

Harvesting Capital Gains and Losses

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Abstract

Various strategies have been proposed to take advantage of the facts that (a) capital gains and losses have no tax consequences until they are realized; and (b) short-term and long-term gains and losses are taxed at different rates. However, analyses of these strategies generally ignore the complexity of the tax code and the riskiness of the portfolios that result from tax-based trading. We use a Monte Carlo simulation model to evaluate several tax-based strategies. The most attractive strategy is to realize all losses, using the excess losses to offset realized gains that will rebalance the portfolio.

Harvesting Capital Gains and Losses

An old Wall Street adage advises investors to lock in profits by selling winners: “Nobody ever went broke taking a profit.” On the other hand, Gerald Loeb argues that investors should sell losers: “[Losses] must be cut quickly before they become of any financial consequence...Cutting losses is the one and only rule of the market that can be taught with the assurance that it is always the correct thing to do.” (Loeb 1965)

Each rule is remarkably pessimistic. The first rule works if stocks that have gone up are likely to go down; the second rule works if stocks that have gone down are likely to continue going down. These rules should be viewed with considerable skepticism if we accept the considerable evidence that past price movements are a poor predictor of future price movements (for example, Jensen 1978; Fama 1991).

The tax code provides a more persuasive reason for deciding whether to sell winners or losers. Several plausible strategies have been proposed to exploit the differential tax rates applied to short-term and long-term capital gains and losses. Unfortunately, these strategies have generally been analyzed with unrealistic assumptions because a theoretical analysis is too difficult in more complicated models. We use Monte Carlo simulations to evaluate several strategies.

Capital Gains Taxes

Tax laws are notoriously complex. For our purposes, the following general rules are sufficient. All realized capital gains are taxable and realized losses can be used to a limited extent to reduce taxable income. Capital gains and losses are long-term if the asset is held for more than a year, and short-term otherwise. To determine taxes, three separate calculations must be made:

net short-term gain: short-term capital gains minus short-term capital losses

net long-term gain: long-term capital gains minus long-term capital losses

taxable gain: net short-term gain plus net long-term gain

If the taxable gain is positive, and neither the net short-term gain or net long-term gain are negative, the net short-term gain is taxed as ordinary income and the net long-term gain is taxed at a 15% rate (or 5%, if the tax rate on ordinary income is 15% or lower). If the taxable gain is positive, but either the net short-term gain or net long-term gain is negative, the taxable gain is taxed as ordinary income.

If the taxable gain is negative, up to \$3,000 (\$1,500 if married filing separately) of this loss can be deducted from taxable income; any excess over this limit is carried forward for possible use in future years. Losses that are carried forward retain their designation as short-term or long-term. If there are both short-term and long-term losses, the \$3,000 allowable loss comes out of short-term losses first. Thus if the short-term loss is less than \$3,000, all of the loss carried forward is long-term. If the short-term loss is more than \$3,000, only the excess over \$3,000 is carried forward as a short-term loss and all of the long-term loss is carried forward.

When an investor dies, the basis is revised to the current market value, thereby eliminating all unrealized gains and losses. Unused carryover losses also expire with the taxpayer's death.

Deferring Gains

The lower tax rate on long-term gains provides an obvious incentive to defer the realization of gains, at least until they become lightly taxed long-term gains. Even after they become long-term, there are continuing benefits from deferring taxes since the investor can continue earning dividends and capital gains on the deferred taxes. By not taxing unrealized gains, the government implicitly loans investors their tax liability at an interest rate equal to the marginal tax rate times the rate of return.

An investor who is confident that a stock's price is about to fall may want to realize the gain and pay the tax. Investors who have no good reason for selling have one good reason not to sell—the deferral of taxes.

Harvesting Losses

One good reason for selling is to realize capital losses so that additional money can be invested. Just as postponing taxes on capital gains allows investors to invest funds that otherwise would be paid to the IRS, the realization of capital losses allows investors to invest funds provided by the IRS. As long as the tax rate is less than 100%, investors cannot make money by losing money. But once a loss has occurred, it can be profitable to realize the loss so that more money can be invested. The tax value of unrealized losses doesn't earn dividends or capital gains and evaporates when the investor dies. The tax treatment of capital losses provides a powerful incentive to realize losses in a timely manner.

