



Memo to Advisors

December 7, 2011

Dear Advisor,

As we approach year-end, I'd like to highlight some of the portfolio management actions we are taking on behalf of clients in our STAR II and III investment strategies. I'll be sending you a series of memos over the next several weeks describing each one in greater detail.

Today, I'd like to discuss tax-loss harvesting. No one likes a loss of course, but positions with unrealized short term losses can be sold to help offset any short-term gains in an account. Furthermore, any net realized losses in excess of \$3,000 carry forward and can be used to offset gains in future years. The benefits of this approach can be significant.

- 1) Reduce current year taxes
- 2) Any amount not used becomes a tax credit that may be used in subsequent years
- 3) Avoid taxable distributions

In STAR II this process is relatively straightforward. Starting in November, we check each fund we hold for any upcoming realized gain distributions. If a particular fund announces a realized gain distribution in excess of a client's current unrealized gain, we typically sell the fund before the distribution, and replace it temporarily with another fund in the same category until the distribution has been made. We also check each fund held in taxable accounts for any significant unrealized losses. If the unrealized loss is significant, and the position is large enough to make the transaction cost-effective, we sell the fund before year-end, and replace it with another fund or ETF as a placeholder for a minimum of 31 days to comply with the IRS' Wash Sale requirements. Consider the following example using the Janus Overseas Fund (JDIAX)

Client purchased 100 shares JDIAX at \$50/share or \$5,000. Today the fund is trading at \$37.75/ share, of \$3,750. Janus has announced an upcoming \$2.50/share short-term capital gain distribution.

<u>Scenario</u>	<u>Short-term losses</u>	<u>Dividend Received</u>	<u>Taxable Amt.</u>
1 (harvest losses)	(\$1,250)	\$0	(\$1,250) credit
2 (keep losses)	\$0	\$250	\$250



In STAR III VEGA the option premium we collect throughout the year is taxable as a short-term capital gain. This can be partially or even wholly offset by selling any ETFs that have unrealized short-term losses and replacing them with substitute ETFs that are similar but not identical. The explosive growth we've seen in the ETF and option market over the last several years is a positive for us in that it gives us a larger pool of candidates to use as tax-loss replacements. Consider the following example showing the performance of the iShares Diversified Emerging Markets ETF (EEM) and its tax-loss substitute the Vanguard MSCI Emerging Markets ETF (VWO) over the last 12 months:



Another way to view the benefits of tax-loss harvesting is by considering two possible scenarios. In both instances, let's use a hypothetical VEGA account that started the year with \$1,000,000 and has gained 5% year-to-date, bringing the total account value to \$1,050,000. This same account has earned \$150,000 in option premium, but has an unrealized loss of \$100,000 on its ETF portfolio. In scenario 1 we realize the ETF losses. In scenario 2, we don't. Here is the side by side comparison:

Scenario #	Short-term gain	Estimated Taxes (@35%)*	Account Value
1 (harvest losses)	\$50,000 (\$150,000 - \$100,000)	\$17,500	\$1,032,500
2 (keep losses)	\$150,000	\$52,500	\$ 997,500



Furthermore, since we replace one ETF with another that is similar, we don't incur any opportunity risk since the account remains fully invested.

On a final note, the above information is not intended to be construed as tax advice. Please consult with a CPA before discussing an individual client's tax situation.

Sincerely,

James Herrell, CFA

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**Estimated taxes are for illustration purposes only. Actual client results and taxes may be different from the example shown.*