Capture	Total Return (%)	Weekly Max Drawdown	
			(%)	Day of Low
S&P500	**X**	**-0.4%**	**-1.9%**	**Thursday**
Materials	X	-0.4%	-2.3%	Thursday
Energy	X	0.7%	-4.4%	Thursday
Financials	X	1.0%	-2.0%	Thursday
Industrials		-0.5%	-1.8%	Thursday
Consumer Staples	X	-1.2%	-1.8%	Thursday
Utilities		1.2%	-1.5%	Thursday
Health Care	X	-0.1%	-2.2%	Wednesday
Real Estate	X	-1.3%	-2.1%	Thursday
Info Tech	X	-2.2%	-3.2%	Thursday
Consumer Discretionary	X	0.1%	-2.1%	Thursday
Communication Services	X	2.2%	-2.2%	Monday
MSCI ACWI Ex-US		**0.5%**	**-0.9%**	**Thursday**
Asia Ex-Japan		1.2%	-0.5%	Tuesday
Japan		0.8%	-0.6%	Thursday
Australia		0.0%	-1.9%	Thursday
Switzerland		0.4%	-1.4%	Thursday
EuroZone		0.0%	-2.3%	Thursday
United Kingdom		0.2%	-0.9%	Monday
Lat America		4.8%	-1.4%	Thursday
Canada		-1.1%	-1.6%	Friday

Areas with Tax Benefit Captures (TBCs) indicates where individual tax-loss harvest trades were executed in each market exposure across all eligible accounts for period specified.
Max Drawdown calculated as max decline from interim peak to Intra-Day Low.
Market statistics calculated using representative ETFs. Market Data Source: Bloomberg

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Green Harvest ASSET MANAGEMENT

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Hedged Strategies Risk

The Hedged Strategies take "short" positions by selling an index ETF that the client portfolio does not own, which exposes the portfolio to costs and risks that are not associated with owning securities long. Certain of these costs and risks are described in the margin disclosure statement provided to you by the financial institution holding your account, and we encourage you to discuss those risks and costs with your advisor. The following disclosure discusses the risks related to Green Harvest's investment strategy.

A short position has an opposing or "inverse" relationship to a long position on the same asset. Generally, the short index position will lose money when the overall long portfolio is rising in value, and the short position will increase in value when the long portfolio is losing money. This relationship provides the "hedging" aspect of the Strategy. Green Harvest seeks to short an index ETF that is expected to have a strong inverse relationship with the strategy benchmark. If the index ETF underlying the short position

deviates from this inverse correlation to the benchmark performance, then the Strategy will not perform as desired, and you could have limited tax loss harvesting outcomes as well as low or negative portfolio returns. Although the short position is intended as a hedge against negative or low returns of the markets, the Strategy's return may be negative. Any dividends paid by ETFs underlying the short position must be paid to the institution lending the security and thus will not generate income for your account.

Tax loss harvesting opportunities exist when the long portfolio has gains and when the short position has losses. Portfolio losses may result in margin calls from your financial institution, and when you instruct Green Harvest to sell portfolio assets in response to margin calls, such sales could generate taxable capital gainmns. Alternatively, you will be required to add cash to the account in response to margin calls.

Short positions can lead to more volatile performance of the underlying security. In addition, the ETFs underlying short positions may experience periods of low trading volume or reduced liquidity, which would restrict the ability to enter short positions. In these periods, Green Harvest can seek to enter short positions through other available transactions, which may have higher transaction costs. All investments are subject to liquidity risk, especially when markets are not functioning normally. If Green Harvest is unable to acquire or dispose of holdings quickly or at prices that represent perceived market value, then the Strategy will be negatively impacted. Examples of events that can lead to heightened liquidity risk include domestic and foreign economic crises, natural disasters, political instability, and regulatory changes.

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