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Help clients keep more:

Managing the impact of taxes in a personalized way

Sharing Perspectives

Introduction

In this issue of *Sharing Perspectives*, we offer insights on the importance of tax optimization and why a personalized approach matters. We highlight Envestnet and BlackRock's shared perspectives on the impact of taxes: why taxes have become so much more essential to the investment conversation; how data and technology-driven innovations are leading to better client outcomes; and how advisors can incorporate tax optimization strategies into their practice.

When it comes to managing a client's overall tax situation, advisors face challenges. Tax-loss harvesting is a manual and time-consuming process and often only a focus for top-tier clients. Tax-efficient strategies offer tax-saving opportunities but not in a personalized way. With sophisticated tax optimization technology solutions and taxes top of mind for so many investors, we believe there is an opportunity for advisors to help manage the impact of taxes in a personalized and differentiated way.

This whitepaper defines four trends we see taking shape in the evolving world of tax management. Our goal is to provide advisors with new perspectives and solutions – so you can validate your current approach to tax optimization or explore new ideas that can add even more value to client relationships.

Active and ongoing tax management: It's essential

The tax landscape is changing. With these changes, investors have become more concerned about how it all might affect them. They are looking for more from their advisors: for help with investing to meet long-term goals while minimizing their overall tax burden.

We believe it's essential for advisors to incorporate comprehensive tax management and a focus on after-tax returns into their service offerings. In the past, tax optimization was typically handled manually at the end of the year. We see a future where advisors leverage data and actively choose the right technology-driven solutions and automated approaches to tax management to help clients maximize their after-tax returns.

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Four emerging tax management trends:

1 After-tax wealth takes center stage

While many advisors intuitively understand the importance of after-tax wealth, focusing on it will be essential as we look to the future. It's critical for advisors to help clients understand the impact taxes can have and to maintain a focus on after-tax wealth.

We see more interest in tax-efficient vehicles that put advisors in a position to deliver better after-tax returns and to do so in a way that is still efficient for their business. Over the last year, the number of accounts using customized tax services on the Envestnet platform grew 32% to over 9,500 accounts.[1]

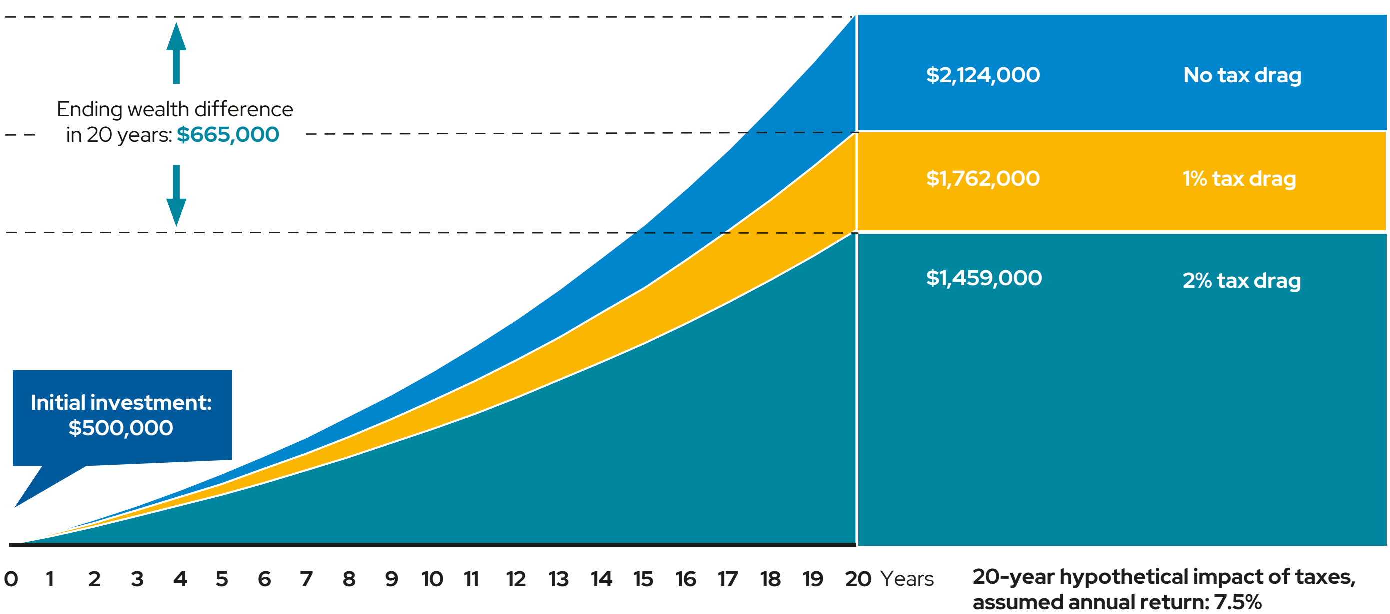
In fact, taxes can be an enormous drag on portfolio performance. For example, if a client was invested in a 50% stock and 50% bond portfolio in a year when pre-tax returns were 4.0%, the after-tax return would be only 2.3%. That's a tax drag of 1.7%, represented by income from the bond portfolio and capital gains distributions from the equity portfolio, with 44% of the portfolio's gains going to taxes over time.[2]

