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Just How Valuable Is Tax-Loss Harvesting?

Research suggests that investors can get substantially higher returns by selling loser stocks and using the losses to offset their capital-gains tax liability

The writer, a finance professor, measured how much investors can benefit from offsetting their capital-gains tax bill. The floor of the New York Stock Exchange in November 2018.

PHOTO: RICHARD DREW/ASSOCIATED PRESS

By Derek Horstmeyer

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Investors looking to improve their overall portfolio returns often turn to tax-loss harvesting at the end of the year. This amounts to selling some stocks or assets that have fallen in value and using the losses to help offset capital-gains tax liability, reducing one's overall tax bill.

But how much can you actually add to your returns by tax-loss harvesting?

My research assistant Kanwal Ahmad and I decided to tackle this question by running simulations over different tax regimens, portfolio sizes and holding periods. We found that on average an investor facing a capital-gains tax rate of 25% can juice an equity portfolio's annual return by 1.10 percentage points to 1.42 percentage points with tax-loss harvesting. The value that can be added is even greater when markets are more volatile, thus producing a bigger number of loser stocks, or when capital-gains tax rates are high, either because the federal government raised rates or an investor is selling short-term holdings.

To explore this issue, we pulled data on all publicly traded stocks on the New York Stock Exchange, Nasdaq and the old American Stock Exchange (which was acquired by the NYSE) going back to 1930. We then created value-weighted portfolios to mimic how most people invest, and ran extensive simulations of each portfolio on how to best tax-loss-harvest. Each simulation we ran sold off particular positions that had incurred losses according to various cutoffs. If a losing position was harvested, we added a similar asset to maintain the portfolio's asset-allocation mix and risk level—though any position that was tax-loss-harvested wasn't allowed to re-enter the portfolio until a month later in line with the IRS's wash-sale rule, which says if an investment is sold at a loss and then repurchased within 30 days, the initial loss cannot be claimed for tax purposes.

The calculations

We then calculated the value of tax-loss harvesting to an investor on a yearly basis as the capital-gains tax rate multiplied by the return of the stock that was cut from the portfolio, adding this up over all stocks that were harvested that year. Averaging this over all simulations and over all years, we were able to come to a maximum estimate for the value of tax-loss harvesting. To make it a bit more realistic, we put in a condition that no more than half the portfolio could be harvested in a particular year—this we defined as our "conservative" estimate of tax-loss harvesting benefits.

Our first interesting finding is that conservatively, investors can juice their returns 1.10 percentage points a year on average, assuming a 25% tax rate. If investors are pushing it in terms of taking advantage of every tax-loss harvesting opportunity, they can add as much as 1.42 percentage points a year to their portfolio's return.

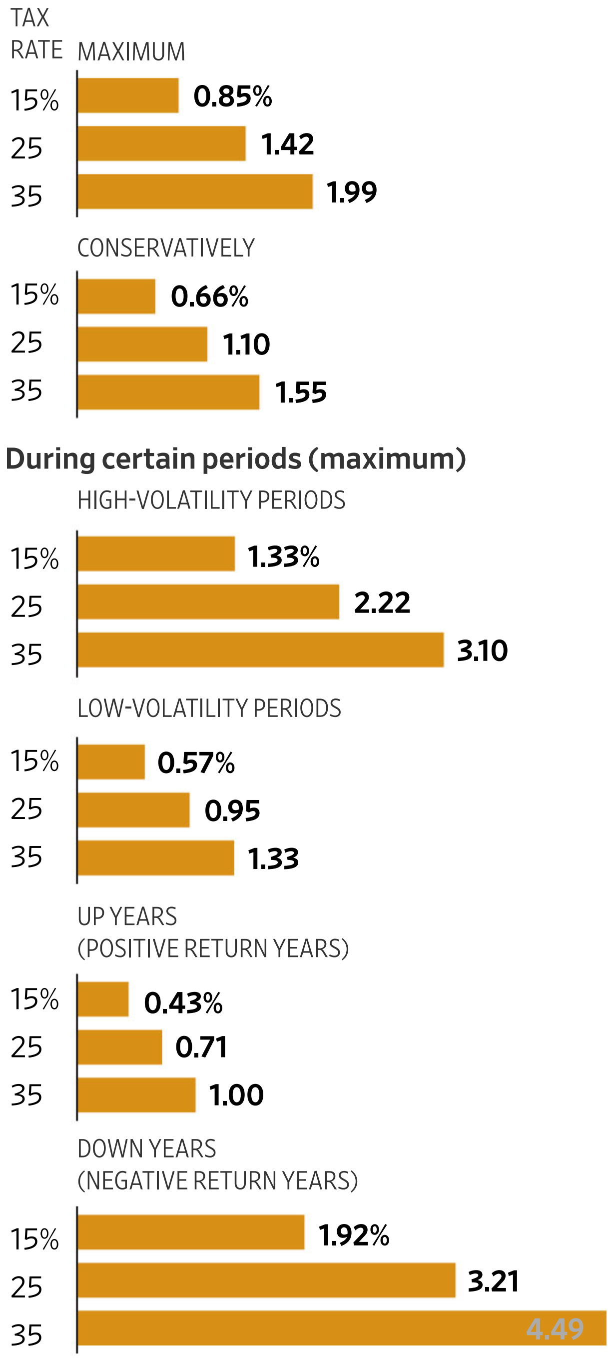
Not surprisingly, investors can reap the most from tax-loss harvesting when the stock market is having a down year. During years when the S&P 500 yielded a negative return, we estimate that the average benefits of harvesting losses amount to 3.21 percentage points of additional return to one's equity portfolio (assuming a 25% tax rate).

Good during volatility

In decades when the S&P 500 exhibited higher-than-average volatility, the average investor can realize 2.22 percentage points a year in additional returns via tax-loss harvesting (assuming a 25% tax rate), whereas low-volatility periods yield only 0.95 percentage point a year in tax-loss-harvested returns.

Harvest Time

Average tax-loss harvesting returns



Source: Derek Horstmeyer, George Mason University

It should be noted that each individual's tax-loss harvesting situation is highly personal. For example, investors facing high short-term capital gains, which are taxed at a higher rate, in particular might benefit from tax-loss harvesting. Next, these results mostly pertain to high-income earners and those who plan to hold on to their winning stocks well into their retirement years (and possibly turn over winner stocks to heirs, taking advantage of the tax exemption for investment gains known as the step-up in cost basis).

Most important, these results highlight how much investors should be paying their asset managers to tax-loss-harvest for them. If an asset manager is charging more than 1% of assets under management annually to tax-loss-harvest your equity holdings, it may not be worth it.

Dr. Horstmeyer is a professor of finance at George Mason University's Business School in Fairfax, Va. He can be reached at reports@wsj.com.

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