Market Insights: New Developments, What to Consider, and Top Questions Answered

Week 12, June 16, 2020

TRANSCRIPT

SPEAKERS:

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Colleen Rolph: My focus is to engage customers like you in their finances across our workplace and personal investing businesses. I'm pleased to be joined by Christopher Fusé. Christopher is a Portfolio Manager for Strategic Advisors LLC. He's the head of Asset Allocation for Taxable Assets within Strategic Advisors. In addition to being responsible for setting various tax policies, he also manages our tax-efficient portfolios for managed account clients here at Fidelity. Hi, Christopher. Thanks for being here. How are you and your family doing?

Christopher Fusé: Hi, Colleen. Thank you. We're doing great. Surviving like everybody else.

COLLEEN: I'm glad to hear it. All right. We're going to start out just by talking a little bit about why we think this discussion is so valuable. It's important to have a plan in place that addresses taxes. This is particularly true if the majority of your assets are in taxable accounts. Now the fact is taxes can have a significant impact on your investment returns at any stage of your investing life. That's why tax-smart investing is a key feature of our managed accounts here at Fidelity and why it also can be important to speak with your tax advisor specifically about your situation.

It's also a great place for me to mention that Fidelity does not give tax advice and nothing we discuss today should be interpreted as tax advice. The information we are providing is general in nature and it may or may not apply to your situation. If you have tax questions about your specific situation, we encourage you to talk to your tax advisor.

Christopher, I want to now turn it over to you. And can you start with sharing what we're going to cover today with our viewers?

CHRISTOPHER: Sure. We thought we would give an overview on how taxes affect your investments. Now taxes impact your financial situation across the board, but we wanted to be pretty narrow and focus on thinking about how they affect your taxable investment piece. We want to really try to bring home with the audience how this investment strategy can be used to their specific situations. We know that taxes can have a significant impact on your investment returns at really any stage of where you are in your investment life. I'm running the slide show here.

COLLEEN: Bring it on up.

CHRISTOPHER: Bring it on. Right. Here we go.

COLLEEN: I'm on board for choices to reduce taxes. I'm sure many of our viewers are as well. My first two questions for you are how do taxes fit in with people's overall financial plan? And what are some of the key ways you help people to manage the taxes they pay?

CHRISTOPHER: Sure. Let me forward on to another slide here. You've seen this slide before likely. Before we even get into the tax piece, this is the really, I think, is even more important than any tax strategy that you can go through. It's talking about the bigger picture and really what I do as a portfolio manager for Strategic Advisors. It's important that you have this broader plan in place and not just focus on individual tax transactions. We believe that the long-term allocation that you put forth is one of the most important drivers of helping get to your long-term financial goals. In order to do this, and many of you maybe have done this through Fidelity, maybe you've done this online, but it's really important to get to know—for us to get to know you as a customer and to help fully understand what your goals are. In order for us to do that, it's really vital—really, no other word—to make sure that we understand what your particular situation is, what your timeframe is for your investments, how comfortable you are with risk, how does this affect your overall financial plan. Again, I think most of Fidelity clients have seen or been exposed to this before. But it's really important that this is the basis of any strategy long before you apply any tax-smart investing techniques to it. That being said, I'm going to assume as we go through all these different strategies that there is a plan in place, that you have some sort of a goal that you are managing towards from an asset allocation standpoint, and that's in place and that we're going to be referring back to that.

COLLEEN: Okay. What I'm taking away then, Christopher, is taxes is one part of our broad financial plan, and it needs to be considered in the context of our overall goals, and assuming, as you said, the asset allocation or active asset allocation. Can you elaborate a bit more on what you mean by that?

CHRISTOPHER: Sure. The active allocation really just means that there is a plan in place that says you should have, based on your specific considerations, some sort of an asset allocation goal and that, whether it's 50/50 stocks and bonds or 60/40, whatever it happens to be, that when you look at that goal as a baseline to start with, any changes will be actively positioned against that static type of a benchmark.

COLLEEN: Okay. Asset allocation or investment mix and looking at that. Very helpful. Now, Christopher, can you speak to how much taxes can impact us and why the choices we make can influence the returns?

CHRISTOPHER: Sure. Let's kind of talk about that. Why is tax management or tax-smart investing important? I think when you think about it, I don't think anybody is in a disagreement that this is not a good idea. I think it's just understanding how much it impacts and what those different strategies are. This slide shows based on a Morningstar study going back over the last 92 years, so pretty long term, investors typically give up about two percentage points of their annual return to taxes. I don't know. That's significant. Right? That's a lot of return that you're giving up. And so, again, hypothetical return of 10% in equities falls to 8%, which is basically leaving 2% of investment return out of your pocket. What we're trying to do is to try to bridge those numbers. Really, you can't ignore the tax piece because as you think about your long term investment goal and rates of return that you need to get there, you want to maximize that return as much as possible and taxes tend to have a pretty decent drag on there. What our team does at Fidelity is that we try to put together a long-term plan and then execute it accordingly based on your specific situation.

