After-tax investing for single family offices

How leading single family offices are moving beyond traditional institutional analytics

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In the evolving landscape of wealth management, we find that single family offices (SFOs) increasingly recognize that after-tax investing demands a fundamentally different framework than the traditional approach used by exempt institutional investors.

While institutions typically have the luxury of focusing on only pre-tax returns, SFOs must navigate the complexities of both income and estate taxes as they operate within unique family objectives around multi-generational wealth preservation.

Relying solely on institutional best practices can leave significant value on the table, as tax drag and inefficient asset placement may erode long-term wealth. This shift calls for a holistic approach to portfolio construction, in our view—one that transcends pre-tax investing and goes beyond simply substituting more tax-efficient strategies.

SFOs face two challenges unique to taxable investors:

1) the bespoke nature of after-tax analysis and
2) the need for after-tax optimization tools not usually available with traditional pre-tax analytics.

For SFOs needing customized solutions, BlackRock specializes in tailoring portfolio solutions for specific situations, reflecting the potential tax impact for each investor or entity in the context of a family's overall financial ecosystem. While all pre-tax investors may earn the same return for the same strategy, taxable entities may face significantly different after-tax returns once everything specific to a particular taxpayer gets incorporated, including:

- **Marginal federal and state tax rates**
- **Eventual disposition of assets** (through an estate or liquidated)
- **Estate taxes**
- **Charitable donation planning**
- **Different events within particular tax years, such as a large liquidity event**

As for after-tax analytic tools, BlackRock has created innovative research on after-tax asset allocation and offers advanced quantitative tools to analyze the interplay of potential risk, return, and tax impact across all asset classes. In 2015, BlackRock wrote a seminal academic paper on after-tax asset allocation, "What Would Yale Do If It Were Taxable?" published in the Financial Analysts Journal. That research measured the impact of different tax treatment for various types of income and highlighted how radically different an after-tax asset allocation can be versus pre-tax. The projections showed how the implications for both tax and risk for any investment need to be incorporated at the beginning of any asset allocation rather than just substituting more tax-efficient strategies. While many SFOs already utilize highly skilled tax professionals with expertise in both estate and income tax, optimizing for after-tax risk-adjusted returns and after-tax wealth maximization presents a different set of challenges from those of tax compliance.

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Examples of best practices for SFOs to implement an after-tax framework

How should an SFO pull together all the components of an after-tax asset allocation that seeks to properly reflect all the specifics of its own unique situation?

The following examples highlight our view of practical implementation of an after-tax framework.

Problems to solve:

1. Concentrated position

Excess exposure to a single position creates a risk problem caused by the high tax costs of diversifying. Learn more about how to target risk mitigation in a more tax-efficient way.

2. Liquidity event

Proper tax and portfolio planning for a major liquidity event like the sale of a company can maximize after-tax wealth for sellers and their heirs, promoting solutions for both income and estate tax challenges.

3. Idiosyncratic risk from an operating company

Incorporating industry risk from a large operating company can help improve overall portfolio risk management.

4. Choosing best portfolio based on planned asset disposition

Certain strategies may work better for assets that will pass through an estate or to a charity, while others may perform better for situations where eventual liquidation is planned.

5. Forecasting tax drag across SFO assets

Many SFOs may not have tax drag forecasting that reflects all of their strategies, making it more challenging to construct an optimized after-tax portfolio.

6. Incorporating values alignment for taxable accounts

Some SFOs may want to customize their portfolios to include values alignment and want to keep their investments as tax-efficient as possible.

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Concentrated position[1]

Problem

A new family office CIO took the helm of a $2 billion portfolio but she felt she was handcuffed with over half the portfolio locked up in a single stock, the result of a previous acquisition of the family business. The CIO faced the classic trade-off between minimizing idiosyncratic stock risk and managing taxes simultaneously.