Tax cost
44%
of the portfolio's gains going to taxes over time

Likewise, when we look at the hypothetical growth of $500,000 at 7.5% annually over 20 years, the potential for tax drag can make a real difference in returns.

It's not what you make, it's what you keep

Hypothetical growth of $500,000 over 20 years at 7.5% per year



This is a hypothetical illustration and not meant to represent an actual investment strategy. Tax drag is the reduction of potential investment returns due to taxes. Taxes may be due at some point in the future and tax rates may be different when they are. Investing involves risk and you may incur a profit or loss regardless of strategy selected.

1 Envestnet, as of June 30, 2023. **2** Morningstar data. U.S. Stocks represented by Morningstar U.S. Equity Mutual Funds. U.S. Bonds represented by Morningstar U.S. Taxable Bond Mutual Funds. Tax Drag is the Morningstar Tax Cost Ratio.

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2 Personalized solutions matter as our tax system becomes more complex

In today's complex tax landscape, any tax changes are sure to have an impact on your clients and their long-term goals. While each tax situation is unique and client needs constantly change, tax considerations are integral to the wealth management process. With a trend toward even more personalization through tax management technology, you can help your clients save money while customizing portfolios in a scalable way.

For many advisors, tax-loss harvesting is their best approach for helping clients minimize taxes. While it can be rewarding and help lower your client's tax bill, it's a time-consuming and manual process to keep track of capital gains and understand the impact of changes across a portfolio. For other advisors, tax-smart investing strategies include incorporating tax-efficient vehicles into client portfolios. While both approaches have their individual merits, it could be more powerful when brought together holistically in a whole portfolio perspective.

