

iSHARES® ETFs AND TAX-LOSS HARVESTING

TAX-EFFICIENT PORTFOLIO MANAGEMENT

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Effective tax management of investor portfolios has become increasingly vital to many advisors who seek to distinguish themselves with a value-added strategy. Market downturns provide advisors with the opportunity to discuss maximizing portfolio tax efficiency with their clients by harvesting unrealized losses and redeploying the sale proceeds.

This report will discuss:

- The general concept and rules of “tax-loss harvesting”
- The benefits of exchange traded funds (ETFs) and the role they can play in implementing tax-loss harvest strategies
- Broad tax-loss harvest trade ideas

As a final introductory note, investors should consult a professional tax advisor before implementing any tax-loss harvesting strategies.

TAX-LOSS HARVESTING

As long as market volatility exists, investors may have numerous opportunities to capitalize on loss positions residing in taxable accounts. The selling of a security—whether a single stock, an open-end mutual fund or an ETF—to harvest an unrealized loss is a time-tested strategy. The benefits are twofold: not only can a harvested unrealized loss be set against realized gains in the same portfolio, the sale proceeds can be reinvested either in a similar position or a newly desired position. Further, tax-loss harvesting can improve the overall tax efficiency of a portfolio even if the amount of unrealized losses harvested exceeds the maximum allowable amount an investor can offset against realized gains.

Tax-loss selling can make sense even for the many investors who have unrealized, or “paper” losses that are far in excess of the amount they could use to offset realized gains and \$3,000 of other income on tax returns. Once realized, those losses can be carried forward and used in future years.

Importantly, investors must be aware of wash sale rules, which disallow the purchase of substantially identical securities within 30 days of a sale.¹ If a client sells a security that is intended as a long-term holding, that security can be repurchased after 30 days and a lower cost basis can be established. Should this wash sale schedule be neglected, however, the tax-loss benefit would be lost (or, “washed away”) and consequently, the position’s tax basis would remain unchanged from the original purchase.

As discussed in the next session, ETFs can be utilized not only to harvest a loss, but may also allow a client to remain fully invested during the wash sale period.

THE ROLE OF ETFs IN TAX-LOSS HARVESTING

According to Morgan Stanley, “Tax swaps using ETFs may provide low-cost alternative to other equity holdings. Exchange traded funds offer diverse equity exposure, have low expense ratios, and trade with good liquidity throughout the day on major exchanges.”²

The unique structure of ETFs can make them a powerful tool with which to implement tax-loss strategies. ETFs are index funds that trade like stocks and represent interests in an underlying

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portfolio of securities. However, ETFs differ from closed-end funds, as the number of outstanding shares can change daily and intraday portfolio values are calculated every fifteen seconds. Therefore, ETF stock prices tend to trade near the value of the underlying portfolio.

Below we summarize some characteristics of ETFs that distinguish them from individual equities and open-end mutual funds.

TAX EFFICIENCY

ETF portfolio turnover is typically much lower than that of actively managed mutual funds. Changes to an ETF portfolio usually occur only when changes are made to the underlying indexes or when the fund does not meet diversification requirements. For

1. The Internal Revenue Service has not released a definitive opinion regarding the definition of “substantially identical” securities and its application to the wash sale rule and ETFs. The information provided is not intended to be a complete analysis of every material fact respecting tax strategy and has been presented for educational purposes only. Tax consequences will vary by individual taxpayer and individuals must carefully evaluate their tax position.

2. Morgan Stanley Equity Research, October 25, 2001, “Use ETFs to Harvest Tax Losses Before Year-End.”

this reason, capital gains tax liability may be expected to be lower than that of actively managed mutual funds.

PROTECTION FROM SHAREHOLDER ACTIVITY

Unlike the structure of a traditional mutual fund, ETF structure enhances tax efficiency by offering protection from the activities of other shareholders. ETF investors interact with one another on an exchange rather than with the fund. Because the exchange provides liquidity, the ETF manager does not have to sell securities due to shareholder activity, minimizing capital gains liability and costs.

STOCK-LIKE FLEXIBILITY

ETFs can be bought and sold through any brokerage account whenever the market is open. ETF investors can employ the same strategies associated with stock investments, including but not limited to market orders, limit orders, buying on margin and short selling.

ASSET CLASS/SECTOR PERFORMANCE

ETFs are designed to closely track their underlying indexes; this helps ensure that the ETF can serve as a precise proxy for the stocks or funds sold for tax purposes, thereby maintaining your client's portfolio allocation balance.

COST CONTAINMENT

ETF annual expense ratios range from 7 bps to 75 bps, substantially lower than most equivalently categorized mutual funds. While ETF transactions will generate brokerage commissions, the savings from lower annual fees can help offset these costs.

TAX-LOSS HARVESTING OPPORTUNITIES

As year-end approaches, tax-loss harvesting often takes center stage and client portfolios may be ripe with stocks or mutual funds carrying unrealized losses. Additionally, some mutual funds may be poised to make large capital gain distributions despite the market's volatility. However, with over 100 iShares® ETFs covering nearly every asset class, style or sector, the means to engage in year-round portfolio tax management is now at hand (i.e., engaging in tax-loss harvesting while maintaining precise allocation balance within the portfolio).

SINGLE STOCK REPLACEMENT

Sell a single stock to incur the loss and purchase a sector-specific ETF to maintain exposure to that sector of the market.

MUTUAL FUND REPLACEMENT

Sell mutual fund shares to either incur a loss or avoid capital gain distributions and purchase an ETF with corresponding investment objective.

ETF REPLACEMENT

Sell an ETF to incur the loss and purchase an ETF with a similar objective.

Finally, there are many opportunities to improve overall portfolio quality using ETFs.

- A portfolio heavily concentrated in certain stocks may improve its risk profile through the diversification offered by an ETF.
- High-cost mutual funds can be replaced with more efficiently priced ETFs.
- While seeking new equity opportunities, clients can maintain broad or sector-based equity market exposure rather than holding cash. Remaining fully invested is a particularly important concept, as the bulk of a market's return in a given year is typically concentrated in a few trading sessions.
- Clients may be interested in correcting for funds that have strayed from their original portfolio objectives. One may receive a possible tax-loss benefit through a harvesting strategy and simultaneously return to original objectives by replacing a wayward security or fund with a pure sector-specific ETF.
- Sophisticated advisors often combine tax-loss harvesting with rebalancing.
- The Correlation Calculator on www.iShares.com can assist you in your tax-loss strategies.

Carefully consider the iShares Funds' investment objectives, risk factors and charges and expenses before investing. This and other information can be found in the Funds' prospectuses, which may be obtained by calling 1-800-iShares (1-800-474-2737) or by visiting www.iShares.com. Read the prospectus carefully before investing.

There are risks involved with investing, including possible loss of principal.

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When comparing stocks and iShares Funds, it should be remembered that management fees associated with fund investments, like iShares Funds, are not born by investors in individual stocks.

Mutual funds and iShares Funds are obliged to distribute portfolio gains to shareholders by year-end. These gains may be generated due to index rebalancing or to meet diversification requirements. Your own iShares Funds trading, too, will generate tax consequences and transaction expenses. Certain traditional mutual funds can be tax efficient as well.

Although BGI believes that market makers will take advantage of differences between the NAV and the trading price of iShares Funds through arbitrage opportunities, BGI cannot guarantee that they will do so.

There are special risks associated with margin investing. As with stocks, you may be called upon to deposit additional cash or securities if your account equity including that which is attributable to iShares Funds, declines. With short sales, you risk paying more for a security than you received from its sale.

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