Action

The Client Solutions Group (CSG) provided analysis across a range of solutions to the classic problem of concentrated stock, showing the potential impact on risk and taxes of a number of approaches to solving the problem, including options, loss-harvesting SMAs (both long only and long/short), exchange funds, and contributing to a family foundation. According to the analysis, some solutions, like options, offered immediate risk mitigation, while others, like equity SMAs, provided tax relief while more slowly reducing risk through whittling down the size of the concentrated position. CSG quantified and presented the expected risk and tax liability over time across the different choices.

Resolution

The CIO was able to see clear measurement of the trade-offs across a range of solutions and choose a strategy that fits the family's situation and preferences. In this case she elected to offset some risk upfront with an options strategy and then reduce the tax burden by tying a liquidation plan over multiple years to match the losses generated by a long/short harvesting SMA. Often no single solution fits every situation, and BlackRock can analyze the potential trade-offs around risk, tax liability, and liquidity.

The trade offs

Minimizing risk
(and the speed at which you do it)

Minimizing taxes

Managing liquidity

The tool kit

Options

Immediate risk mitigation and opportunity for income from call writing

Long only SMAs

Unwind concentrated stock with low tracking error

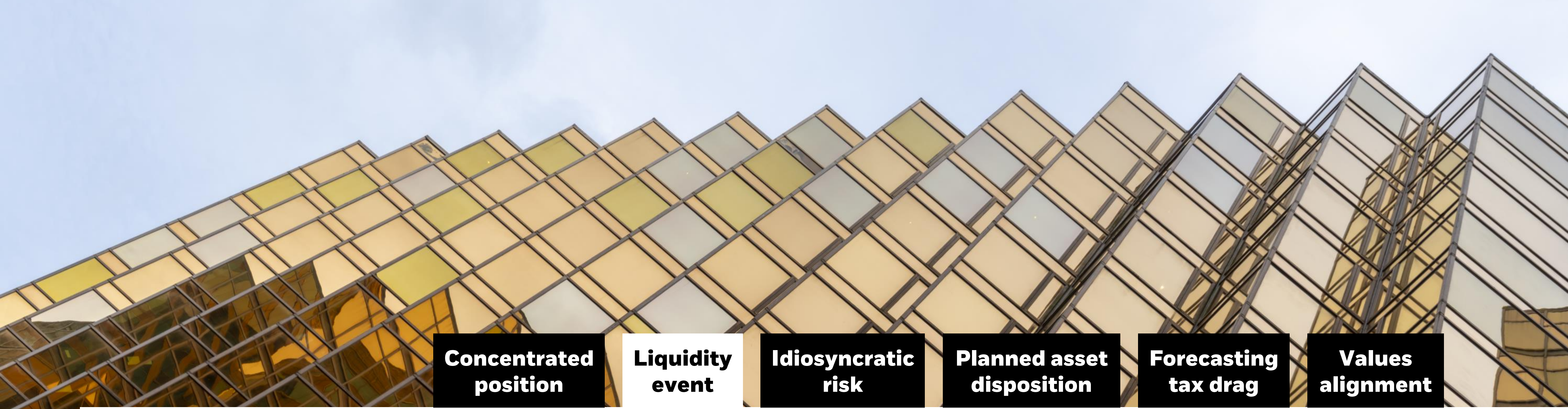
130/30 SMA

Unwind concentrated stock faster but with higher tracking error

Borrowing

Options can potentially provide capital at preferable effective rates

1. Case studies are shown for illustrative purposes only, and were selected to demonstrate BlackRock Family Capital's capabilities. There is no guarantee than an actual strategy will be executed or executed as shown above, or that if executed, will be profitable. The individual case studies were selected as they represent examples of solutions offered for common SFO challenges. Case studies do not predict future results, even if a similar strategy is used.



Planning for a liquidity event

BlackRock's After-tax Wealth Strategists (ATWS) focus on the intersection of income taxes, investing, estate planning and philanthropy to help family offices solve complex problems and seek to maximize after-tax family wealth.

Problem

An SFO anticipating the sale of a major business for nearly $400 million wanted to plan effectively to maximize wealth by reflecting the impact of both income taxes and estate taxes across multiple generations. This family had already funded several hundred million dollars in Intentionally Defective Grantor Trusts (IDGTs) in order to transfer assets outside of the estate of the founding generation. The SFO wanted to know what kind of planning in advance of the sale could lead to optimal after-tax wealth.

