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Maximizing the upcoming tax loss selling season

Prudent planning can reap dividends

It's been a rocky year for investors but that doesn't mean things need to get worse as we near tax loss selling season. Some prudent planning done now can reap dividends later.

Generally speaking, most retail investors conduct tax loss selling during the latter part of November and the first two weeks of December. After taking a hard-nosed look at their portfolios, and deciding which stocks to cut from the lineup, they sell in order to apply the capital losses to their tax returns.

Mutual fund managers also discard their losers. Known as 'window dressing', some managers sell their biggest losers so they are not reported as part of the fund's holdings in year-end reports. According to Credit Suisse, approximately 50% of U.S. mutual funds have a fiscal year end between October and December.

If a large number of retail investors and fund managers conduct tax loss selling in December, it is reasonable to expect some market volatility. This puts investors, who conduct tax loss selling early, in a cash position and able to take advantage of potential buying opportunities before the later sellers can re-enter the markets. They also enjoy the benefit of time to analyze potential purchases, without the distraction of having to focus on tax-loss decisions.

On a year-to-date basis, a good chunk of the S&P/TSX Composite Index is comprised of decliners, with most of the losses stemming from the energy and materials sectors. Those holding positions on the venture exchange have been hit especially hard. The heavy decliners will be the ones to watch.

In order to crystallize a capital loss, investors must abide by superficial loss rules and wait 30 days before repurchasing the investment. Losses in non-registered accounts are applied against current year capital gains. Excess losses are either carried forward or applied to capital gains accrued in the past three years.

There are options for investors who wish to realize losses but still want to maintain exposure. They can buy an exchange-traded fund that is linked to the desired sector, or purchase shares of a similar company.

For instance, an investor who wants to sell Baytex Energy (TSX: BTE) but is still bullish on energy could purchase the BMO S&P/TSX Equal Weight Oil & Gas Index ETF (TSX: ZEO). Alternatively, they could acquire shares of a different energy company.

Investors who plan on selling an exchange-traded fund (ETF) and then repurchasing in the same asset class should be careful. It is not enough just to replace one ETF with another. Investors must

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be sure they aren't selling and purchasing ETFs based on the same index.

A stock that is down shouldn't be sold just to trigger a loss. It isn't crystallized as either a winner or a loser until it is sold so, if you believe it will recover, you may want to keep it. There should always be a good reason to part with a stock.

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