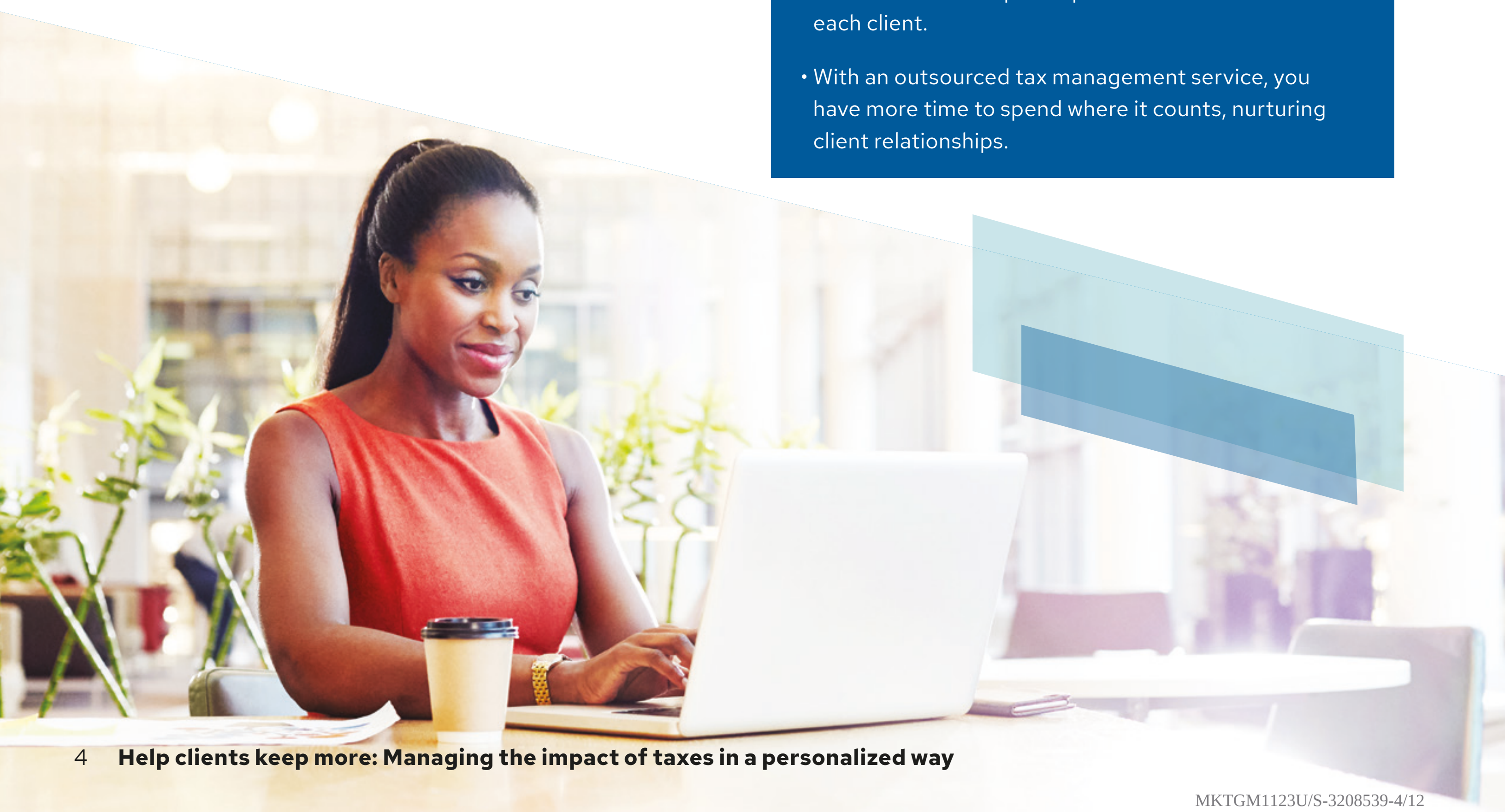
When you partner with a tax management technology expert, you can leverage solutions that look at an entire portfolio in the most comprehensive way. Then, you can help deliver customized and better outcomes for each client, eliminate your manual workload and feel confident you are providing your client with results that reflect their unique situation.

Today, new tax management technology solutions allow you to offer clients better outcomes (without putting the burden on your shoulders) and to better scale your practice for future growth. Tax optimization algorithms are much more available today than ever before, and with this availability, investors have come to expect a more sophisticated approach to tax management.

Tax optimization technology and services can improve outcomes

Optimization engines look at overall portfolio positions and do the analysis faster and more precisely than could ever be done manually.

- Sophisticated optimization tools can manage hundreds to tens of thousands of portfolios.
- With optimization technology, each portfolio is customized daily and in a consistent and reliable way.
- Sophisticated technology analyzes the entire portfolio and shows how each investment can best work together from a tax perspective, giving you the insights you need to make better portfolio decisions for your clients.
- When you have more portfolio construction options to consider, you can develop a customized plan to achieve the most optimal portfolio allocation for each client.
- With an outsourced tax management service, you have more time to spend where it counts, nurturing client relationships.