Action

BlackRock ATWS listened carefully to understand the family's existing structures as well as planning for their goal of minimizing taxes on the sale. ATWS discussed the potential tax advantages of closing the deal early in the year and then putting a significant portion of the proceeds in a high-leverage, tax-managed long/short strategy to maximize loss harvesting. Since IDGTs are grantor trusts, ATWS also raised the idea of leveraging the existing IDGT structures for additional loss harvesting to offset even more gains from the sale. Finally, since the family's goal was to maximize after-tax family wealth, the ATWS team also suggested taking advantage of trust swap powers to substitute out the most highly appreciated positions in the IDGTs in order to plan for a step-up in basis and allow trust assets to grow undiminished by capital gains taxes.

Resolution

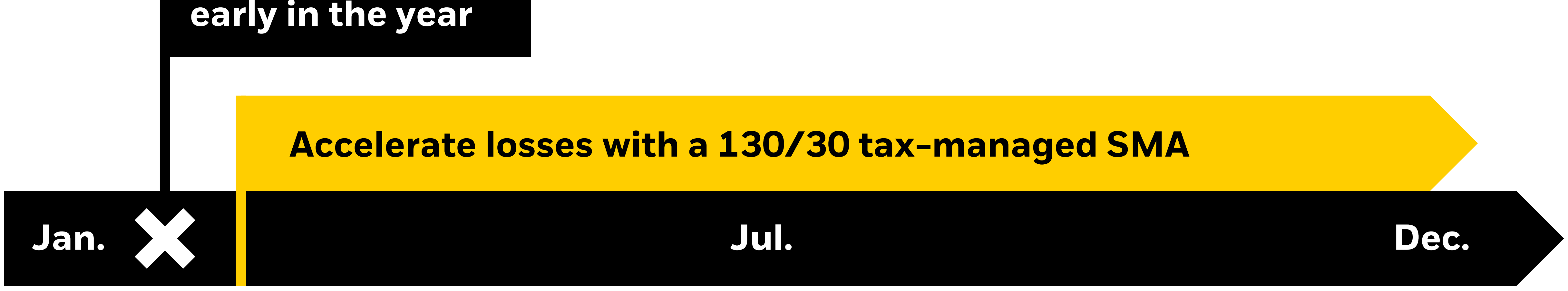
Closing the deal early in the year and then aggressively tax loss harvesting using both the proceeds from the sale as well as existing planning structures enabled a significant portion of the gains from the liquidity event to be offset. Swapping out highly appreciated assets from the grantor trust in exchange for higher basis assets helped to reduce future capital gains and maximize after-tax family wealth across generations.

