who are exploring this new service dimension and the tools that support it—will get a discount.

DataPoints costs $165 a month for Fallaw's assessments and the KMSI.

And for advisors who want to go deeper, Quamme's coaching service is priced at ten hours per quarter for $1,000 a month or $3,000 per quarter. It is not hard to envision that Trove members will avail themselves of her services, and that her advice will help more advisory firms get more comfortable with helping clients develop the habits of people who consistently achieve economic success.

Inside Information exists to give its readers a heads-up on future trends. This new unexplored dimension in life planning, moving beyond goals to coaching on actual habits and proclivities that lead to achievement go goals, is going to catch on and eventually become as mainstream in the future as goals-based discovery meetings are today.

Before DataPoints and KPSI, the profession lacked the tools to uncover client habits and proclivities, and to understand how they could be modified toward (financially) healthier ones. Now we're in the early stages of understanding how to expand a planning engagement into this area of enhanced client success, and making client engagements and advice more valuable.

Nobody is more interested in creating better client service and advice than Inside Information readers. Think of this as a 'heads up,' a chance to be among the first to get acquainted with something new, different, and potentially better. ■

Optimizing Portfolios at Scale

Synopsis: ***A presentation at T3 showed how advisors can add value to client portfolio management—and save as much in taxes as they charge in fees.***

Takeaways: ***Create direct index portfolios and use software to automate systematic, opportunistic tax-aware rebalancing throughout the year.***

As I reported in the February issue of *Inside Information*, most of the sessions at the recent T3 conference in Las Vegas focused on what was new and different—new features, proposed new features (using AI and creating a gestalt user interface to tie different parts of the tech stack together), and new companies offering entirely new tech vistas, like TestimonialIQ, Nebo Wealth, Syntax, VRGL and the new Astra custodial interface at APEX.

> ***Advisors who rebalance portfolios and harvest tax losses once a year are missing most of the potential value.***

Most of the sessions involved demos and description of features.

One session stood out in all this introducing and demo-ing: Jerry Michael, founder of Smartleaf's portfolio management and direct indexing platform (*https://www.smartleaf.com/*), offered a deep dive into how the profession can start offering personalized, tax-optimized portfolios at scale. The presentation compared how most advisory firms are creating and tax-managing portfolios with how they could be doing it—basically turning the demo idea on its head by offering a CE session on advanced portfolio management without ever once showing the Smartleaf product.

Advisors who use AdvisorEngine, APEX Clearing's portfolio management engine or SEI's trading and rebalancing platform are already using Smartleaf without, perhaps, knowing this, and of course many Orion users have some of the same capabilities. Michael's presentation was an invitation to do a lot more with the tech on behalf of clients.

So what did he recommend? First, Michael said that advisors should rethink the idea that rebalancing and tax-loss harvesting is a once-a-year, end-of-the year activity. His memorable line: *"I think* *once-a-year rebalancing is a lot like once-a-year bathing: it's not often enough*."

The presentation offered a graph which shows that opportunistic, systematic rebalancing and tax management (the two are, of course, tied together) throughout the year could reduce client tax burdens by 64% over the more traditional once-a-year approach.

But, Michael said, that's only half the value-add. He also showed that, on average, the systematic rebalancing/tax management process also results in a 60% reduction in tracking error in client portfolios.

The value, Michael said, comes from what he called risk-sensitive gains deferral—defined as not selling overweight positions if the trade would trigger short-term capital gains. "Risk-sensitive gains deferral," he explained, "basically means that you are constantly balancing your desire to have more tax deferral with your desire to give the client the type of portfolio that you think is best for them." It is balancing lower taxes with low tracking error.

This is more complicated than it sounds—and I wish Michael had talked about how to automate these visibly labor-intensive activities earlier in his presentation. He probably lost some (labor-avoidant) audience members when he talked about having a percentage of each asset class in the tax-deferred as well as the taxable accounts. It's more work, but it lets advisors choose to rebalance some positions at the household level out of the tax-deferred accounts (no taxable gains triggered), if there are no loss positions to sell in the taxable portfolio.