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3 Tax conversations deepen client engagement and empower advisors

Investors spend more time thinking about taxes in today's environment, especially those sitting on significant unrealized capital gains. They may be questioning whether to hold onto these positions, so they don't take the tax hit, but then worry about the impact on their asset allocation strategy and portfolio returns.

Taxes can often be a client's biggest expense. This creates an opportunity for you to provide value and deepen your relationship by proactively identifying ways to help them save money. That means comprehensive tax management needs to be an essential part of your value proposition. If you're not having tax planning conversations with your clients today, the chances are that someone else will be educating them about opportunities to manage their overall tax burden.

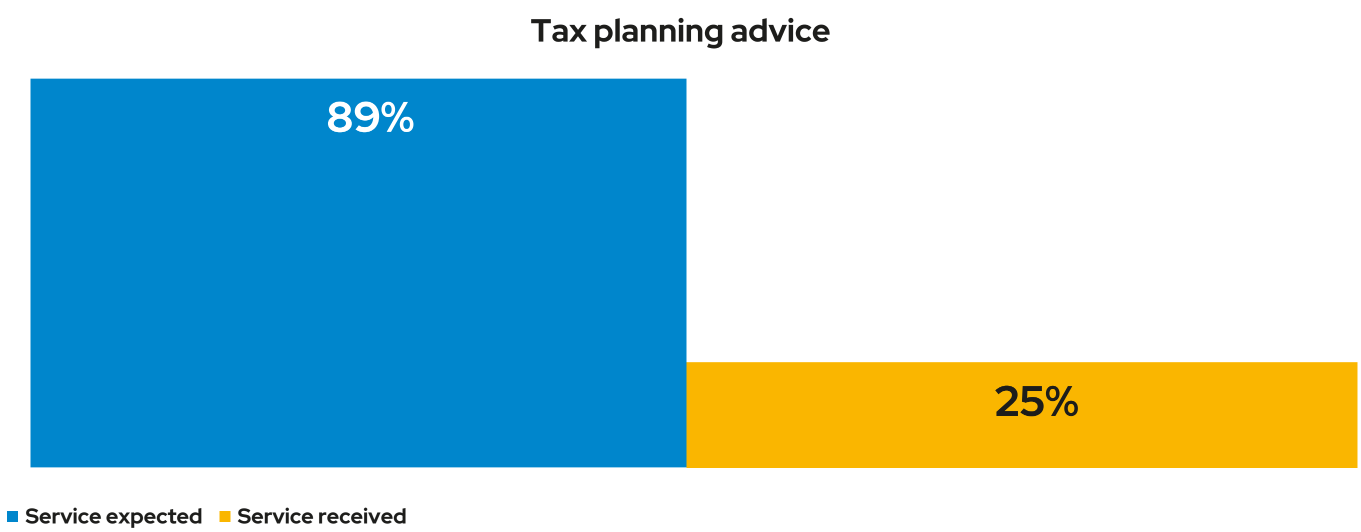
In fact, research shows that investors expect their advisors to consider taxes when managing their portfolios, with 89% expecting tax planning advice but only 25% receiving it. It's important to align your services with what today's investors want and need.

4 Risk management and the search for tax alpha demand greater focus

While risk management is always a critical consideration, when combined with a focus on tax alpha, you can manage risk, monitor tax exposure and customize tax-efficient portfolios. Many advisors engage in annual tax-loss harvesting at the end of the year, but the losses might not be available then. Some advisors find themselves selling securities to avoid capital gains taxes and then repurchasing these same securities at a higher price later on.

Other advisors don't sell appreciated securities because they don't want to deal with the tax implications. That is when model drift can occur: an investment portfolio with a target weighting that places 60% in stocks and 40% in bonds can quickly drift to a 70% stock and 30% bond allocation, exposing clients to more risk. Top advisors are increasingly leaning into sophisticated services that optimize risk and help ensure portfolios are aligned with a client's risk tolerance, preferences and tax sensitivities.