Exploiting the Difference Between Short-Term and Long-Term Rates

Even if the tax rate on short-term gains and losses equals the tax rate on long-term gains and losses, the preceding section explained why investors can profit by deferring gains and harvesting losses (also see Constantinides 1983). Unless they are confident that their winners will soon do poorly, investors should hold on to investments with unrealized capital gains and let the taxes due on the capital gains expire with their death. For investments with capital losses, investors should realize these losses if the tax saving is larger than the transaction costs of liquidating the investment and reinvesting the proceeds.

More sophisticated strategies attempt to take advantage of opportunities to deduct capital losses from fully taxed ordinary income while paying lower tax rates on long-term capital gains. Constantinides (1984) argues that when the tax rate on short-term gains is higher than the tax rate on long-term gains, investors should realize long-term gains in order to increase a stock's tax basis and restart the clock for future short-term losses; that is, they should realize gains in order to create opportunities to realize losses. The problem with continuously implementing this strategy is that gains and losses realized in the same year are offset for tax purposes, effectively

equalizing their tax rates and eliminating the benefits from this strategy. (Even if long-term gains exceed short-term losses, the long-term gains are taxed at short-term rates.) Constantinides's ingenious solution is to realize losses in odd-numbered years (thereby obtaining their tax benefits) and to realize both gains and losses in even-numbered years (thereby resetting the basis of stocks that have appreciated). In his empirical analysis of the period 1962-1977, this strategy substantially outperforms a strategy of realizing losses and deferring gains every year.

However, his analysis relies on several assumptions. He assumes that the investor's portfolio is liquidated at the end of a 15-year holding period. Thus the competing strategy that does not realize gains only defers taxes for a maximum of 15 years (and typically a much shorter period) and does not benefit from the favorable treatment of unrealized gains at an investor's death. Realizing gains to reset the basis is clearly more advantageous if the gains will be realized soon in any case.

Constantinides also assumes that the proceeds from a stock sale are always used to purchase an equal number of shares in that stock. The tax refund from the realization of short-term losses is invested in Treasury bills taxed at a 50% rate; funds needed to pay capital gains taxes are borrowed at this same interest rate. The primary advantage of realizing losses is to obtain additional investable funds; this strategy is clearly hobbled if the additional funds are invested in low-return assets. Similarly, the main cost of realizing gains is the loss of investable funds; this strategy is helped if these funds can be replenished at a low interest rate.

Dammon, Dunn, and Spatt (1989) show that Constantinides' results also depend on the specific historical period 1962-1977. The market rose during the years 1962-1968 and then fell back to its 1962 level over the next five years. The strong 1962-1968 market reduced the opportunities for profitably realizing short-term losses; the 1969-1974 market decline rewarded investors who realized capital gains during the 1962-1968 period to restart their bases. They redo

Constantinides' simulations over 15-year horizons using randomly selected monthly returns for 75 randomly selected stocks during the period 1963-1983. They find that the benefits from restarting are generally much smaller than reported by Constantinides and are generally less than the costs if unrealized gains are not taxed at the end of the 15-year period.

Dammon, Dunn, and Spatt buttress their conclusions with Monte Carlo simulations involving a single stock with mean annual returns ranging from 5% to 20% and annual standard deviations ranging from 10% to 80%. They again use a 15-year horizon and assume that the cash fund earns 5% before taxes. They report only 25,000 simulations though they note that more simulations are needed to provide an accurate approximation of highly skewed distributions.

Dammon and Spatt (1996) show that it may be advantageous not to realize modest short-term losses near the expiration of the short-term holding period because these losses may turn into lightly taxed long-term gains. This argument for not restarting the clock so that short-term losses might turn into long-term gains is a nice complement to Constantinides' argument for realizing long-term gains in order to restart the clock for future short-term losses.