COLLEEN: Yeah. In thinking about those percentages that you just mentioned, Christopher, if someone has say $50,000, based on what you just shared, that hypothetical return is approximately $5,000 just based on some of those percentages you threw out, and the tax savings is almost $1,000 or thereabouts. I know I certainly don't want to ignore that amount of money. That's important. That's how I work through things in my head. Can we help people reduce this potential impact of their taxes?

CHRISTOPHER: Yeah. Sure. I'll forward onto the next slide here. This is kind of a busy slide, but I want to make sure that everybody understands what this really means. In that prior example where we lose about 2% a year per taxes, I think some clients look at that and say, yeah, okay, that's just the cost of doing business. That's true to some point. But if we can minimize that to a different level, I think it makes a different outcome for clients. If a client, for example, was looking at an index fund that had a 2% fee versus one that they could choose for zero, they would never choose the one with the higher fee. When you think about taxes as being an expense, we're always looking to reduce those across the board on a pre-tax basis. I think this is an interesting slide. Because, again, when you think about 2% in a year, yeah, okay, I don't want to pay that, but maybe it's okay. But let's think about this from the longer term.

And so here's an example of how tax-smart investing, while not maybe large on a year-by-year basis, compounds to a pretty significant amount. This shows a hypothetical example using an initial million-dollar investment in a growth portfolio - a growth portfolio is like a 70/30 stock to bond mix—first in 2002 up to the end of 2018. No contributions. No withdrawals. It's cumulative.

There is some assumptions that are in here that are kind of generic. The tax savings is reinvested monthly and the investors aren't taking their saving money to pay any taxes. But you see the difference in cumulative return is an additional $410,000. That's a shocking number. That's, to me, a lifestyle change. That's your portfolio at the end of this time. I think the numbers go from $2.3 to $2.7 million just from a tax piece. Again, this has a huge impact on getting to your goal. Interestingly, we have the dates here of January 1st, 2002. Why that date? That happens to be the date where Fidelity started calculating after-tax returns. This is actually from our own internal client piece. That's not an arbitrary number. That was something that we worked multiple years on and tried to put together something that we think is an industry leading type of calculation.

Quick story. We were convinced that we were getting some sort of like a duck boat parade in downtown Boston when we figured this out. Now I'm not even sure anybody actually even bought us lunch. This is something that from a standpoint of being able to calculate and to quantify brings home for us this is how important it really is.

COLLEEN: For sure. Thanks for clarifying that [indiscernible 00:09:59]. Because, to me, this line is really showing the overall power and value of tax-smart investment management, to your point. That 2% can add up. And bringing it closer to reality for me, for instance, even at a smaller investment amount of $100,000 versus $1 million, that's approximately a $41,000 increase. To me, it adds up quickly. Christopher, let me ask you then. How do the types of taxes in your tax rate impact what we're talking about here?

CHRISTOPHER: Sure. Okay. We know the why, why we want to approach this as a tax-smart investing process. Let's kind of talk about some of the rules. When you look at the different types of gains taxes that are out there, we have long-term capital gains, which is kind of our favorite thing because it's usually one of the cheapest rates that are out there. Right now, long-term capital gains and qualified dividends are around 23.8 as a maximum. This is federal. Right? There's state and there's local taxes that take place. Folks, I think you know that states have some very large state taxes and other ones that are certainly much more nominal. But when you get to the short-term side, short-term capital gains are also taxed the same as interest and non-qualified dividends, basically the same as your paycheck with your last dollar, so that rate when you throw in taxes. You see a difference between those rates and that's something that we want to use as part of some of our strategies that we'll get to in just a few minutes.

COLLEEN: For sure. I mean, that can make a big, big impact just in federal and then when you add savings, Christopher.

CHRISTOPHER: Right. Again, it's important—it's vital. I don't want to say it's important. It's imperative that you know where your rates are. Because as we get through some of these examples, if you're off or you make assumptions that aren't accurate, it can change the outcome of what your investment decisions are going to be.

COLLEEN: I completely agree with you. Now that we understand how taxes fit in with your overall financial plans we've been talking about over the past few minutes and the extent that they can impact us, let's transition to how people can manage these taxes. Can you start us off with what people should be considering first?

CHRISTOPHER: Yeah. One of the things that we also look at is trying to figure out where taxes have been and where they're going. I throw this slide up just to kind of put the current tax rates into a longer-term context. As you can see, there have been periods of time when rates have been very high, they've been very low. They have moved all over the place. One of the things that we try to do also is to adjust any changes that take place with your tax piece. Going from there, I think we want to start to think about—and questions that I think clients should be thinking about themselves—do you know how taxes affected your portfolio last year? Now we're in a very unique situation right now where the tax—your taxes actually aren't due until July 15th. If you're like me, you wait until the last possible day or the last possible weekend to do that. Maybe you don't know how they affected or impacted your portfolio last year, but when you go through your taxes or you're getting them back from your tax advisor, this is a great opportunity to take a next level in and see where and how taxes affected your portfolio last year. The second piece to talk about is how concerned are you about taxes? Are they taking a very large bite? Are they taking a very nominal bite? Again, something for you to figure out. Taxes are a very personal thing, so you come up with that piece on your own. And then the last part is do you know how to create or plan to manage deferred or reduced taxes and kind of use the tax-smart investing techniques, which we'll certainly walk through.