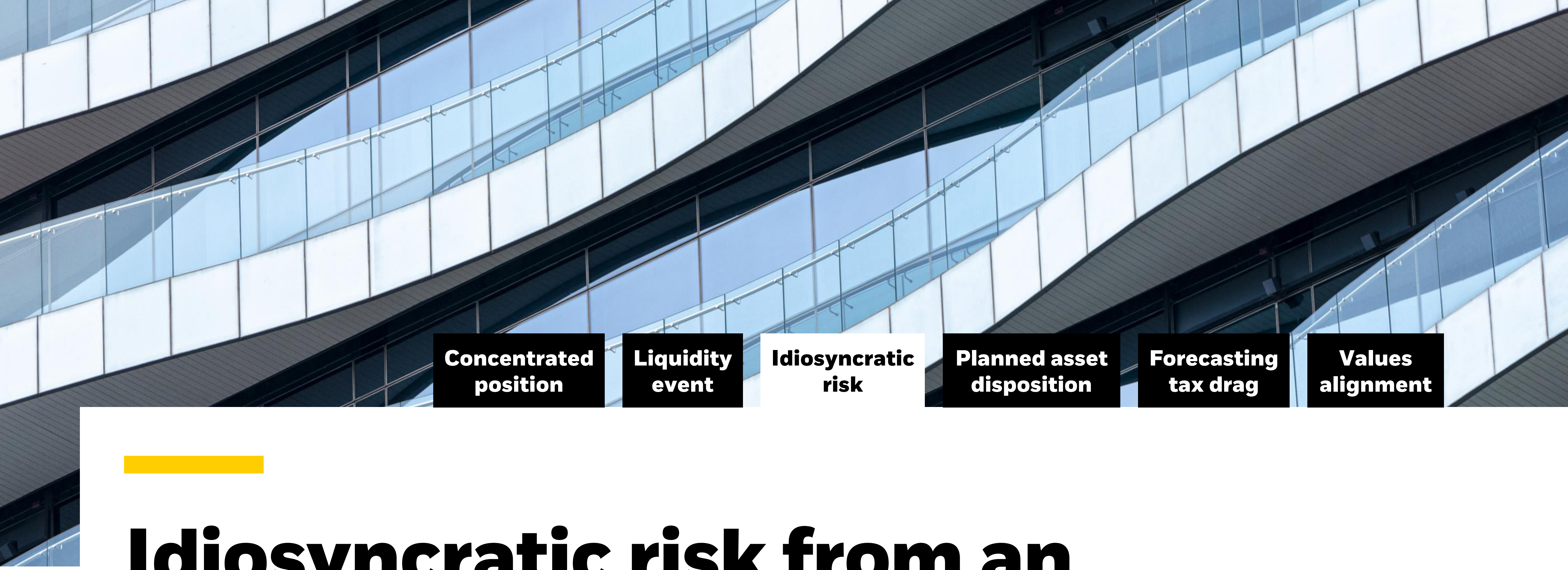
"Managing the tax calendar" *Illustrative example*

Year of liquidity event

1-2 years preceding the liquidity event

- Overall tax planning across 3 years
- Charitable intentions
- Disposition strategy (e.g., GRAT, CRUT)





Idiosyncratic risk from an operating company

Problem

A CIO was tasked with optimizing a $2B investment portfolio around a family's $3B construction operating business that was highly sensitive to economic growth. The CIO struggled with how to best proxy the operating business to maximize the diversification and tax-efficiency of the related investment portfolio.

Action

With the help of Client Solutions Group (CSG), the family began by mapping out its unique objectives and constraints, from return targets and risk tolerances to liquidity needs and planning for specific cash flows. Next, CSG modeled the $3B construction business in our Aladdin® platform to incorporate the underlying economic drivers of that business into an after-tax optimization model. BlackRock's extensive after-tax capital market assumptions broadened the range of asset classes available for investment, including public equity SMAs built around the risk exposures of the operating business. BlackRock was able to quantify the potential risk benefit from creating a customized portfolio to avoid doubling down on the same risks created by the business, helping minimize additional industry or specific factor exposure.

