

Ossified Portfolios Aren't the End of the Road

Reframing Tax Lock as a Planning Opportunity

What it is

Tax alpha builds across the portfolio lifecycle through loss harvesting, gain deferral, compounding, and other tax-aware decisions.

Why it matters

Effective tax management improves after-tax outcomes and preserves flexibility in mature portfolios.

Where it's going

Tax-aware strategies will increasingly rely on tax-lot control to sustain value as portfolios mature.

The Low-Basis Dilemma

"My client is locked up."

"The tax bill is too big to make a change."

"What happens when the losses run out?"

For advisors working with high-net-worth clients and mature portfolios, these are familiar challenges. Over time, successful portfolios accumulate embedded gains, making change feel prohibitive and, in some cases, avoidable altogether.

This often leads to the conclusion that there may be limited opportunity to continue adding value at the portfolio level. With fewer losses to harvest and meaningful changes carrying a tax cost, the role of ongoing tax management may come into question.

In this context, direct indexing and other tax-aware strategies can provide greater control over tax outcomes as portfolios evolve over time.

The Misconception: Ossified Means Inactive

The idea that an "ossified" portfolio no longer offers meaningful opportunities to add value is often misguided. Of course, as portfolios appreciate, the opportunity to harvest losses does decline. That is expected, but it does not mean that active portfolio management becomes irrelevant.

Unlike pooled vehicles, portfolios constructed from individual securities enable active decision-making across hundreds of positions and tax lots, even at low basis. In practice, even highly appreciated portfolios remain active across multiple dimensions:

- Cash is raised for withdrawals or reallocations by prioritizing higher-cost-basis positions
- New cash flows, including contributions, dividends, and other income, are reinvested to create new tax lots
- Charitable gifting is used to reduce low-basis exposure efficiently
- Risk and tracking error are continuously monitored and managed

Tax lock is a natural feature of mature taxable portfolios—it reflects a decline in available loss-harvesting opportunities as gains accumulate. It is not, however, a signal that the portfolio is “stuck,” nor a reason to eschew active management.

Tax Alpha Does Not Disappear. It Evolves.

Another common misconception is that tax alpha is driven exclusively by loss harvesting and therefore diminishes as losses become less available. This view is incomplete.

As portfolios mature, the primary driver of value shifts toward gain deferral and compounding (see exhibit 1).

By deferring gains:

- Taxes are postponed rather than realized, allowing a larger portion of the portfolio to remain invested
- The value of this deferral increases with time, as a longer compounding horizon allows a greater portion of pre-tax capital to remain invested
- The longer gains are deferred, the greater the potential impact on after-tax outcomes
- If held through an estate event, embedded gains may receive a step-up in cost basis, potentially eliminating the associated tax liability

Managing Ossified Portfolios in Practice

Direct indexing is designed to operate within the constraints of low-basis portfolios, providing multiple levers to maintain flexibility over time. These include:

Staged Transitions

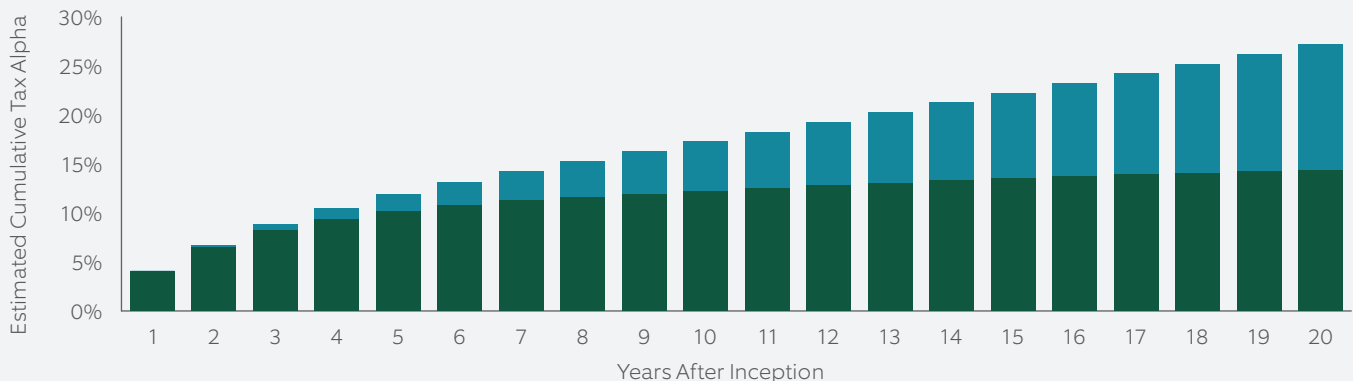
Rather than triggering a large, immediate tax event, portfolios can be repositioned gradually. This can be aligned with a client’s tax budget, market conditions, and planning horizon.

Tax-efficient share selection

When raising cash, managers can selectively sell higher-cost-basis shares to help minimize realized gains. This is an advantage not available in pooled vehicles.

EXHIBIT 1: Immediate and Continuing Benefits of Tax Loss Harvesting

■ Immediate Benefits ■ Continuing Benefits



Source: Northern Trust Asset Management. Assumes loss harvesting rates outlined in exhibit 1. Assumes 7% Return on the S&P 500 Index. It is not possible to invest directly in any index. Index performance returns do not reflect any management fees, transaction costs or expenses. Past performance is not indicative of future results. Important Information on the last pages for notes on hypothetical projections. For illustrative purposes only

Charitable optimization

Highly appreciated securities can be donated to:

- Remove low-basis positions
- Avoid capital gains
- Create a possible tax deduction
- Support client philanthropic objectives

Ongoing portfolio activity

Even mature portfolios continue to evolve through ongoing turnover, driven by:

- Dividend reinvestment
- Corporate actions
- New contributions

These flows create new tax lots over time, which help regenerate the opportunity set within the portfolio.

A More Durable View of Tax Management

Low-basis portfolios are a common reality for high-net-worth clients, but they are not a dead end. Tax lock indicates a shift in the opportunity set—towards gain deferral, the compounding of tax savings, and ongoing tax-aware decisions.

In select cases, advisors may consider complementary approaches, such as tax-aware long-short strategies, to expand the range of potential outcomes and introduce additional sources of tax-loss generation. Ultimately, any strategy that offers tax-lot-level flexibility is better positioned to adapt, maintain control over outcomes, and continue adding value over time.

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