COLLEEN: I mean, Christopher, the first thing is I'm glad to know I'm not alone with procrastinating and/or waiting until the last minute for my taxes. I'm with you. But in terms of these three questions, you know, I'd answer them, first, I don't know, I don't have an idea of how the taxes impacted my portfolio last year, and I am very concerned about taxes in general, and I don't think I'm alone in that category, too. I'm sure some viewers can relate to that. I don't know how to create a plan. Let me start with what's the best way for people to figure out how taxes impacted them last year?

CHRISTOPHER: Yeah. I think the best way is if you have the tax advisor—I think this is where you want to spend an extra few minutes and just ask that question. Whether your tax advisor is formal, whether it's the cousin or the neighbor down the road, ask that question. Can you tell me how taxes impacted my investment piece or how my investments impacted my overall tax piece? I think you'll get kind of a crash course on significant, not significant, where that all plans out. If you do your own, though, if you're doing TurboTax or something like that, it's usually pretty easy to find - it's the Schedule Ds, maybe the Schedule B on part of it - and just looking through there and seeing where the capital gains piece adds up and how that affects it on your main tax report. You can get a really clear understanding very quickly that, wow, that was more than I expected. There is not that much—kind of just getting an idea. Checking with that advisor, that tax advisor or pulling out those old tax returns will give you a huge, huge advantage.

COLLEEN: Yeah. That's really helpful. I think I'll be checking in with mine because I usually only focus on one or two numbers there.

CHRISTOPHER: Right.

COLLEEN: Let's spend the bulk of our time then, Christopher, on the remaining third question there and specifically focusing on the management piece. What are some key ways that people watching can manage their taxes that you'd share today?

CHRISTOPHER: Sure. Normally, this is the don't do this at home. No. This is what you should be doing at home piece. These are the strategies that we use in our client portfolios, so please take these—take all the details on this and really apply this to your own situation. We use really six key techniques. I'll just read them off here. I think they're mostly self-explanatory, which is tax-smart transition management, tax-loss harvesting, capital gains, exposure to—and kind of in the withdrawal stages of your portfolio—tax-smart withdrawals.

COLLEEN: To me, I've heard of some of these but not all of them. I'm going to need details here for everyone watching. It's where the rubber meets the road, Christopher. Before we talk about these six items, is there a cadence or frequency that people should be considering each of them or, for example, is it once a year at tax season? What do you recommend there?

CHRISTOPHER: Sure. It's going to, of course, be different for every person because if you're in the accumulation phase course of your investment cycle, the withdrawal piece may not mean too much, or if you're already in a managed account program, the transition piece might not be very important. But the tax management cannot be—it must not be a once a year or a once a quarter piece. It is an ongoing constant piece. That's really—going back to that $400,000 piece which sticks in my mind of that excess return. To get that substantial piece, that percentage of excess return, these have to be applied constantly. It sounds like a lot of work, but we'll walk you through and kind of show you when you need to be part of that.

COLLEEN: Yeah. That makes sense to me because, you know, at the end of the day, I do look to save money throughout the year, so why would taxes be any different? That's the way I look at it. Let's now turn to those six ways and start with the tax-smart transition management, as you said. What is it? How should people think about this choice?

CHRISTOPHER: Sure. Okay. The tax-smart transition piece really is, if you think about it, it's a way that we may be able to reduce taxes that you pay by aligning your account from where it is right now to where that ideal portfolio should be. When we talked before about having that overall asset allocation plan, this is kind of that piece when you're starting out. When you're thinking about that I need to be in a 50/50 portfolio or whatever that combination may be, we're going to look at your existing positions and see how we can transition those into that new portfolio. Now this slide shows, frankly, what a lot of our competitors would prefer that you do, which is sell everything and then move into the best ideas right off the bat. That's not necessarily good for you, by the way, but it's not something that we think is the best outcome for our clients.

COLLEEN: It's not all about making it easy for you, Christopher. Come on.

CHRISTOPHER: I understand that. What we look to do is that if your current portfolio, which typically has a lot of stuff in it, a lot of different types of stocks, bonds, bond funds, ETFs, whatever the combination is, we look through and can bring in over 20,000 different individual securities. That's a lot. You look at each one of those based on the pre-tax merits and then what the tax consequences would be on selling that and oftentimes we can incorporate a part of those securities into this new portfolio. We don't have to sell everything and then start brand-new. We can actually save potentially a bunch of taxes by moving in—by using some of your funds or positions and then just really building the rest of the portfolio around them. Clients money on [indiscernible 00:19:38].

COLLEEN: When I'm thinking about this, Christopher, what you just shared, I can't imagine anyone wants unnecessary tax consequences, so things that you've bought, and some may even be thinking about investments that have made them a lot of money and that there might be an impending tax bill. I'm thinking you've heard this from clients before.