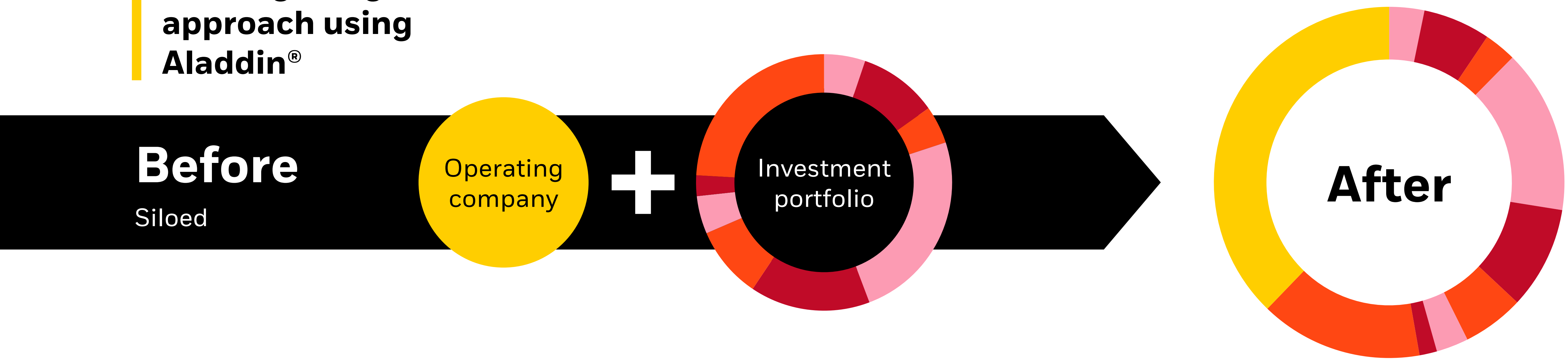
Resolution

The CIO was able to implement a tighter level of risk control based on the entire portfolio being modeled across economic factors that drive performance across asset classes. In addition, the SMA offset portfolio allowed the CIO to maintain public equity exposure without exacerbating the expected risk from the economic drivers underlying the construction business.

Across asset classes...

...and **within** public equities Aperio can construct an offset portfolio to optimize risk

Seeking integrated approach using Aladdin®



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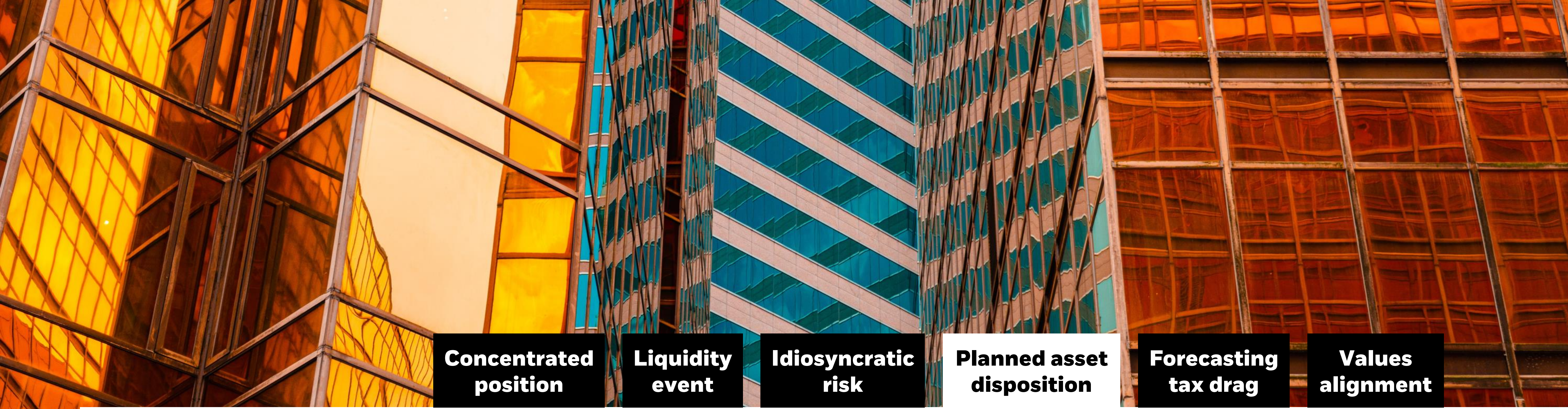


Choosing portfolio based on planned asset disposition

Problem

A family office invested through multiple entities, including taxable grantor trusts for different generations and a private foundation. When designing an optimal after-tax asset allocation, after-tax return assumptions can vary significantly based on whether a particular asset will:

1) Pass through to an estate or charity, or
2) Get liquidated for consumption or other investments.

The SFO needed help allocating assets to those two different baskets and adjusting the after-tax returns to reflect which strategies might be more appropriate for one but not the other.

Action

Based on its proprietary research on asset location, we learned from the family office which assets were earmarked for eventual liquidation and which were expected to pass through an estate or to a charity, as well as the likely holding period. BlackRock's after-tax portfolio analytics highlighted and measured the potential advantages of holding high-appreciation assets with expected lower cost basis in vehicles destined for an estate or charity. That category would typically include both public and private equity, as well as certain real estate assets that might face depreciation recapture if liquidated. BlackRock's tools also helped identify assets we found more ideally suited for liquidation, like municipal fixed income, where there shouldn't be as much advantage to a step-up in basis.

