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The Tax-Loss Harvesting Conundrum

Are you familiar with the concept of tax loss harvesting? Simply put, it is the process of selling securities at a loss to offset taxable gains elsewhere in an investor's portfolio. By many, this is considered to be an opportunity that can offer substantial tangible benefits to high income taxpayers. And the potential for savings can be extremely seductive.

However, in the complex worlds of investing and taxation, tax-loss harvesting is not always as simple as it seems and the benefits garnered can vary widely. Sometimes in ways that are not readily apparent.

When one scours the internet, as I have, for information relating to tax-loss harvesting, what you'll find is an abundance of literature promoting the tax benefits that can be garnered. It should come as no surprise that much of the information is written by tax experts who are zealously dispensing advice with little regard to the investment implications. With modest caveats, the greatest caution often provided relates to making readers aware of the "wash sale" rules that are a part of the tax code for which you must coordinate this maneuver. We'll talk about the "wash sale" rules later.

Numerous references were found, similar to investopedia.com, saying: "if properly applied, it can save you taxes..." Aside from the constant use of those words "if properly applied", few articles provided readers an appreciation for the combined cost-benefit relationship of doing so. In fact, almost no one offered a perspective of the varying degrees of utility garnered from tax-loss harvesting or the impact to your strategy of investing. Wait! Doesn't this concept of tax-loss harvesting seem to be encouraging us to sell investments lower than we bought them? Doesn't that seem counter-intuitive to what we should be doing to create wealth? I thought "buy low" and "sell high" was the proper formula for success. Isn't it?

Actually, it makes perfect sense to sell for a tax-loss when we have an investment that no longer offers promising potential relative to other alternatives in the market place. It may also make sense when we can substitute an investment for another that offers similar opportunity for gain and risk taking. Nevertheless, when not approached thoughtfully, tax-loss harvesting can easily turn afoul when one doesn't consider the investment as part of the strategy. "One of the primal fears of clients and advisors", says Jeremy Held, regional sales manager for the Select Sector SPDRs, "is as soon as an underperforming investment is sold at a loss, the investment will bounce back in price."

As readers of our newsletter well know, wealth management is the ultimate goal of all that we do at Hoffman, White and Kaelber. Yes, we promote our services; yet, you will find that we always seek to present thought provoking topics that are relevant to our wide audience.

This month's newsletter will discuss tax-loss harvesting and provide you some food for thought on how to blend your investment and tax advice. If you are an investor with a

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taxable account, you should come away with a broader understanding of how you may optimize your after-tax returns. Once you've read this timely written piece, please be sure to spend some time looking over our market comment and performance for the month past. It will be well worth the investment.

The "Wash Sale" Rules

First off, the "wash sale" rules apply to U.S. taxpayers and are part of the U.S. Internal Revenue Code and Regulations that, under certain circumstances, do not allow for the deduction of losses from sales or trades of securities.

The following excerpts, in *italics*, come directly from the current IRS Publication 550 at the time of this writing:

A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

- 1. Buy substantially identical stock or securities,*
- 2. Acquire substantially identical stock or securities in a fully taxable trade, or*
- 3. Acquire a contract or option to buy substantially identical stock or securities.*

If you sell stock and your spouse or a corporation you control buys substantially identical stock, you also have a wash sale.

There are also "wash sale" rules that cover options, warrants and futures contracts that must be considered for more sophisticated strategies.

Substantially identical. *In determining whether stock or securities are substantially identical, you must consider all the facts and circumstances in your particular case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. However, they may be substantially identical in some cases. For example, in a reorganization, the stocks and securities of the predecessor and successor corporations may be substantially identical.*

Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, where the bonds or preferred stock are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may make these bonds or preferred stock and the common stock substantially identical. For example, preferred stock is substantially identical to the common stock if the preferred stock:

- 1. Is convertible into common stock,*
- 2. Has the same voting rights as the common stock,*
- 3. Is subject to the same dividend restrictions,*
- 4. Trades at prices that do not vary significantly from the conversion ratio, and*
- 5. Is unrestricted as to convertibility.*

Short sales. *The wash sale rules apply to a loss realized on a short sale if you sell, or enter into another short sale of, substantially identical stock or securities within a period beginning 30 days before the date the short sale is complete and ending 30 days after that date.*

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For purposes of the wash sale rules, a short sale is considered complete on the date the short sale is entered into, if:

- 1. On that date, you own stock or securities identical to those sold short (or by that date you enter into a contract or option to acquire that stock or those securities), and*
- 2. You later deliver the stock or securities to close the short sale.*

Otherwise, a short sale is not considered complete until the property is delivered to close the sale.