CHRISTOPHER: Yes. Unfortunately, not always with a great outcome. Oftentimes, we'll see a portfolio that comes over to us and there's one or two positions out of the majority of the assets. I look at an account that came in the other day that was mostly Apple and they did really well. We ended up selling a big chunk of that. We had the conversation with the client beforehand saying, look, you've—I think they were up 10 or 11 times on their initial investment. Great return. But here is a position that it doesn't fit into the portfolio because you have now told us that you're moving on in your investment cycle and you need some income and you need safety, and so we would be willing to go ahead. But I do remember—this is a story that haunts me still—that back in the late '90s, we were out visiting a branch and we met a bunch of clients who were working for a technology company and we were telling them about how diversification is a good thing for clients, how it's safety, and they were looking at us with kind of a skeptical eye. Their portfolios were essentially 90% plus one stock. They had gone very—they just didn't want to—they thought that would continue. Of course, that was in, I think, the late 1999 or so or mid 1999. The next year, that stock is down 80%. I still can see the people. I can see the dreams that they had where this was going to go. We look at a gain like that as an opportunity to celebrate. Like, hey, look, paying taxes isn't the worst thing. This is not a tax avoidance service. It's tax smart. Sometimes being smart means taking taxes.

COLLEEN: Yeah. [indiscernible 00:21:51] that one. That's a really tough one. I can see why it's haunting. No one likes to be in that position. I can say, right, that it may happen at any time with any organization. I think we both have seen that over the years. Tax-smart transition management is worth considering for your future in this case. Which speaking about returns, I've got to come back, can you share with our viewers about the capital gains, which is the second way to manage taxes?

CHRISTOPHER: Sure. Capital gains, very generic term. What we're really talking about here is, okay, let me give you the background on capital gains. A capital gain refers to the amount by which the selling price of an asset is more than the tax basis, or usually what you bought it at. Usually, you pay tax on it, unless there are losses that are out there to offset those. Remember, as we talked about before, short-term capital gains get taxed at your ordinary rate. Long-term capital gains usually at a lower rate. Here is an example of a $10,000 hypothetical pre-tax gain. At the left-hand side is a short-term—the impact of taxes on a short-term gain. Now why we're bringing this up isn't to show the difference. I think everybody can pretty much do the math on this. We wanted to run a scenario by you that comes up to us very often. Let's just do a quick recap of the math here. In this case, on a short-term gain, the client basically $10,000, keeps $5,920, $4,080 goes off to the Treasury Department. If that's a long-term gain, based on the highest tax rates, again, at 23.8%, $7,620 stays with the client and then $2,380 goes off to the Treasury Department. The interesting part of this and where this comes up in our portfolios is that, okay, clearly, I want to be on the right, but what happens if this is 300 days into the year of owning the security? What's the risk trade-off—excuse me—of holding onto the position versus selling it right now? This is one of the dilemmas that we go through all the time is can we wait. This is an example of a client who held it for 300 days. What is the risk considerations that we want to take for hanging on for another 66 days? When you think about the difference in return, it's pretty substantial. In many cases, it's okay for us to wait until that happens. We monitor the risk on these very closely. Occasionally, this is something that we want to actually take that short-term gain on. But most likely, it's a very difficult hurdle to have to overcome just to wait that 66 more days.

COLLEEN: Yeah. Logically, it makes sense to me. Just waiting that extra two months or so in your example can save on that tax bill as we can see in the graph. Given, though, the market goes up and down, we've seen it a lot of late, who may be in the best position to leverage this technique?

CHRISTOPHER: Sure. Anybody who has a difference in a long-term gain versus a short-term gain. If your taxes are substantially different, that's when that trade-off is certainly going to be something that you definitely need to consider. Now some of the times when you do this, it's a no-brainer, like 364 days, I can wait for two more days and it's really not going to be a risk. But again, it's something that any time you're taking—you're looking to take a gain in your portfolio, look to see is that long term or short term. If it's long term, no problem. It can't go short term from there, so that's the taxes you're going to pay. But if it's short term, what is that timeframe? What is your need for those dollars? If it's do you need it for something that's immediate? Well, then you pay the short term. But if you can, you can substantially reduce your tax impact by waiting for those extra days.

COLLEEN: For sure. It's really good information. Now we're going to transition over to the third item here, exposure to fund distributions. What should people consider with this one, Christopher?

