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Loss Trading

In a recent devotional I read, the writer started with "Life is a series of battles and blessings, battles and blessings, battles and blessings, battles and blessings, battles and blessings…". He extended this out for a few more written lines, and the point he made was memorable and profound: When we are in a period of battle, it is hard to believe that it will ever end. When we are in a period of blessing, we sometimes expect it will go on forever. However, life is not like that. There are battles and blessings, sometimes happening simultaneously on separate tracks.

This concept is ever true in our financial lives, specifically with the stock market. The last three months have been a battle. The preceding two years were a blessing. In periods of battle, there are many tactical and strategic decisions that we make as your investment advisor, one of which is to loss trade in an effort to give you a tax advantage. This offers you a silver lining in down markets.

Before detailing this strategy, let us define some important terminology all of which are related to loss trading:

After-tax account – A brokerage account with after-tax dollars (non-IRA or Roth). The taxation is different with these accounts. With IRA accounts, you pay ordinary income tax rates on all monies withdrawn from the account. With after tax, the taxation is a function of when you sell, not withdraw. You also pay tax on dividends and interest whether or not you actual withdraw those funds from the account.

Realized vs. Unrealized capital gains – If you purchased 100 shares of XYZ at $80 per share and it is now worth $100 per share, you have a $2,000 UNREALIZED Capital gain. You do not pay tax on unrealized gains. If you sell those 100 shares of XYZ, then that $2,000 gain is REALIZED and you pay tax on that gain.

Cost Basis vs. Current Value – Cost basis is the value at which you purchased a security. Current value is just that, the current value. When we sell a security in your account, the realized gain/loss is determined by subtracting the cost basis from the current value.

Net Realized Capital Gains/Loss – At the end of each calendar year, all of your realized gains (and losses) net against each other. Therefore, if the sum total of all realized gains totals $32,000, but you have -$15,000 in realized losses, your NET realized capital gain for the year is $17,000. Conversely, if your losses exceed your gains, then you have a NET loss for the year. In the case of a NET loss, the IRS allows you to claim $3,000 against ordinary income. The remainder will carry over to future years without limitation. For example, if your annual net capital loss is $10,000, you can reduce current income by $3,000 in this calendar year and carry forward $7,000 of losses to offset gains in future years.

Wash Sale Rule – A wash sale occurs when you sell (and realize) a security and then buy back that same security within 30 days. Since realized losses are a tax benefit, the IRS has a rule in place that states you cannot participate in a wash sale and receive a tax benefit for a loss. As an example, you own those same 100 shares of XYZ purchased at $80 per share, but now they are worth $70. You have a $1,000 unrealized loss. If you sell (and realize) XYZ and proceed to buy back that same security within 30 days of the sale, you cannot receive a tax benefit for the loss.

In times of "battle", we want to be proactive in realizing losses in your accounts, all the while keeping you fully invested in the market. When the ship turns, it turns fast, and positive returns come quickly (cite +10% since the recent lows on 12/24). That is why you hire us—to pay attention to the details! In December, we spent a good amount of time loss trading in accounts where appropriate.

Loss trading – This is a strategy to sell securities with an unrealized loss, thus realizing that loss, which will either reduce the account owners NET realized gain for the year, or generate a NET realized loss. The sell is immediately accompanied with a buy to ensure that the account stays fully invested to the account owner's long-term asset allocation.

Whew…deep breath.

Here is a live example:

Billy owns ABC Mid Cap Fund with a Cost Basis of $37,500. The Current Value is $30,000. We sell ABC, thus realizing a loss of $7,500. Immediately, we buy back $30,000 worth of DEF Mid Cap Fund. Billy gets the tax benefit of the capital loss, but still has the same Mid Cap exposure in his account.

For those of you with after-tax accounts, when you receive your year-end report from P&A, look at the Realized Gains and Loss Report. You will see the sum total of all trades throughout the year and will be able to apply the content of this article to your specific situation.

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