However, Dammon and Spatt ignore the reality that gains and losses must be offset. (Although they analyze only a single security, they assume it is traded weekly and ignore the offsetting of gains and losses on the same security.) The mandated offset vitiates their strategy. And if an investor avoids the offset by never realizing losses, the foregone benefits from deducting losses will generally far exceed the benefits from a lower tax rate on realized gains—particularly if the realization of gains can be postponed indefinitely.

They also make the unrealistic assumption that each stock has a tax-exempt counterpart with a riskless tax-free rate of return equal to the expected value of the stock's risky, taxable return. Tax refunds are invested at this interest rate and tax bills are paid with funds borrowed at this interest rate. This peculiar assumption is in sharp contrast to Constantinides' assumption that

funds are invested and borrowed at the taxable and tax-deductible T-bill rate. This difference clearly underlies their differing conclusions about whether it is profitable to realize long-term gains in order to restart the basis.

Another problem with all of these analyses is that they ignore the \$3,000 limit on capital losses that can be realized in any year.

Risk and Diversification

Most investors care about risk as well as return. One of the lessons of modern portfolio theory is that it pays to diversify. This fundamental principle is usually ignored by analyses of tax-based strategies, most obviously when the portfolio consists of a single stock.

In the Constantinides (1984) model, the investor always holds the same number of shares of each stock. He argues that this restriction ensures that each strategy is equally risky. This isn't entirely true since the strategies hold different amounts of cash, or are leveraged. More importantly, an equal number of shares doesn't ensure a balanced portfolio, even when the portfolio is formed, since prices per share may vary widely from stock to stock.

Unbalanced portfolios are generally riskier than balanced ones, and a portfolio consisting of an equal number of shares of each stock may become increasingly unbalanced over time as some stocks do much better than others. Because investors may want to reduce their risk by rebalancing their portfolios, an important difference between two strategies may be how well they facilitate such rebalancing. For example, a buy-and-hold strategy only allows rebalancing through the investment of dividends; in contrast, a strategy of realizing gains allows the redeployment of funds invested in the stocks that have increased in value.

Similarly, the analysis of trading strategies involving a single stock ignores the fact that losses on one stock can be used to offset gains on another stock. Instead of being carried forward, perhaps for many years, realized losses that exceed the \$3,000 limit can be used to offset realized

gains and thereby rebalance the portfolio.

We should note that Warren Buffett has expressed skepticism about rebalancing: “To suggest than an investor should sell off portions of his most successful investments simply because they have come to dominate his portfolio is akin to suggesting that the Bulls trade Michael Jordan because he has become so important to the team.” (Buffett 1997) The crucial difference between Michael Jordan (in his prime) and a successful stock in an efficient market is that Michael Jordan’s performance could be reliably predicted from his past performance. Perhaps Buffett’s record justifies his confidence that his best-performing investments will continue to do well. Mere mortals who cannot predict stock returns reliably from past performance should be wary of unbalanced portfolios.

A Monte Carlo Simulation Model

A Monte Carlo simulation model can be used to illustrate these points concretely. The investor begins with \$200,000 that is divided equally among 20 assets (or asset classes); we will call these assets stocks. We simplify the analysis by assuming that trading occurs at one-year intervals, or a day later to allow capital gains to become long-term. More frequent trading would increase the potential advantages from tax-based trading strategies.

Each stock pays an annual dividend (or other cash flow) equal to 1% of the stock’s current market value. The annual change in market value is described by a lognormal distribution:

$$\ln \left[\frac{P_t}{P_{t-1}} \right] \sim N[\mu, \sigma^2]$$

The values of μ and σ are set so that the annual percentage change in each stock’s price has an expected value of 5% and a standard deviation of 40%. The correlation coefficient between each pair of stock returns is 0.25.

The 6% expected return is intended to reflect current expectations that future stock market returns will, on average, be substantially lower than historical returns. The assumed values for

the dividend yield and standard deviation of prices reflect the observation that investors employing tax-based strategies should select stocks with relatively low dividends (which are heavily taxed) and relatively high volatility (which create opportunities for capital gains and losses).