CHRISTOPHER: When we think about fund distributions—there we go. I was just buying time for that. All right. Mutual funds—when you own a mutual fund, any trading that takes place within that mutual fund that causes a gain, so if they sell a stock that they bought years ago and there is a capital gain, or if there is a dividend, or an interest payment, that has to get passed on to you. Mutual funds—open-ended mutual funds are a pass-through security. They have to give you whatever the gains that they realize. We think that—the chart that we're showing up now is very generic and just basically shows that distributions happen throughout the year, but capital gain distributions, which can be the more substantial ones, typically happen at the end of the year, individual securities that they bought and sold at a gain. Different types of these securities have different types of impacts. When you see the greens, the qualified dividends are usually, again, as we talked about before, pretty low on the scale of tens and zeroes, sometimes 15, sometimes kind of high at 23.8. For dividends that don't meet that criteria, the qualified, then this ordinary, which is the darker green, again, now you're at your ordinary income tax rates. And then the capital gain piece makes it a little bit more interesting because you can get a combination of short and/or long-term distributions, each one having a different tax impact. We talked about long-term rates, short-term rates. Depending on your current tax rate and how you expect the fund to perform, what your embedded gains are, how long you've held it for, it might make sense—might—to trade the fund before a distribution or to make a charitable contribution using that position. That could actually potentially lower the associated tax bill.

COLLEEN: Okay. I'm thinking about all that you just mentioned. Do you have any tips to share on how to stay on top of these distributions? That's key there.

CHRISTOPHER: Absolutely. Because it's all about the information. Right? You don't have it, then you can't make that decision. This has changed over the years. Now most, if not all, providers—I don't want to say all. I would say the vast majority of providers, mutual funds or ETFs, will make public before distribution takes place the amount and the type as well as the date of the distribution. Now you know that on December 1st, you're going to be paying out a $2 distribution on the next investment. Now you can look to see to your portfolio and say it doesn't make sense to move out of that position beforehand. It doesn't make sense just to eat that distribution. It doesn't make sense to make a charitable donation to that for that security. Information is key. Once you get all that information, then it's really just going to the websites or calling the 800 numbers. Once you get that information, you really can then figure out your best course of action on your own particular portfolio.

COLLEEN: Okay. That's a good tip. We're about halfway home here having covered the first three ways of managing taxes that included tax-smart transition management, capital gains, and exposure to fund distributions. Christopher, we're going to now move onto the fourth way with municipal bonds.

CHRISTOPHER: Okay. This, of course, applies to the fixed income side of your portfolio. You get more over there. The tax piece is always interesting when it comes to municipal bonds because your first instinct—and this is showing two bonds, one with a 3% - a municipal bond with a 3% yield and a taxable bond with a 5.1% yield. This will start to give you an idea of, wow, what are my different choices that are out there? Remember, municipal bonds are generally exempt from federal taxes. It doesn't really matter whether you purchase them through a fund or an ETF or a separately managed account. It is purely a function of your tax bracket, which, again, you need to know your tax information to make these decisions because this one especially can make a very large difference. Additionally, if you own a municipal bond in your primary state of residence, that income may also be exempt from state and local taxes. It's kind of an icing on the cake here. When you see—oh, sorry. This is what happens when you talk with your hands.

COLLEEN: I'm with you there.

CHRISTOPHER: I'm flying around over here. Okay. Here is an example of you see a bond yield, a taxable bond, whether it's a government or corporate, it doesn't really matter, with a 5.1% yield and a municipal bond with a 3% yield. You're like, oh, I want the 5.1. That's higher. Right? But in reality, if you're in the highest tax bracket, in this example at least, they give you the exact same yield. Now it's a question of why would I want one versus the other? Well, municipal bonds tend to be of a higher quality. Right? If you own a New York State bond, one of the great things that they could always do to pay off their bonds is they could raise taxes. Right? You have a different type of credit quality. It may be, in this case, a double B bond or something that has more of a potential credit risk. Maybe you're not getting—it's a wash on the yield piece, but maybe you're actually getting a higher quality position when it comes to the municipal bond piece. Clients also like to feel like that they should have all their money in state munis. Right? The state piece is I don't want to pay taxes on the federal level. I don't want to pay it on the state level either. We approach this in maybe a little bit different way. We certainly agree that the state piece is an important part of your municipal bond portfolio if you are in a high tax bracket state, but sometimes balancing it out with some national exposure might actually end up being better off from a risk adjusted basis.

COLLEEN: Yeah. That balance seems to make sense. What are the pros and cons, though, Christopher, of state versus national muni bond exposure here?

CHRISTOPHER: Yeah. Again, the state piece, the benefit, of course, is that you're kind of free of taxes all the way through. You have no federal and no state, potentially local, maybe, it depends on where you are. But it increases risk. Again, I'm pushing three decades managing money or being with Fidelity. This is probably the only time I could actually say right now is one of the situations where individual state munis have potentially more risk than they have in their past. Think about COVID right now. Obviously, we're all part of it. We've all been locked down. We've all been quarantined. What happens if there is a particular state that has a flare-up that has to shut the state down for three more months? That could wreck the finances of that state and really affect the municipal bond piece. It's not something that might affect two states over. It's only going to affect that one or maybe a neighboring state. Having national exposure, this is one of the really important times to be able to have a diversified portfolio giving you really that extra benefit. It's the risk piece. I think right now is this is where that's shining out as a potential benefit for you.

COLLEEN: For sure. Understanding what's going on [indiscernible 00:33:30] and how that's impacting there. All right. We're going to now move into the fifth way to manage taxes, which is tax-loss harvesting. Christopher, can you tell us what it is and why our viewers should consider it?

