The Cambridge Index Strategy

Taking Advantage of U.S. Tax Law

(U.S. Patent 20060064364)

To spur economic growth and recognize the impact of inflation, the U.S. tax code for many years has charged less for long-term capital gains (assets held one year or longer) than for taxable income – currently 20% vs. 37% for the highest income bracket since 2017. It also allows net capital losses as a tax deduction from ordinary income, up to $3,000 per year. Any losses not used this year can be carried forward indefinitely until they are entirely consumed (a $30,000 capital loss could provide income deductions for up to 10 years). The following is an illustration of a typical situation and is for educational purposes only. It shows how the Cambridge Index Strategy is designed to take advantage of these almost ancient provisions in the tax code with little investment risk.

Jeff and Sue are married. Both are dentists. From early on, they had worked long hours, saved their money, and invested wisely. Now, a bit past the half-way point in their lives, they earn a high joint income and have accumulated a substantial nest egg.

But when tax-time came around, they were reminded of how much they were paying in taxes. They were in the highest marginal federal and state (Ohio) tax brackets. For every $100,000 in additional taxable income they earned, $37,000 was being siphoned off by the IRS and $5,390 by the state, a total of about $45,000. It meant they were working entirely for the government until about the middle of May every year. They wondered if an investment strategy existed that would reduce this, even by a little.

As conservative investors, they were not interested in esoteric or high-risk investment schemes. They simply wanted a better way to fully utilize all the common, ordinary elements of the tax code to help reduce the outflow.

From a friend, they heard about the Cambridge Index Strategy (CIS) and contacted their financial advisor, Pat. She had not heard of the strategy and was skeptical. Many tax strategies involved rather obscure investments and gray areas of the tax code. But she promised to investigate it to see if it would work for them.

Pat contacted them a short time later. “It’s a simple but clever strategy,” she said, “and I think we should try it for your taxable accounts.” She felt that if her assumptions, calculations, and projections proved correct, it made a lot of sense for them in terms of tax savings. At their next review meeting, Pat presented her findings.

She explained that, by utilizing just a few trades each year, CIS captures the lower tax rates associated with long-term capital gains. It simultaneously harvests tax deductions from temporary, short-term capital losses that occur as stocks fluctuate up and down randomly in the market. For every $100,000 they invested by December 1, CIS would buy 50 different stocks: 30 that made up the Dow Jones Industrial Average, the top ten in the S&P 500 by size and the top ten in the NASDAQ. There would be no over-lapping, so it would be $2,000 in each of 50 different stocks (Phillip Morris and its parent, Altria, are specifically excluded from the 50).

Nothing esoteric here - the companies were among the largest in the world – household names like Apple, IBM, Exxon, etc. – and certainly not obscure investments! Furthermore, Jeff and Sue had an allocation to large caps already, so switching would create no change in the asset allocation characteristics of their portfolio. After the purchase, no trading would take place until the following dates:

> **October 21: "Losers"** - any stock worth less than its original purchase price - is sold to capture short-term capital losses. All proceeds are reinvested in SCHX, a no-transaction fee U.S. Broad Market index ETF with an expense ratio of only 0.03% - about the lowest management fee anywhere on the planet (0.75% is about average). All dividends during the year are also invested in SCHX.
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> **November 25: "Winners"** – any stock which has bloomed to 10% or more above its original cost is transferred to a separate "Greenhouse" account to preserve long-term capital gains. The Greenhouse itself is monitored on an ongoing basis. So long as a stock does not fall by 5% or more from its original cost in two consecutive quarters, it is held. If it does fall, it is sold and proceeds are invested in SCHX or any other suitable investment.
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> **November 30: "Runts"** – all remaining stocks in the CIS, which had neither fallen by October 21 nor risen by more than 10% as of November 25, are sold or simply remain in the Strategy account to avoid wash sales. Any S&P 500 or NASDAQ stock which fell in value from its original cost between October 21 and December 1 is excluded from CIS for the following year. Cash in the Greenhouse account is transferred and added to the cash already in the CIS account. If the total value of cash and Runt stocks is less than $100,000, new cash must be invested to bring it up to the minimum of $100,000. The strategy then begins again, fresh and new.

Pat pointed out that the trading strategy used by CIS is designed to gather in short-term losses and preserve long-term gains. The strategy offers several tax saving and other financial benefits. First, any net short-term capital losses can be used to offset any current long-term capital gains from other investments (Jeff and Sue owned rental property). Second, if they had no gains, they could carry the losses forward indefinitely to offset future capital gains or ordinary income (up to $3,000 per year). Accumulating these losses over time could become important when they ultimately sold their dental practices or one of their rental properties and enjoyed a very large capital gain. Third, as stocks accumulated in the Greenhouse, they could be ultimately used for a legacy, trusts, gifts, or donations. Forth, the strategy would perform very much like a low-cost index fund with returns somewhere near the average for the Dow, S&P 500, and NASDAQ. After her presentation, Jeff and Sue agreed to invest.

The following year, there were Winners, Losers, and Runts. They transferred the Winners, whose gains amounted to $15,000, into the Greenhouse account. From the Losers, they harvested $10,000 in short-term losses. They retained all the Runts. They deducted $3000 from their income (saving about $1,460 in federal and state income taxes that year). The remaining $7,000 in short-term capital losses were carried forward for future years. These could be used against any capital gains in the future and up to $3,000 against income. (Capital losses can be carried forward until death, but cannot be used for estate matters.)

The bottom line was that, for each $100,000 they invested, they were ahead by a net of $5,000 from the $15,000 in gains less the $10,000 in losses and also saved about $1,350 in taxes (about 45% federal and state income taxes combined). They were satisfied they had made a good choice and reinvested in the CIS the following year.