Michael addressed the additional work issue directly. "The obvious question is: *why don't we hear about this?*" he told the audience. "The tax-deferred accounts create an extra tax-management level, but most advisors think of it as: *I put my bonds and alts into the IRA because they generate short-term capital gains*. They make it a one-and-done decision," Michael added. "Including the tax-deferred vehicles in your tax-managed rebalancing is an ongoing perpetual task."

The process of demonstrating your tax savings has to be honest and straightforward.

Buttoned-down tax optimization

Advisors who decide to embrace this first recommendation, Michael said, gain a new opportunity to demonstrate their value. He recommended something that looks even more labor-intensive (which, as we'll see later, can also be automated): documenting to clients that you are saving or deferring more in tax obligations than you charge in fees.

Apparently, this can actually be done; that is, if you embrace the idea of continual tax-aware rebalancing, the numbers will work in your favor more often than not. Michael cited one firm that documented its tax savings and deferrals; it found that 68% of client households passed this 'tax value greater than fees' test, and the number went up to 90% when they did the calculation on a dollar-weighted basis.

"The reason those are different is that the average dollar is in a larger account," Michael explained. "Larger accounts generally belong to investors who have higher tax rates, and larger accounts are generally charged lower fees on a percentage basis. So it's easier for the taxes to be greater than the fees."

The reader might question the fairness of this calculation. In a later explanation, outside of the presentation, Michael showed an example from a direct-index portfolio composed of individual stocks—an asset management methodology which he recommended in the presentation. Imagine a client's IBM holding reaches 4% of the account's total value, but the target weight is actually 3%, and the holdings have an unrealized loss. The Smartleaf software will recommend reducing the exposure from 4% to 1%, not just rebalancing, but also harvesting the loss. The software will assume that the harvested loss will be used to offset gains elsewhere in the rebalancing process.

But the realized loss, in the tax value calculation, will only assume the difference between reducing the holding from 3% to 1%, since a normal rebalance would have taken it from 4% to 3%. Only the additional harvesting is calculated in the tax value shown to a client.

Suppose that 4% IBM holding had unrealized short-term gains. Smartleaf would recommend no rebalance, at least until the gains become long-term—and only the difference between short-term and long-term tax rates would be included in the tax benefit report.

If the 4% IBM holding has unrealized long-term gains, then Smartleaf would recommend holding the position as is, and would count the unrealized gains that were not taken in the tax benefit report.

Michael confirmed that this 'taxes saved or deferred' report is calculated in the Smartleaf system daily and year to date. In the presentation, he told the audience that advisory firm are showing the tax-savings report to great effect in prospecting meetings. But the benefit is not what you might think.

"These advisors define themselves first and foremost as financial planning firms," Michael told the audience. "And of course the value of financial planning is that it is rather hard to document. You can see it after 30 years, but not easily in the initial stages of the client relationship."

Michael said that tax mitigation is, at best, maybe the third most important thing a planning firm does in the eyes of the prospect. "But when they see this report," said Michael, "it tells the prospect that this firm is so buttoned-up on the third-most-important thing that they do that the prospects become comfortable that the firm is also buttoned-up on the things which are more important. The main benefit of documenting that taxes saved or deferred exceed your advisory fees is not proof of value," he continued; "it's proof of competence."

If you ditch the sleeves in custom indexing, you replace a lot of complexity and decision-making with a more workable solution.

Ditching the sleeves

From there, Michael moved the presentation to direct indexing, which he said is almost certainly superior to what most of the profession is doing with their client portfolios in a variety of ways—and, Michael said, "probably more than you realize."

He started with the transition of a prospect's portfolio to the advisor's own models, which incurs the tax drag of selling the prospect's holdings and buying the advisor's recommended assets. Michael cited a study of 8,000 different portfolio accounts, showing that the liquidation process would, on average, result in a tax loss equal to 7.21% of the portfolio—obviously more in some cases, some less, depending on how well the prospect's holdings match the ETFs and mutual funds in the advisory firm's models.

"What if, instead, you took those legacy equities and simply dropped them into a direct index?" Michael asked rhetorically. "The average loss to taxes would have dropped to 0.29%." He didn't explain the difference, but it's not impossible to imagine building a mix of individual stocks around the existing holdings to create a transitional portfolio with low tracking error against the recommended index allocations.