We assume that the annual maximum tax-deductible capital loss is \$3,000 and that this amount does not increase over time. Using discount brokers, brokerage fees are negligible and are ignored. The tax rate on short-term gains is 36% and the tax rate on dividends and long-term capital gains is 15%.

The investor does not try to time the market or to identify over- or under-valued securities, but does try to profit from the tax code. Five strategies are considered:

1. Buy and hold: never sell any stocks. This is the benchmark for the tax-based strategies.
2. Realize gains and losses: realize all capital gains and losses each year. This strategy allows the investor to rebalance the portfolio completely each year.
3. Realize gains in even-numbered years: realize losses every year and realize gains in alternate years in order to create opportunities to realize future losses.
4. Realize losses: realize all losses and defer all gains; excess losses are carried forward.
5. Realize losses and rebalancing gains: realize all capital losses each year. Excess losses are used to offset realized capital gains on those stocks that have become the largest part of the portfolio. If there are insufficient capital gains to absorb the capital losses, the excess capital losses are carried forward.

All of these strategies generate cash each year, from dividends and (possibly) stock sales. This cash is invested in the 10 stocks that are the smallest components of the portfolio, with two exceptions. Strategy 2 invests equal amounts in all stocks, and Strategy 4 does the same in alternate years.

Results

As noted above, when working with compounded returns from lognormal distributions over long horizons, a large number of simulations are needed to provide accurate estimates of the probability distribution. We consequently used one million simulations of the model.

Table 1 shows the mean and median values of terminal wealth relative to the buy-and-hold strategy. By these measures, a strategy of realizing gains and losses or realizing gains in alternate years does substantially worse than the other strategies (particularly over long horizons). Because they take advantage of the tax-deductibility of capital losses, the mean values of wealth for the strategies of realizing losses and realizing losses and rebalancing gains are comparably higher than for buy and hold. The wealth distribution for buy and hold is very skewed, with median wealth far below mean wealth. The strategy of realizing losses and rebalancing gains is particularly effective in increasing the median value of wealth relative to buy and hold.

Table 2 shows the standard deviations of the wealth distributions, again relative to buy and hold. The strategies of realizing gains and losses or realizing gains in alternate years have very compact distributions because they completely rebalance the portfolio every year or every other year. Among the other three strategies, a strategy of realizing losses and rebalancing gains reduces the dispersion of wealth substantially.

Table 3 gauges the degree to which a portfolio is unbalanced by looking at the average fraction of the portfolio that is invested in the largest stock holding. With buy and hold, after 10 years 18.1% of wealth, on average, is invested in a single stock; after 30 years, this fraction is up to 30.7%. A strategy of realizing losses each year has only a modest effect. A strategy of realizing losses and rebalancing gains cuts this fraction approximately in half.

Two of the strategies have relatively low average wealth and dispersion in wealth, compared to the other three strategies. One way of comparing strategies with such differences is to

compute the probability of a loss—here the probability that wealth is less than the initial \$250,000. Figure 1 shows that, by this measure, the strategy of realizing losses and rebalancing gains is the safest.

If we assume that the observed simulation frequencies are approximately equal to the probabilities of obtaining various levels of wealth, stochastic dominance allows us to compare risky strategies while making the weakest possible assumptions about preferences (Quirk and Saposnik 1962, Fishburn 1964, Hadar and Russell 1969).

Strategy A exhibits first-degree stochastic dominance over Strategy B if the cumulative probability distribution of wealth for A is never to the left (and sometimes to the right) of the cumulative probability distribution for B. This requirement that the cumulative probability distributions don't cross means that the probability that wealth will be less than or equal to any specified amount W is never larger for Strategy A than for Strategy B and is sometimes smaller. Equivalently, the probability that wealth will be larger than or equal to any specified amount W is never smaller for Strategy A than for Strategy B and is sometimes larger. Any investor who prefers more wealth to less unambiguously prefers a strategy that exhibits first-degree stochastic dominance.