Resolution

The family's wealth was allocated to pursue an optimal after-tax risk-adjusted strategy while also reflecting the differences in tax impact based on type of disposition. Assets were optimally categorized as follows:

a) Taxable accounts earmarked for liquidation,
b) Taxable but likely to pass through an estate or to a charity, and
c) Held in a private foundation with a very low tax rate. BlackRock's optimal portfolio reflected the family's specific legal and financial needs and reflected sophisticated after-tax metrics.

Taxable earmarked for liquidation	Taxable likely to pass through to estate/charities	Private foundation
Assets with limited benefit from basis step up	Appreciated assets with significant basis step up benefit	High return, low tax efficient assets (e.g., private credit, high yield bonds)

Forecasting tax drag across SFO assets

Problem

A family office wanted to forecast accurately its after-tax returns but faced a complicated accounting challenge across their existing strategies, including numerous K-1s from various asset classes that varied from year to year. Consolidating data across multiple years and strategies could help in constructing an optimal after-tax asset allocation but might not have been worth the cost to gather the information.

Action

The SFO met with BlackRock's Client Solutions Group (CSG) and After-tax Wealth Strategists (ATWS) to analyze all the information available from the SFO and from BlackRock's innovative research as the only major asset manager who provides after-tax return assumptions. Relying on BlackRock's proprietary data across multiple asset classes, such as Preqin and eFront for private investments, the SFO was able to assess the situations when it was appropriate to rely on an average tax drag based on broad historical asset classes, thus saving time and the cost of building a complete database across strategies. The BlackRock team also helped the SFO identify unique situations where an asset class average for tax drag would not apply, e.g., an existing investment in distressed private credit that was paying no current interest, with all returns coming in the form of deferred capital gains, atypical for a private credit investment. For other asset classes, like infrastructure and private equity, the SFO determined that BlackRock asset class estimates of tax drag appropriately represented their specific investments.

Resolution

The SFO implemented a sophisticated and optimized after-tax asset allocation with customized assumptions on tax drag based on its own specific investments but avoided the cost of an exhaustive data gathering exercise by relying on BlackRock's asset category averages when appropriate.

Best source for data to forecast tax drag by strategy?

	BLK asset class averages	SFO internal data
	Average tax drag from proprietary databases across multiple asset classes State-of-the-art research methodology	Historical data from K-1s and other tax documents Intimate knowledge of tax implications of SFO's specific strategies
Advantage:	Comprehensive tax drag across strategies	Reflects SFOs actual strategies rather than averages
Disadvantage:	May not capture unusual tax drag from specific strategies	May be time-consuming and expensive to gather complete data
	BlackRock after-tax Capital Market Assumptions eFront powered by Preqin private markets database	Internal data when it's efficient to gather Rely on BlackRock forecasts when extra cost not justified

Smart balance of cost and efficiency

Sophisticated after-tax allocation that minimizes the cost of exhaustive data gathering

