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By Jen Ryan
A Dow Jones Newswires Column

NEW YORK (Dow Jones)--Many investors would cringe at the thought of sitting out of the market for 31 days.

But, for those with assets in separately managed accounts, that's often the case around this time of year.

Before the year comes to an end, many advisors try to minimize their clients' tax burden by selling certain stocks at a loss in their SMAs - individual accounts where the investor directly own the underlying securities - to offset gains elsewhere in their portfolio.

Often, the idea is to resume the position, but IRS rules state that if you report a loss on the sale of a stock you can't buy it back for 31 days. As a result that money often sits on the sidelines for that period. While this may not be a big issue if the market falls, if it rises that could mean losing out on some strong gains.

"You really only know if you're looking in the rearview mirror," said Richard Coppa, a former tax attorney and president of Wealth Health LLC, a registered investment advisory firm in Roseland, N.J.

If the market goes down, holding cash isn't a bad idea, but if it goes up during that time, it can be disastrous.

This is especially true if there are a lot of losses being realized. For instance, if the sale of stocks increases the cash position to 5% from 2%, it may not be that big of a deal. But if you have a larger number of losing assets in your portfolio, the sale of those could make your cash position double from your ideal allocation. If the market goes up while you're holding that cash, it could alter the target risk profile of your portfolio.

But the money generated from the sale of losing stocks doesn't have to sit on the sidelines. One popular alternative is to put the money in an exchange-traded fund - which resembles index-tracking mutual fund but trade on an exchange like a stock - that closely corresponds to the stock being sold.

"We like [using ETFs] because you're still fully invested...if the option is there to put it into an ETF we will do that," said Tom Meyer, chief executive of Meyer Capital Group, a financial firm in Marlton, N.J.

Meyer said he recently used the iShares Russell 1000 Value Index (IWD) ETF as a temporary replacement for a client who sold stocks in a large-cap value SMA. In that case, the ETF and the SMA had the same benchmark.

While a broad-based ETF may have fit best in that scenario, some situations call for an ETF that covers a specific sector or style.

For instance, if you're selling shares of Boston Scientific Corp. (BSX), Lewis Walker, president of Walker Capital Management Corp., a financial planning firm in Norcross, Ga., said a technology-based ETF like the Technology Select Sector SPDR (XLK) might be a good fit.

But choosing the right ETF requires a lot of research. "You have to understand the different ETFs and understand how much potential correlation the stock has with a given ETF," Walker said. (The Select Sector SPDRs Web site - www.sectorspdrs.com/correlation - has a tool that measures the correlation between stocks and ETFs.)

According to Wealth Health's Coppa, "you could screw up the investment discipline if you don't park the money in the right place."

It's possible that even though the ETF may be the easiest place to move the money, it may not be the best.

If that's the case, Coppa said, another alternative is to talk to the manager of the SMA about investing the money in a different stock that they may be buying for new portfolios.

For example, say an investor bought an SMA in January. At the time the money manager was buying shares of Pfizer Inc. (PFE). Now, though, the manager is buying Merck & Co. (MRK) instead for newer portfolios. It might make sense to talk to the manager about selling shares of Pfizer and buying Merck.

Freezing an investor's account is another tactic that Meyer Capital's Meyer uses in select situations, though he said it can be risky.

This could be helpful for a client who has a lot of unrealized gains but doesn't "want to take the risk of that manager flipping out of one of his other positions where he had huge unrealized gains," he said.

However, if the manager is selling a stock in the SMAs that is declining, but can't do so in the frozen account, it could hurt the returns for that investor.

While some advisors wait until the end of the year to decide which stocks to sell and where to put the profits, others say that realizing gains and losses throughout the year is better for investors.

Jason Graybill, managing director with investment management firm Abner, Herrman & Brock in Jersey City, N.J., said that when it comes to harvesting tax gains and losses, "we're oblivious to what's happening with last few weeks of the year."

"It's a process that is fluid and occurs throughout the year based on the different stocks that you own and the volatility of the market," he said.

(Jen Ryan is one of four Getting Personal columnists who write about personal-finance issues ranging from new tax proposals to education-funding strategies to estate planning.)

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