Strategy A exhibits second-degree stochastic dominance over Strategy B if, for all specified levels of wealth, the area under A's cumulative probability distribution is never larger (and is sometimes smaller) than the area under B's cumulative probability distribution. This requirement means that A's cumulative distribution must start to the right of B's cumulative distribution and can cross it as long it as the difference in the areas before they cross is greater than the difference in the areas after they cross. Roughly speaking, A has a lower probability of both relatively low and high levels of wealth, and the differences in the low-wealth probabilities are larger than the differences in the high-wealth probabilities. A risk-averse investor who prefers more wealth to

less (a concave, positively sloped utility function) prefers a strategy that exhibits second-degree stochastic dominance.

Table 4 shows that the strategy of realizing losses and rebalancing gains exhibits either first- or second-degree stochastic dominance over each of the other strategies for various horizons.

Conclusions

Strategies that involve the realization of losses would fare even better if the \$3,000 limit on tax-deductible capital losses were increased in the future. Anything is possible with the tax code, but it seems unlikely that the current limit will persist indefinitely. The Monte Carlo simulations also assume that transactions are only made once a year. More frequent transactions would increase an investor's chances of realizing annual capital losses up to the tax-deductible limit and would also increase the investor's opportunities to use excess losses to rebalance the portfolio.

Even so, a strategy of realizing losses and rebalancing gains is very attractive. This strategy not only increases the average return by taking advantage of the tax-deductibility of losses, but also mitigates risk by allowing low-cost portfolio rebalancing. The basis and time clock are also restarted when stocks with capital gains are sold and the proceeds are reinvested in rebalancing stocks. There is no direct profit from this restarting since the implicit tax rate on the capital gains equals the tax rate on losses; however, this restarting plants seeds that allow a continual harvesting of future capital losses that can be deducted from income and can be used to perpetually rebalance the portfolio.

In comparison, buy and hold foregoes the profits from deducting losses and leads to very unbalanced portfolios when some stocks do much better than others. Realizing losses takes advantage of the deductibility of losses, but does little to rebalance the portfolio: selling stocks that have gone down in value and reinvesting the proceeds doesn't alleviate the problem that past winners now dominate the portfolio. A strategy of realizing all gains and losses annually permits

complete rebalancing and thereby reduces the variability of wealth; however, the taxes paid on the excess capital gains outweigh this benefit. Realizing losses every year and gains every other year is not much of an improvement.

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Table 1 Mean (Median) of Wealth Relative to Buy and Hold Strategy

horizon (years)	Realize Gains & Losses	Realize Gains in Alternate Years	Realize Losses	Realize Losses & Rebalancing Gains
10	0.76 (0.87)	0.78 (0.88)	1.04 (1.04)	1.04 (1.05)
20	0.60 (0.79)	0.62 (0.80)	1.06 (1.07)	1.05 (1.11)
30	0.48 (0.75)	0.50 (0.76)	1.07 (1.09)	1.07 (1.18)
40	0.38 (0.71)	0.40 (0.73)	1.08 (1.12)	1.07 (1.25)
50	0.31 (0.69)	0.32 (0.70)	1.08 (1.14)	1.08 (1.34)
60	0.24 (0.67)	0.26 (0.69)	1.08 (1.16)	1.08 (1.43)

Table 2 Standard Deviation of Wealth Relative to Buy and Hold Strategy

horizon (years)	Realize Gains & Losses	Realize Gains in Alternate Years	Realize Losses	Realize Losses & Rebalancing Gains
10	0.49	0.52	1.03	1.00
20	0.33	0.36	1.04	0.98
30	0.22	0.24	1.05	0.95
40	0.14	0.15	1.06	0.91
50	0.07	0.08	1.06	0.83
60	0.04	0.04	1.06	0.73