Clients expect tax help but aren't receiving it
Clients want their advisor to be thinking about taxes, but many aren't. This is an opportunity for you to differentiate your practice and enhance your value prop.



Source: Spectrem August 2021 Defining Wealth Management. Neither Envestnet, Envestnet | PMC nor its representatives render tax, accounting, or legal advice.

Lean into tax conversations to grow your business

When was the last time you talked with your clients about taxes and how did you do it? For many advisors, it's a conversation that takes place a few times a year, generally around the end of the year when they think about tax-loss harvesting and during tax season as they help clients with tax reporting documentation.

We believe it's essential to get comfortable talking about a client's tax situation throughout the year and to holistically manage assets in a tax-smart way. Here are four concrete steps to help you get started:

Align on the importance of after-tax returns.

Spend time discussing various pre-tax and after-tax return scenarios with your clients and the strategies you have available to preserve after-tax performance. As you build and monitor portfolios with a focus on tax efficiency, make this a core component of your value proposition. Tax efficiency can equate to a better client experience as you help clients keep more of their money working and growing for the future.

Help clients understand how taxes can impact their unique circumstances.

Take a closer look at the variables that may affect how much tax a client pays each year. For example, the sale of a business, inconsistent sources of income, asset location and changes to lifestyle goals may impact a client's tax situation. As part of this discovery process, find new ways to understand changing life circumstances and determine how you help connect every facet of your client's financial life.

Conduct a client portfolio review session with a focus on taxes.

Plan a portfolio review session that includes your client's tax and estate planning professionals. Discuss all aspects of your client's financial picture, the impact of taxes and your sophisticated approach to tax management.

When prospecting, position your tax management focus as a competitive edge.

A personalized approach to tax management has become a more critical part of the investment conversation today. Help prospects understand the technology available to help you manage taxes faster, in a more sophisticated way, and for more clients than your competitors. For those prospects who manage their investments on their own, help them understand how you focus on tax planning strategies all year round, another benefit that comes with an advisory relationship.

Shift your thinking: Tax conversations then and now

As more advisors focus on managing their clients' overall tax situations, they are shifting the conversation. Whether you manage taxes as part of your broad client service offering or think of tax management in less of a comprehensive way, here are five examples of advisor conversations in the past versus now.

Then	And now
Conversations with clients focus on maximizing risk-adjusted returns.	**The new conversation is about maximizing after-tax risk-adjusted returns, net of fees and taxes.**
Advisors don't feel comfortable talking to clients about taxes because they are not tax professionals. That's a conversation better to be had with a client's CPA or accountant.	**Advisors are committed to deepening relationships with clients by building their after-tax wealth. They see themselves as a bridge between a client's tax and estate planning professionals as they focus on the tax implications of investment choices.**
Advisors have attempted to help clients manage their overall tax situation, but do so manually, generally at the end of the year.	**Advisors are engaged with clients on taxes because they don't want to miss the opportunity to be more essential. With the tax optimization tools available today, advisors can offer clients a more sophisticated approach to tax management with more transparency and better outcomes.**
Advisors are not worried about the tax side of the equation because it's not something clients have ever brought up before.	**Advisors understand the importance of tax implications, and a focus on tax efficiency becomes a real differentiator when prospecting. For clients, an advisor's investment advice is always geared toward balancing tax sensitivities with return goals.**
When thinking about tax management, advisors generally focus on asset location: taxable, tax-exempt or tax-deferred accounts.	**Advisors realize the tax conversation includes so much more than asset location. It's about how sophisticated technology can help them make better decisions and actively manage taxes within each location, especially the taxable bucket.**