CHRISTOPHER: Sure. I'm going to spend probably the most time on this set of slides because, well, it's that important. This is the part where when you look at all the graphs that we showed you beforehand on the accumulation piece and how you've got all those extra dollars, this is really the cornerstone of it. It's also, conceptually, probably one of the easiest things to think of. But in reality, it's one of the most difficult things to do. I'll show you why. Tax-loss harvesting refers to selling an investment in an asset like a stock or a bond at a loss. That loss you can either first offset any gains, maybe potential income, and then if you have more than what you need to offset things, you can carry these forward in future years really indefinitely. This is really our most powerful way of letting you keep more of what you've earned. This is, again, this is that important. I think if you walk away with any strategy, this is the one you really want to do. Really effective during volatile markets. Over the past few months, this has been bread and butter for us, to say the least. Again, the idea—and I'll show you some slides on how this works on a portfolio basis—is very powerful.

Let's take a quick look before we go there. One of the things you can do that the IRS allows is that if you have a loss, you can use—and if you've offset any gains, you can actually use that loss to offset up to $3,000 worth of income. Now you think about that, you go, no, that's nice, but if I have $100,000 in losses, it's going to take me 33 years to offset all of that income. That's not very effective. Well, keep that in mind. We'll show you actually how you're typically going to use that in the portfolio context. Let's look at, okay, yeah, let's look at this first example. It's a client, they have two investments, Investment A and Investment B. They look at Investment A and they're both at long-term gains. They've held positions for long term. The first one is at a $5,000 gain. She is willing to sell it and wants to pay—and is willing to pay the tax. The tax on that at the current tax rate equals out to be about $1,190. Well, she just did this seminar—or webinar, I should say and said, wow, I remember, I should go look to see if there's any losses in the portfolio. Lo and behold, the other investment that she has, Investment B, is at a $4,000 loss. She says, you know what, I'm going to sell that position, too. That takes that $5,000 gain minus the $4,000 loss, nets. And so now you have $1,000 gain, which instead of paying $1,190 in taxes, you're now paying $238 in taxes. It's a nice way to kind of reduce that tax liability by just looking around the clear portfolio.

COLLEEN: Yeah. I was going to say because I do love this technique. I mean, we all have gains and losses and it's using your losses in a very smart way here. But my question for you is are there any pitfalls that you've seen that customers should watch out for here?

CHRISTOPHER: Yeah. There's a few. One is there is a lot of information and data that you have to keep. Right? The good news is that all the investment firms, Fidelity included, keep very detailed accounts of what your cost basis is and what your gains are. One of the things you have to be super careful of is, maybe you've noticed this on your 1099Bs, we actually now, we being Fidelity, when we report up to TurboTax or somebody like that, it's actually sent to the IRS. The idea is if you are on that long-term gain and you said I bought this at $10, now it's at $20, you can't say I bought it at $500 and now it's at $20 and I have a gigantic loss. You can't make stuff up. The transparency in keeping this as accurate information as possible is vital. I think it's super easy. When I do my taxes, I use TurboTax. I take all of my Fidelity stuff, it gets downloaded and populated in about 30 seconds, and it's all there and it's accurate. That's a big one.

The other piece is that when we start to move this out to a portfolio context, if this were—kind of think about this in just one small space of large cap growth and large cap value. You're selling your large cap growth which has done really well recently at a gain but your value really has been lagging like many clients, you want to make sure that this stays—you're keeping your portfolio integrity intact. If you have a plan, which, again, going back to what we said before, you really should have that plan, that we're not violating that plan and that you're taking that loss and being able to redeploy those assets to make sure that you're truing up the rest of that portfolio.

And then the last piece is wash sales. I think everybody has heard of a wash sale, but it's kind of a weird term. Right? It basically says a wash sale is if you repurchase a substantially identical asset to the one that you sold 30 days before or after you sold it, you can potentially negate that capital loss. It's something to be careful of. Again, talk to your tax advisor if you're unsure about what that actually means in your particular circumstance. But it's something that you just want to be careful of and look out for.

Let's get into this in more of a portfolio context and how we think about this. Here is a situation where going back to 2008, if you remember the Great Financial Crisis and invested through it, there were losses available essentially everywhere. It didn't really matter what you owned. It probably went down. Here is an example of a client who took a $10,000 net loss in 2008. I'm not going to get into to writing off of income on things. Picture this as an example for just your investment portfolio. That client ended 2008 with a $10,000 loss. They carried it forward to 2009. In 2009, the markets did rebound. Right? They had a big discrepancy. You ended up recognizing $2,000 in capital gains. No tax on that because you have this tax savings account that you're carrying forward. In 2010, that $10,000 loss carried forward minus the $2,000 is now worth $8,000; 2010 was a decent year, too. Now you recognize some more gains, $3,000 worth of it. Now your loss carried forward for 2011 is now $5,000. And again, see how this runs up to 2012. The idea is that following a year, a substantial year in losses, that investors might be able to use those losses to offset gains from numerous years. This goes back to that whole piece of allowing you to keep more of what you earned. That's a compounding effect. That's a very powerful way to be able to help with wealth generation. Right? This is what it's all about. Right? Going back to that 10% return versus an 8% which you kept, we can get closer to that 10%. You're going to get to your goal a lot faster. This is a marvelous way to do it. We think that this is a really good way to be able to defer paying taxes really as long as possible. Again, that's the tax-smart piece that we're trying to do.