Table 3 Average Fraction of Portfolio in Largest Stock Holding

horizon (years)	Buy & Hold	Realize Gains & Losses	Realize Gains in Alternate Years	Realize Losses	Realize Losses & Rebalancing Gains
10	18.1	4.0	4.0	19.5	9.2
20	25.7	4.0	4.0	25.9	11.7
30	30.7	4.0	4.0	29.8	14.3
40	33.8	4.0	4.0	32.3	16.3
50	35.9	4.0	4.0	34.0	17.9
60	37.1	4.0	4.0	35.2	19.0

Table 4 Stochastic Dominance of a Strategy of Realizing Losses and Rebalancing Gains

Strategy	Stochastic Dominance	Horizon (years)
Realize gains and losses	first-degree	36 or more years
Realize gains in alternate years	first-degree	23 or more years
Realize losses	second-degree	8 or more years
Buy and hold	second-degree	8 or more years

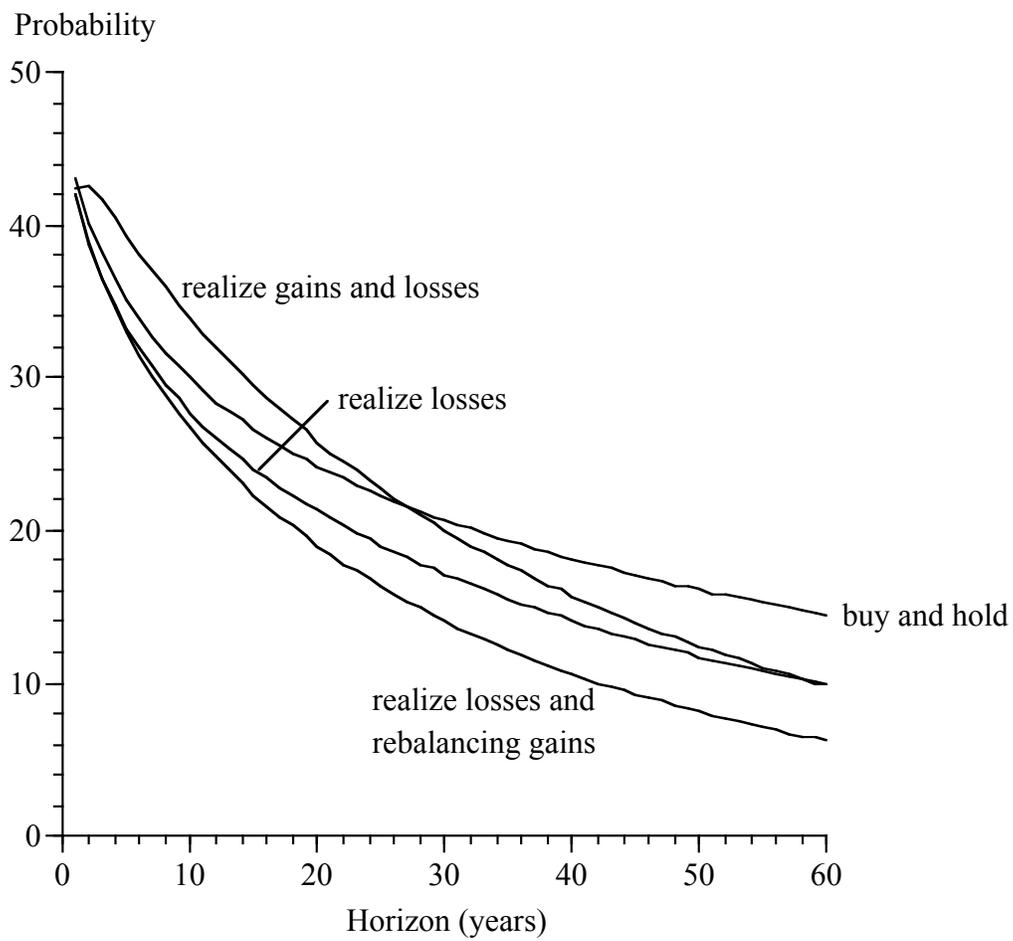


Figure 1 Probability of a Loss