How to report. *Report a wash sale or trade on line 1 or line 8 of Schedule D (Form 1040), whichever is appropriate. Show the full amount of the loss in parentheses in column (f). On the next line, enter "Wash Sale" in column (a) and the amount of the loss not allowed as a positive amount in column (f).*

Maximizing the Tax-Loss Harvesting Strategy

In October 2004, the University of Kansas' John Charnes and University of Miami's Howard Marmorstein addressed the Institute for Operations Research and the Management Sciences ("INFORMS") on the topic of optimal tax-loss harvesting. They began that talk with the following definition and research questions:

"Definition: Realizing capital losses for tax purposes to offset any other gains an investor may have. Tax harvesting may:

- Bring capital gains taxes down to zero,
- Generate a \$3,000 ordinary tax-loss deduction, and/or
- Create loss carry-forwards for subsequent years

Research Questions

- At what price should an investor harvest a loss?
- How much is tax-loss harvesting worth to a taxable investor?
- What factors influence the answers to the above?
- How large are the effects of these factors?"

Now, in answer to some of these questions, let's consider some additional information.

On the taxation side of the equation, presuming you successfully maneuver through the wash sale rules, the maximum tax rates for short-term capital gains are higher than for long-term capital gains. To not let this get too technical, I'm going to assume that you understand what a capital asset is and what creates a capital gain or loss. However, whether a capital gain is classified as long-term or short-term is worth noting. The IRS classifies a long-term capital gain as realized when coming from a capital asset that is held more than twelve months before being sold. This is a fairly important concept all by itself.

Under the U.S. tax laws currently in effect, and before consideration for the effects of state and local income taxes, long-term capital gains are taxed at a maximum rate of 15%. While short-term capital gains are taxed at a maximum rate of 35%. Therefore, it becomes exceedingly more valuable to offset short-term gains when harvesting losses. To fine tune this

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observation, it is important to note that short-term losses must first be used to offset short-term gains before they can be used to offset long-term gains and vice-versa.

On the investment side of the equation, evaluating what to sell and when is far less certain and an error in judgment can quite often cause more loss than the tax benefit sought. Keep in mind that you're reclaiming 35 cents on the dollar from federal taxes against short-term gains and 15 cents per dollar from long-term gains. This is where you really need to factor in your opinion for the potential of the investment with the tax benefits you are seeking. Why is this so?

Most investors understand that some investments, especially in the case of individual stocks, are generally more volatile than others. By this, we mean that some investments can fluctuate 3% or more in a single day; while others may not fluctuate more than 1% in an entire month. If you have a shallow loss relative to how that investment may fluctuate, it may not be a good idea to realize the loss. Especially, if it has the potential to recover one or two days after you've sold it. However, if you're looking at a much deeper loss, you'll probably want to reconsider the overall merits of the investment and whether your reason for owning it remains consistent with your reasons for purchasing it to begin with. If the fundamentals of the investment have taken a long-term trend for the worse, then tax-loss harvesting clearly makes sense.

As an alternative, if you can find a substitute investment that is not substantially identical under the wash sale rules but which offers substantially similar opportunity for gain, then you might want to consider it. Fixed income investments are often better suited for this than equity investments. However, be aware that not all investment opportunities are easily substituted with any level of precision.

In Conclusion

As mentioned at the start of this letter, tax-loss harvesting can offer substantial tangible benefits to high income taxpayers. And it can make perfect sense to sell for a tax-loss when we have an investment that no longer offers promising potential relative to other alternatives in the market place. It may also make sense when we can substitute an investment for another that offers similar opportunity for gain and risk taking. Nevertheless, when not approached thoughtfully, tax-loss harvesting can easily turn afoul when one doesn't consider the investment as part of the strategy.

Our clients can take comfort that we have substantially harvested tax-losses for our clients when we updated our asset allocations in the latter half of this year.

Hoffman, White & Kaelber Financial Services Investment Performance Update

During November, the economic data that seemed to have the largest impact to U.S. equity markets was the revision of third-quarter GDP from 1.6% to 2.2%. The revised report showed surging profits and a downward revision to labor compensation. Compared to the GDP the U.S. experienced in the first half of the year, the revised numbers were not all that exciting. However, they were much stronger than most economists had expected and the

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markets responded by moving forward with less fear. This confidence extended to international markets as well.

In mid to late October we repositioned our portfolios and increased our international exposure. On top of gaining value from a falling dollar, we began to favor selected global ETF opportunities in technology, financials, business services and natural resources. In seeking value, one of the criteria that appealed to us were opportunities where the ETF exposed us to cash rich companies with relatively lower debt levels. At the same time, we have closed out all of our short positioning and are currently managing our portfolios long only. While it is more than clear that the U.S. economy is slowing, we think valuation levels are not near being considered irrationally exuberant and are reasonable given market yields on long-term U.S. Treasuries.

For the month ended November 30, 2006, our one-month performance is up 3.87%, our one-year return is up 7.20%, our three-year return is up 5.66% and our average annualized return since inception is up 8.67%. Our since inception risk measures edged upwards slightly, but remain very conservative at +/- 5.92% (+/- 6.69% and +/- 6.09% for one-year and three-year measures, respectively) and our since inception Sharpe Ratio (reward for risk taken) remains very respectable at 1.02.

[For more performance information, please see our web site for details.](#)

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