Low? The slide illustrating the difference in tax cost noted that the tracking error will (obviously) be zero if the prospect's portfolio is liquidated and moved into the advisory firm's model. It averages about 1.54% when the assets are moved (on a tax-aware basis) into a direct index allocation.

But many advisors are already implementing direct indexing, are they not? Michael said that the most popular direct indexing methodologies don't capture most of the benefit of the concept. "You typically see advisory firms having SMA accounts, with sleeves or subaccounts that are partitioned," he said. "Every custodian, wirehouse and platform has some sort of SMA arrangement where the money is spread out among several different managers, each with their own responsibility."

His recommendation was to get rid of all that structure and simply manage a portfolio of individual equities supplemented by ETFs.

"The sleeveless approach," Michael told the audience, "is not just better; it's MUCH better."

For starters, it's simpler. "There's none of this, every time a client puts some cash in, you have to figure out how much cash to give to this SMA sub-manager," said Michael. "Every time there's a cash out, you don't have to figure out, how much cash should I ask of each of my SMA managers? If there's an asset class rebalancing, you don't have to figure out how much cash goes in or out with each of the SMA managers, or the wash sale avoidance across different SMA managers. All of that goes away when you get rid of the whole subaccount, sleeve infrastructure. And," he said, "it's less expensive."

And, he said, the portfolios experience lower overall portfolio-level drift and dispersion.

Why? Michael said that when you chop up the portfolio into pieces, you cripple your efforts to manage risk and taxes. He imagined the not-uncommon case where a midcap stock experiences a nice gain, so that it no longer fits into the midcap sleeve. It is now a large cap. So the midcap sleeve sells the stock, and the large cap sleeve eventually buys it. The process, repeated many times over the life of the portfolio, generates unnecessary taxable gains, since the midcap stocks that grew into large caps were among the biggest winners.

"If you're managing the portfolio holistically, the stock will just stay there," says Michael. "It's now a part of your large-cap allocation."

Rebalancing is also less complicated with direct indexing *sans* sleeves. A holistic direct index portfolio would selectively sell a few of the large cap stocks, preferably the ones with little gains or a loss, buy some midcap stocks, and the process is complete.

Michael concluded that, done right (and automated), managing a direct index portfolio should be as easy as managing an ETF portfolio. And he noted that personalized portfolios are easier to create with direct indexing (think ESG value screens and client preferences). (Syntax did an entire presentation on how to automate highly-customized client portfolios at T3.)

The good news is that managing, rebalancing and tax-harvesting customized portfolios can be automated or outsourced.

Automating or delegating

The presentation finally got around to automating all of this—which might have revived the audience members who were imagining that Michael was destroying their lives with complex (daily) portfolio tasks. He said that the standard should be: one staff person in the office should be able to manage the daily opportunistic tax-loss harvesting and rebalancing, and also manage the client reports on the value of customized tax management.

"The end goal here is that for every client, you provide them with whatever level of tax management personalization you think is right for them," said Michael. "Not the amount that you can afford to do. There should be no compromise due to the operational complexity; just whatever is in the best interests of the client."

Later, he said that automation is the only way to deliver personalized portfolio management and tax optimization at scale.

The key is to centralize or outsource the rebalancing activities. Michael said that firms should not have their advisors manage the trading and rebalancing activities because, he said (not exactly mincing his words) "most of them suck at it."

More politely, he said that advisors have far more important things to do: manage the client relationships and give advice that can transform their lives for the better. The more time they spend on that, the better for the firm and clients.

And then Michael added that rebalancing is not, and never will be, a core competitive differentiator.

Smartleaf offers the software that automates risk-sensitive gains deferral and portfolio tax optimization, and also (through Smartleaf Asset Management (*https://www.smartleafam.com/*) an outsourcing option. Michael said that, in his opinion, it makes more sense for advisory firms to outsource than to manage the tasks he outlined in-house.

The good news, Michael said, is that advisory firms are becoming more willing to embrace automation and provide more portfolio personalization and tax-related value. After this presentation, the T3 audience became more aware of how to provide it at scale.■