We're not trying to use all of your losses up in one year just to market or to call it even. We want to see that credit available to you for as long as possible.

COLLEEN: Yeah. Christopher, I'm all for the compounding piece, as well as on the flip side deferring paying taxes if there's no penalty for sure, too. You did mention risk, though. What should people consider?

CHRISTOPHER: Let me forward to look at one more slide because I think this gets into maybe what you're asking here. This is an interesting slide. It shows a number of things. The red and the green lines are the annual returns of the S&P 500 for going back to 1980. You see a lot of green there, first of all. I think that's one of the most interesting things that you're going to find. The blue dots actually show the maximum drawdown that the market had in that given year. If you look at 2009, for example, which is right here, you ended up almost 30%, but at one point you were down 27%. Right? The idea—this goes back to what we talked about before of that you want to make sure that you're watching the markets on a more active basis. Again, when you see that the S&P has certainly returned—has been up much more than it's been down. The intra-year pieces are there. Even if you're in a bull market and there are numerous bull markets that took place through here, the average drawdown in any given year is 14% since 1980.

COLLEEN: The green. It is [indiscernible 00:43:19], to your point, Christopher. It makes me think, though, not everyone watches the market closely on a regular basis. I know I'm certainly in that camp. Which leads me to ask who is most appropriate to use tax-loss harvesting realizing that?

CHRISTOPHER: Yeah. Anybody who can benefit from kind of this type of a strategy. I think it's really anybody. Anybody who has gains and losses and is in that higher tax bracket piece, this is really true for almost anybody. One of the things is that you asked about the risks before. One of the things that we see happening is you've got a nice long bull market over here. The market goes down. What do you do? This is, I think, the biggest mistake that clients make. This is why I said it's very difficult. So far, it makes sense on how to tax-loss harvest. But to anybody who is listening who was watching their investments in March, who went in on those really dark days and looked at their portfolios? Right? In many cases, it was I'm going to go walk the dog. I'm going to go do anything else but have to acknowledge my investments just went down. I mean, tax-loss harvesting is really just an acknowledgement that you've lost money on your investment. Right? It's an emotional thing to have to go in there and say, you know what, I'll check back tomorrow. Right? You want to be able to—you need to be able to check your investment ego at the door on this one. To get that compounding effect, to get those types of returns that have helped you from an after-tax standpoint, you need to not listen to the it's only a loss if I sell it type of story in your head. I'm sorry. The market value is what the market value is. You at least now have an opportunity to claw some of that back. And so I think that's the part that is really difficult for clients. Again, ask yourself in March when everything was going down, oil went negative, interest rates went negative, did you pull up your equity portfolios or your other positions and sell things at losses because that would have been the right thing to do. We were doing it. Right? We were doing this. We don't have a lot of remorse or emotion attached to this part of what we do because it's very easy. It's very easy for us to go and see a loss and then take it. I'll go back to 2008-2009. In early 2009, remember the market bottomed in March, clients were saying stop. We just don't want any more losses. We're never going to use them. Well, look at some of these returns since then. I'm sure there's a lot of clients who are saying, well, do you have any more of those because I've been used to getting my—having my after-tax return be very close to my pre-tax return.

COLLEEN: Yes. To your point, mine is personal and emotional. Sometimes it is hard to check it at the door. That's where we can certainly help in looking at it through a different lens. Christopher, realizing the time, I want to share with everyone our sixth and final item, that tax-smart withdrawal. Can we move into that item for everybody?

CHRISTOPHER: Absolutely.

COLLEEN: Great.

CHRISTOPHER: Okay. One of the things that I don't think most people think about from a tax management standpoint. I think you think about this during an accumulation phase, but it's even more vital and more helpful to apply these strategies when you're looking at the phase of your life when you're starting to take money out. It's really—the impact on the withdrawal piece stays consistent with whatever your goals are and as your goals change, which I think is the most important piece that you can think about when it comes to tax law withdrawals. Let's look at this real quick. Okay. Now you're at the phase where you want to take money out of your account. Choosing what investment to sell when you're doing this can make a huge impact on your investment mix and what you pay in taxes. This can impact the level of risk in your account and potentially even impact your account value. We use the same variety of things that we have just walked through in terms of tax-smart investing techniques to make your withdrawal a smart withdrawal from an after-tax standpoint. We rebalance. We can help maintain the level of risk in your account. Again, keeping you on that plan. Obviously, we'll get to some of the basics. We'll try to sell things on a long-term gain rather than a short-term gain. At that point in your life, long-term gains are usually going to be at a lower rate. We may sell a position in a fund before it generates a distribution, a large taxable distribution. We maybe use dividends and distributions to reach distributions in mutual funds in our program. We use that cash as ability to plug and pull. It's the same strategies that we've used before in the accumulation stage. It works just as effectively on the withdrawal stage.