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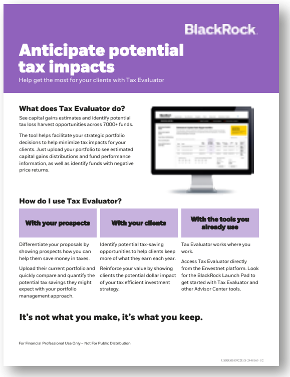
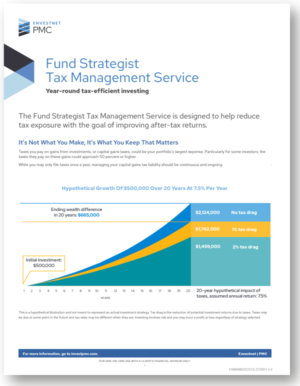
Getting results: Resources to help you minimize the tax drain

Whether you're already helping clients with tax planning techniques or looking to expand your service offering, we believe in the power of tax management, and we are committed to helping advisors uncover opportunities and add more value. With our investment vehicles and sophisticated technology solutions, you can broaden your value proposition and add more scale to your practice:





- Envestnet offers after-tax reporting capabilities, a **Unified Managed Account (UMA) program**, and services to automate your tax management processes.
- The **Envestnet | PMC Tax Overlay Service** and **Fund Strategist Tax Management Service** are always-on technologies that automate tax management based on your clients' unique needs. The Envestnet platform also offers access to tax-efficient strategies, like municipal bonds and tax-efficient ETFs.
- BlackRock's **Tax Evaluator tool** helps monitor potential and historical capital gain distributions across more than 7,000 funds as well as identify tax-loss harvesting opportunities in portfolios. Using the tool can help advisors minimize tax drag for clients' portfolios while also saving time. In addition, BlackRock offers tax-efficient ETFs and tax-aware model portfolios.
- BlackRock's **Tax Foundations online Continuing Education** course highlights why managing taxes matters and how you can adapt your investment processes to maximize after-tax returns.

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Tax management can add significant value

An Envestnet | PMC study shows that advisors can add value to client portfolios by focusing on tax management. Because efficient tax management in an all-equity portfolio can add approximately 100 basis points of value annually, it's a component of advisor-value add that can't be ignored.

Tax management adds value

Capital Sigma is our term of the sum total of advisor-created value. We have found 5 sources of measurable value:

Source	Description	Annual value-add
Financial planning	Retirement planning; tax planning; asset location; behavior coaching	> 50 bps
Asset selection & allocation	Diversification contributes positively over the long term	52 bps
Investment selection	Active management	67 bps
	Passive management	61 bps
Systematic rebalancing	Annual rebalancing helps control risk and can enhance return	30 bps
Tax management	Tax optimization of taxable accounts is a significant contributor	100 bps
Total		**~ 300 bps**

Source: Envestnet; Morningstar; Vanguard. Francis M. Kinniry Jr., CFA, Colleen M. Jaconetti, CPA, CFP®, Michael A. DiJoseph, CFA, and Yan Zilbering, "Putting a value on your value: Quantifying Vanguard Advisor's Alpha," March 2014, Vanguard. David Blanchett and Paul Kaplan, "Alpha, Beta, and Now...Gamma," Morningstar, 2012.

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Summary:

Engage in new conversations to help reduce tax burdens in a personalized way

At a time when tax concerns are paramount, we are committed to helping advisors create better tax-aware outcomes for their clients. Through the intersection of data, technology and efficient tax management, you can deepen client engagement and jump-start the growth of your business. With an outsourced tax management technology solution, you can offer your clients the best of both worlds: a personalized approach to sophisticated tax management and your comprehensive wealth management advice to help match potential solutions to their unique goals.

As investors understand more about the value technology can add to the equation, we believe they will come to expect more from their advisors. When you can offer clients a new way of thinking about tax minimization in a truly personalized way, with innovative technology, tools and resources, you will position yourself as the advisor they turn to for advice on their entire financial wellness picture today and in the future.

Contact us today to learn more about the array of sophisticated tax management solutions that advisors have at their disposal.

We look forward to introducing more *Sharing Perspectives* in the future. For our other *Sharing Perspectives* pieces, read here.

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