

Tax lot harvesting:

Enhancing after-tax returns for captive insurance portfolios

As fee compression erodes other sources of efficiency in captive insurance portfolios, Kevin Yousif, CFA, president of Yousif Capital Management, argues that disciplined tax management has become a repeatable and underappreciated source of after-tax value, and that tax lot harvesting deserves a more prominent place in portfolio strategy

Kevin Yousif, CFA
president
Yousif Capital Management





The battle over fees has largely been won. The next frontier is after-tax returns. You can reduce your tax liability and preserve more capital for long-term growth

Yousif Capital Management is not a tax advisor. While this paper discusses tax lot harvesting strategies, individuals and organizations should consult their tax advisor to gain clarity on their specific situation.

For taxable investors, the value of post-tax return is often underappreciated, yet acutely felt each tax season. This dynamic is particularly relevant for captive insurance companies, where investment portfolios play a critical role in supporting long-term liabilities and surplus growth.

While investment performance is typically evaluated on a pre-tax basis, it is after-tax returns that ultimately determine the economic value retained within the captive.

Historically, the industry's focus has centred on management fees, commissions, and custody costs as the primary drivers of efficiency. However, the rise of low-cost indexing has compressed fees across the industry, shifting the conversation. As pre-tax alpha in highly efficient markets such as public equities becomes increasingly difficult to generate, tax drag, the reduction in returns due to taxation, has emerged as a key determinant of portfolio outcomes.

Traditional investment vehicles present structural inefficiencies for taxable entities. Mutual funds, for example, distribute capital gains and dividends periodically, creating taxable events irrespective of whether the investor has sold their position. For captive insurers, this can lead to mismatches between taxable income and liquidity needs.

Exchange-traded funds (ETFs) have improved tax efficiency through in-kind creation and redemption mechanisms, but investors remain exposed to capital gains taxes upon the sale of shares.

Tax-aware investing provides a framework to address these inefficiencies. Central to this approach is tax lot harvesting, the systematic realisation of losses by selling securities that have declined in value. These losses can be used to offset realised gains elsewhere in the portfolio, reducing the overall tax burden. After the applicable wash sale period, positions may be re-established to maintain target exposures while resetting the portfolio's cost basis.

The benefit of this process is often referred to as tax alpha, the incremental return generated through effective tax management. Unlike traditional sources of alpha, which depend on security selection or market timing, tax alpha is derived from improving after-tax outcomes without meaningfully increasing portfolio risk. For captive insurance companies operating in a taxable framework, this represents a consistent and repeatable source of value.

Consider a captive insurance portfolio with US\$10 million in taxable assets. Assume the portfolio needs to raise cash to

Exhibit 1: Impact of tax-aware versus non-tax-aware portfolio management

* All figures are in US dollars (US\$)

Scenario	Non-Tax-Aware Approach	Tax-Aware Approach
Portfolio Value	\$10,000,000	\$10,000,000
Realized Capital Gains	\$500,000	\$500,000
Harvested Losses	—	(\$400,000)
Net Taxable Gains	\$500,000	\$100,000
Assumed Tax Rate	21%	21%
Tax Liability	\$105,000	\$21,000
Tax Savings	—	\$84,000

This example illustrates how tax loss harvesting can materially reduce realised tax liabilities by offsetting gains with harvested losses. Results are hypothetical and for illustrative purposes only.

fund liabilities, resulting in realised capital gains. In a non-tax-aware approach, these gains would be realised on a pro-rata basis across holdings, in our example realising US\$500,000 in capital gains for the year. Assuming a 21 per cent effective tax rate for illustrative purposes, the annual tax liability would be US\$105,000.

Under a tax-aware approach, gains can be paired with harvested losses, realising US\$400,000 in losses from underperforming securities, reducing net taxable gains to US\$100,000. The resulting tax liability falls to US\$21,000 in that year.

The resulting US\$84,000 in tax savings is substantial and would be a missed opportunity for those that do not implement a tax loss harvesting strategy.

In addition to reducing current tax liability, deferring taxes allows more capital to remain invested and compound over time, further enhancing long-term after-tax returns.

When implemented systematically within a disciplined portfolio framework, direct indexing has emerged as a particularly effective tool for tax-aware strategies. Direct indexing is a strategy where an investor holds individual securities rather than commingled vehicles.

Through a direct indexing structure, captive insurance companies gain greater control over portfolio construction, customisation, and tax management. This structure increases the opportunity set for tax loss harvesting, as individual

securities within a diversified portfolio will exhibit varying performance over time.

Diversification remains fundamental. Within a broadly diversified portfolio, certain securities may generate significant gains, such as the well-documented outperformance of the 'Magnificent Seven' in recent years, while others may lag. In a direct indexing framework, this dispersion is advantageous. Underperforming securities can be harvested to realise losses, while outperforming positions continue to compound, aligning with a disciplined buy-and-hold philosophy.

Advancements in portfolio management technology have made these strategies increasingly accessible. Automated systems can monitor portfolios continuously, identifying harvesting opportunities with precision and efficiency.

What was once a manual and episodic process can now be implemented systematically, enhancing consistency and scalability.

In today's environment, where fees are compressed and markets are broadly efficient, optimising after-tax returns is no longer optional; it is essential. For captive insurance companies, where investment income directly supports long-term financial strength, managing tax drag is a critical component of portfolio strategy. Tax lot harvesting offers a practical and effective means of enhancing after-tax performance, allowing more capital to remain within the captive and compound over time. ■