COLLEEN: Yeah. Christopher, you've given us an awful lot to think about and consider to manage our taxes, which, again, include, and I think you're going to bring up the slide for us, which is the tax-smart transition management, tax-loss harvesting, and the use of the loss carrying forward to reduce future taxes, managing capital gains, managing that exposure to fund distributions, investing in tax-exempt securities, and finally that tax-smart withdrawals which you just ended on.

At this stage, just looking at the time, before we jump in there, all of this, to me, has brought to light that effective tax management, as we mentioned earlier, is an ongoing process and throughout the year, not just during tax season. I know that's a takeaway for me and for all of us to consider. And realizing, I think we probably have time for a couple of questions, Christopher. You have a few minutes still.

CHRISTOPHER: Absolutely.

COLLEEN: We'll transition into Q&A. Okay. Great. This is the final section for today. Like I said, we did receive lots of questions here. Based on the time, we'll probably address a couple, a handful here, and then we'll wrap it up. The first question for you, Christopher, is with the onslaught of the pandemic and the dramatic decline in the markets, no surprise here, right, what has that meant for tax management within a typical investing strategy and what are opportunities and challenges that have been looked at there?

CHRISTOPHER: Well, okay, that's a good question. This manufactured recession and then manufactured upturn made the speed of this, as everybody who has watched the markets, you saw how fast it went down, how fast it bottomed, and how fast it returned. And so the opportunity for us was how do we get all of our clients to be able to participate in our favorite thing, which was slide number five, which was tax-loss harvesting, and being able to recognize those losses, keep those portfolios intact. I'm going to give like just a kind of a hypothetical example here. The markets went down. A lot of our clients at that point, because equities were going down faster than anything else, that 60/40 portfolio maybe wasn't 60/40. It was probably lighter on equities than what the benchmark, than what the idea was, the ideal portfolio. When we sold those positions at loss to capture those tax assets, we also sold some fixed income and rebalanced the portfolio back to where it was. When the market did a complete V-shaped recovery on this one, we were able to have clients participate fully on that upside. The speed made it very difficult for us. A lot of folks on our team transitioned to working from home while all of a sudden having to then deal with this onslaught of speed in the market. That was tough, but we did it. We've been doing this for many years. We have the process down. I think that for the average client, they saw a really decent tax asset. Again, not everybody, but the clients who were able to—who had the cost basis in that negative area. They were also able to participate on that upside on the way up. It was rough. It was fast. It's still moving along at a quick pace. But during that initial piece, we definitely recognized a significant amount of tax assets for the clients.

COLLEEN: Yeah. For sure. Nothing faster. Good ways to describe it in these unprecedented times. Christopher, I think we'll do one more question just given the time and then quickly wrap it up, which is—the second question is how can charitable giving help from a tax perspective?

CHRISTOPHER: Oh, gosh. That's a good one. Charitable giving, when you think about this, is something that I think has to go hand in hand, providing you're charitably inclined. This is a way for us to think about a highly appreciated asset that you are looking—that may be sold for a number of reasons, just reconstructing the portfolio for quality reasons. You have an opportunity to then donate that security to a 501C3 and you can get a tax deduction. The tax deduction is based at your income tax rate. Now you have that. We talked about where income tax rates or short-term rates are. You then avoid also paying the capital gains tax on that. Right? You're getting kind of a double whammy on this one. And you're giving to a charity. The altruistic part of this is incalculable. If that happens, I know we think it's so important that in our service, if you're a client in our managed account service, if you emailed your rep and said, hey, look, I want to make a $10,000 donation to whatever the charity is, Fidelity charitable gift or whoever it is, we will have an investment manager walk through the portfolio and say I think this is the position or the positions that we should move. It's a recommendation. You don't have to follow it. You're getting people—you're getting portfolio managers who are on this account specializing in tax management giving you their best advice or their best recommendations. I think it's a powerful way to enhance that after-tax piece and still do the right thing.

COLLEEN: I would agree, Christopher. There's a trifecta of the win-win-win, as you said, with that last question. Thank you very much for addressing some of the Q&A we received from our viewers. We did receive a lot of questions and only had time to answer two today given the time. If we didn't address your specific question, please contact your Fidelity advisor or representative and they'd be happy to discuss it with you. Christopher, at this point, I'd like to say thank again for being with us today.

CHRISTOPHER: My pleasure. Thank you, guys.

COLLEEN: Yes. And thanks to all of you for watching today's webinar as well as those who did send in the questions. We hope you found the information informative and it demonstrated the value of tax smart. Remember, if you do have tax questions, please consult your tax advisor. If you have retirement or investing questions, please give us a call here at Fidelity. I encourage you to set up an appointment. Hoping you and your families are staying safe and healthy. Until next time. Thanks.

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