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# UNIQUE OPPORTUNITY IN THE YEAR OF MAJOR LIQUIDITY EVENT

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So, you've done it. You sold your business, or maybe a big piece of real estate. Now you have cash, but, "the market is too high" or "the market is crashing" and you are nervous about moving on to your next investment.

Should you dollar-cost average? Should you "wait for a pullback?" What other options do you have?

If this is not your area of expertise, the first thing you should do is [select the right team to work with.]

A few things to remember: This new cash resulted from the sale of whatever was created earlier. Whether the cash was in a privately held business, a piece of real estate, or something else, the new cash did not come out of thin air. Thus, looking for the right next investment is usually high on most people's to-do list.

One option is to invest in a liquid and diversified basket of stocks and bonds. If you go this route, there are generally only three results from the types of strategies Creative Planning would employ. (One disclaimer as I start; I've oversimplified the concepts below to keep this from becoming a lengthy "white paper").

A. First - the market can go sideways and you will likely have better dividends and interest than sitting in cash.

B. Second – the market can fall. This is not fun but you will still collect dividends and interest as you wait for the market to recover.

C. Third – the market can rise. If you are invested, you will participate and continue to grow your nest egg.

While thousands of articles exist on these topics, this letter is only meant to focus on item "B" above (what happens when the market falls). Particularly in the calendar year of the liquidity event.

Let's now use two simple illustrations:

Scenario #1

a. Investor A sells their business for $10 million. The basis is $1 million. Thus, there's a $9 million long-term taxable gain.

b. If nothing is done to offset that gain, there is a tremendous tax burden due to the IRS and potentially the state of residence.

c. Strategies to offset the gain often include charitable giving, or, selling losers in the portfolio at year-end (a simple version of tax harvesting).

Scenario 2

a. Investor A sells their business for $10 million. The basis is $1 million. Thus, there's a $9 million long-term taxable gain.

b. If the investor moves to a well-diversified portfolio of stocks and bonds (tied, of course, to their economic situation), we can then apply the possible outcomes which could occur to this portfolio per item "B" above. The most pertinent being that if the market falls, aggressive tax harvesting can offset part of the $9 million capital gain.

Before evaluating this further, let us first identify how Creative Planning treats tax harvesting.

- What tax harvesting is NOT: Arbitrarily selling investments which are down late in the year simply to figure out your next move with the new cash.
- What tax harvesting IS: Accepting that markets fluctuate, but generally rise over time. Thus, by being disciplined when markets are down, we can sell a position which has temporarily moved down in price, capture the loss for our tax return and simultaneously repurchase a similar (but different in the eyes of the IRS) investment to remain invested.

Building on Scenario #2 above. Assume you invest $100,000 in the S&P 500 (the largest 500 companies in the United States) and that $100,000 drops to $90,000 in value. We are still collecting our dividend (a good thing) and we know that while the $90,000 could fall further in value, the $90,000 may recover to the $100,000 invested and then rise to new highs in the future.

The method of tax harvesting which can be done in the example above is this: When the $100,000 drops to $90,000, the S&P 500 position can be sold. The $10,000 LOSS is then moved to the client's tax return (more on this later), and the S&P 750 is immediately purchased so that the $90,000 remains invested in a similar asset class. This ensures that if a recovery happens (which it often does) that the investor is still participating with the long-term growth of the markets.

Now, where this gets very interesting in the calendar year of the liquidity event, is that the loss in the liquid portfolio is a dollar-for-dollar offset against the capital gain created by the sale of the business. Let me say that again: The loss created in the liquid portfolio is a dollar-for-dollar offset against the capital gain created by the sale of the business or property.

For an investor who realizes that 1) they are moving from one investment to a new one; 2) that markets ebb and flow upwards over time; and 3) their portfolio is tailored to their unique needs,

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A HUGE OPPORTUNITY COULD BE LOST BY NOT MOVING INTO THE NEW STRATEGY ASAP. This is because the losses generated ONLY in the calendar year of the liquidity event can offset those against the sale of the business or real estate.

Arguably, while there is risk of depressed values on the monthly statement of an investment account, if markets fall immediately after investing, the losses generated from tax harvesting could have a large impact on the investor's tax return (actual costs).

Imagine now that the investor in the example above agrees with this approach and the following occurs:

- $10M is invested after the sale of their business or property
- Markets go down 30% and the $10M is only worth $7M for a period of time (again, we believe the $7M will eventually recover to $10M and grow thereafter)
    a. This recovery can be accelerated by appropriate rebalancing while markets are down; see video in reference notes below for more on this.
- The key takeaway here is that the $3M loss can be realized on the client's tax return and used to offset the capital gain of their business or real estate sale. Thus, if the investor does not move to reallocate asap there could be substantial opportunity cost left on the table.

Your Creative Planning advisor can review this with you in more detail any time. My simple hope is that you are now enlightened to a very powerful strategy, ONLY available to you in the calendar year of your liquidity event. Understanding this concept could have a dramatic impact on the amount you actually pay in taxes.

Additional Creative Planning articles which build on some of the nuances in this article:

- To Win The Game, You Have To Stay In The Game
- Cash is King?
- Yield vs Total Return
- VIDEO: Mistakes Investors Make and How To Avoid Them

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