Prudent tax loss selling strategies

Some year-end tips

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By Kim Inglis

It's been an interesting year for investors and regardless of headline noise most of the major indices are well into positive territory. Despite this there are still a number of stocks experiencing negative returns on the year so investors who develop a strategy for tax loss selling 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. Add in the potential for rate hikes in the U.S. and the prospects for volatility appear even greater. 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, the S&P/TSX Composite Index is currently weighted more towards the losers than the gainers so there are plenty of tax loss selling candidates. Generally speaking, the ones to watch for tax loss selling volatility tend to be the worst and best performing equities.

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 shares in Canfor Corp but is still bullish on forestry could purchase the Guggenheim MSCI Global Timber ETF. Alternatively, they could acquire shares of a different forestry 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 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

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recover, you may want to keep it. There should always be a good reason to part with a stock.

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