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— WEALTH —

“PORTFOLIO OSSIFICATION”

In previous posts we have highlighted our conviction around direct indexing as a compelling strategy for targeting benchmark returns while potentially adding alpha through tax-loss harvesting. Direct indexing is owning the individual equity components of a benchmark index in a separately managed account (SMA) rather than a pooled vehicle like an ETF or mutual fund. See our prior post [here](#).

In positive multi-year cycles such as we have experienced since 2022, direct indexing strategies can also create a challenge: **“portfolio ossification.”**

Portfolio ossification occurs when substantial embedded gains from strong market performance make tax-loss harvesting and portfolio rebalancing increasingly difficult. Over time, this can lead to a direct indexed portfolio becoming “ossified,” dominated by over-concentrated holdings with large unrealized gains.

This phenomenon is not limited to direct indexing strategies. Portfolio ossification resulting from concentrated stock positions or deeply embedded capital gains can also arise from employee compensation plans, equity based M&A or business sales, inheritance, or just successful investments over time.

While in most cases these positions represent a windfall, they can also result in a less dynamic and potentially underperforming portfolio. The need for cash up-front to extend tax loss harvesting opportunities can be challenging for investors who already have a significant portion of their wealth tied up in existing positions.

In addition to nullifying the potential benefits of tax-loss harvesting, an ossified portfolio may also present new risks and challenges, including concentration risk, an asset allocation that is inconsistent with the original risk profile, and the adverse tax consequences of remediation due to the accumulated unrealized capital gains.

Fortunately, there is no shortage of good solutions for the “nice problem to have” of portfolio ossification. Here we highlight just a few.

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1. Deploy a New SMA Strategy

- Overlay the direct index portfolio with an options-based or long/short strategy matching notional exposure between long and short positions to rejuvenate loss-harvesting, restore balance, and continue to add tax alpha.

2. Fund Philanthropic Goals

- Donate appreciated shares, perhaps utilizing a Donor Advised Fund (DAF), Charitable Remainder Trust (CRT), or Charitable Lead Trust (CLT) to receive a charitable deduction, minimize capital gains taxes, and create an income stream or legacy gift.
- Consider using cash to replenish positions, resetting the cost basis and the appropriate portfolio balance.
- These strategies not only aid in diversification but also support philanthropic goals, providing both financial and social benefits.

3. Exchange Fund

- Investors with low cost basis positions, high tax rates, and minimal liquidity constraints may consider using an exchange fund to achieve diversification without triggering immediate tax consequences.

4. Diversify Gradually

- Gradual diversification is a straightforward yet effective strategy for managing concentrated stock positions. This approach involves systematically selling portions of the concentrated stock and reinvesting the proceeds into a diversified portfolio over time. By spreading out the sales, investors can manage the tax impact more effectively and reduce the risk of timing the market poorly.

5. Gift Shares to Family

- Investors can gift shares of their concentrated stock to family members. This can be particularly tax-efficient if the recipients are in a lower tax bracket. This strategy can reduce the size of the concentrated position and shift future appreciation to family members. Additionally, gifting stock can help with estate planning by reducing the size of the taxable estate.

6. Acceptance

- Recognize the tax cost as an unavoidable consequence of successful investing, and maintain rebalancing discipline regardless of tax consequences.



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While it may be a “nice problem to have,” portfolio ossification does indeed pose significant risks and challenges. Concentrated, low-basis stock positions, while often the result of good fortune, present unique challenges that require careful management. By understanding the risks and employing strategic tax and diversification techniques, investors can reduce their exposure and improve their portfolio’s overall stability without incurring unnecessary tax liabilities. Whether through SMAs, exchange funds, option, long/short, or gradual diversification strategies, the key is to take a proactive approach to managing ossification and ensuring long-term financial health and security.

Challenges can open up new opportunities, new approaches, and new solutions for achieving your goals.

Is your portfolio “ossified”? We would love to engage with you.

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