Incorporating values in an SFO portfolio

Problem

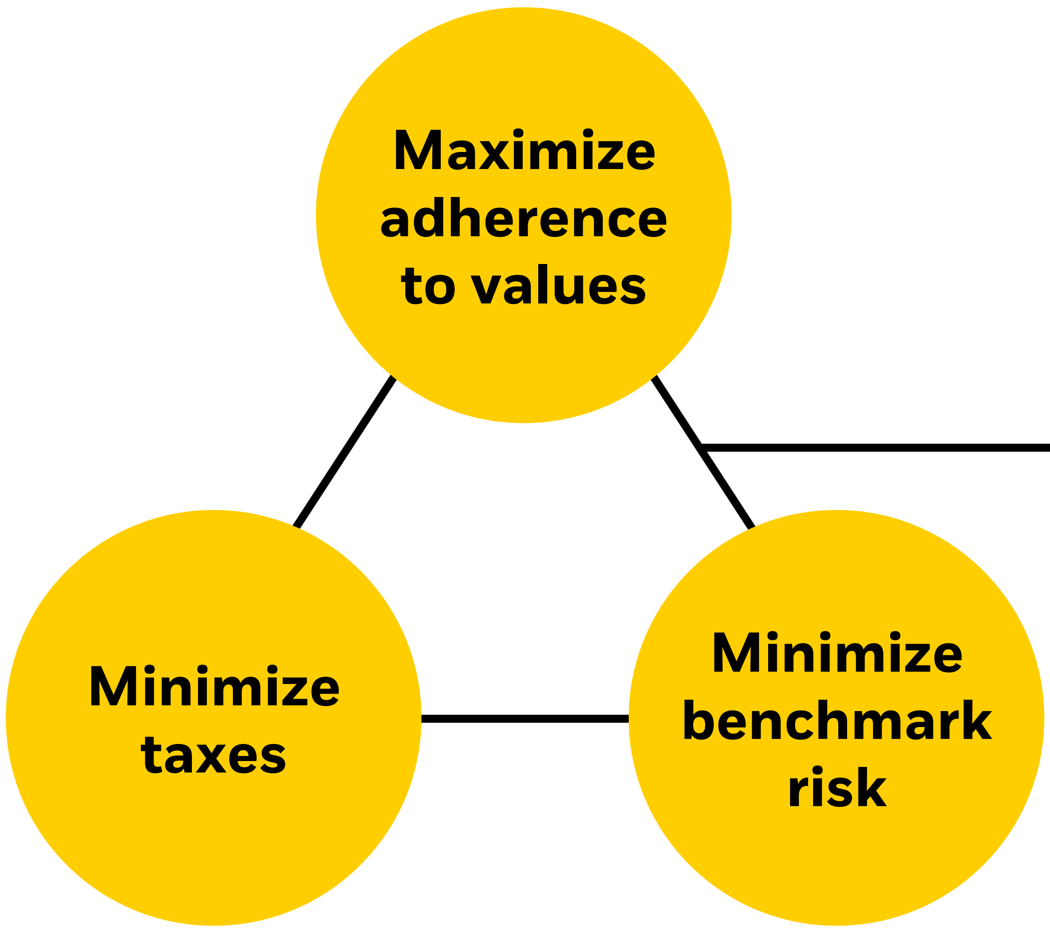
A patriarch and his three professional daughters wanted their portfolio to reflect their family's values around a number of social and environmental issues. They had felt frustrated that their wealth advisors hadn't been able to create a portfolio that reflected their particular requirements, especially since the younger generation brought a focus on different issues from the father.

Action

BlackRock professionals who specialize in values alignment met extensively with the family over a number of meetings to flesh out and document their priorities around their values and the challenges of measuring corporate behavior based on a range of different data sources. After modeling the family's specific preferences, BlackRock presented portfolios that included a range of solutions with different trade-offs among risk, tax impact, and how strictly the family's values were to be incorporated. The family also chose their preferred level of involvement with proxy voting that reflected their values.

Resolution

The family was able to implement a tax-optimized portfolio that reflected their values across multiple asset classes, including private equity, private credit, real estate, and infrastructure strategies. For the family's private foundation, for example, BlackRock advised that it was easier to implement all of the values alignment in a public equity SMA without any tax cost, while the family preferred that the taxable portfolios move toward alignment less aggressively in order to reduce the tax burden of any transition.



Managing trade-offs

You can't get the best of all three at once

We can build the portfolio that seeks to optimize around your preferences for these trade-offs

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Tax alpha is defined as the after-tax active return minus the pre-tax active return. Tax alpha is a measure of the value added through active tax management. A positive number indicates a potential tax savings (from realized capital losses), while a negative number indicates a potential tax drag (from realized capital gains). Tax alpha is mathematically identical to the portfolio tax benefit plus the benchmark tax drag. Also, if the pre-tax portfolio return is the same as the pre-tax benchmark return, then tax alpha and after-

tax active return are mathematically the same. Aperio's tax-loss harvesting strategy seeks to generate positive tax alpha while providing market-like pre-tax returns.

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