SMALL CHANGES, BIG IMPACT - *IDEAS FOR TAX ALPHA*

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Recently, in reviewing a prospect's investment portfolio, we encountered what I only know to refer to as a "double whammy" in the investment world … a fund with negative returns for the year and high capital gain taxes that were generated based on the investment income and turnover of the fund during that same calendar year. In this particular example, even though the fund shareholders lost -6.9% in the mutual fund investment, the investor was still required to pay taxes on the dividends and capital gains that the fund generated in 2016. When the prospect received their 1099-DIV tax reporting documents from the institution and realized the tax impact of the mutual fund holding, it is no wonder they decided to ask for clarification of this type of tax issue. Thus, as we have just wrapped up another tax season, we thought it was an opportune time to start a conversation around the tax impact of different investment methodologies and identify strategies for improving net returns to investors.

Investment loss due to taxes is often overlooked. Most investors and financial advisors don't review the tax exposure of a portfolio until gains are reported on tax returns, if at all, and the fund industry tends to report and promote returns on a pre-tax basis. However,

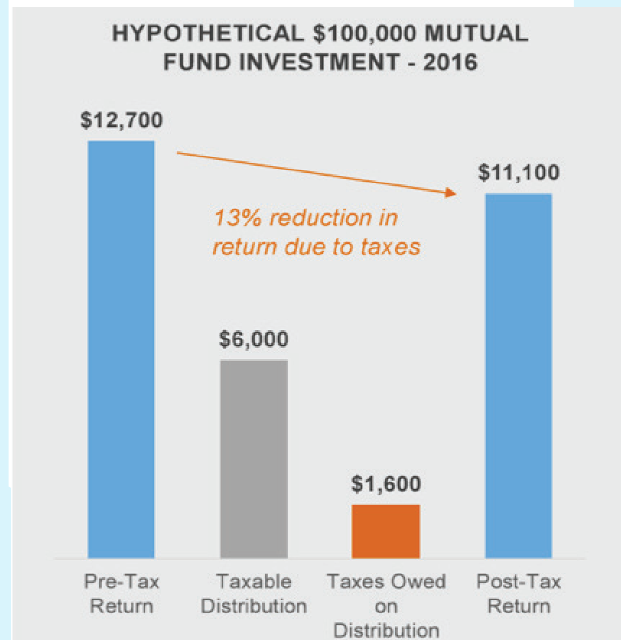
taxes can be one of the largest drags on investment returns if not managed properly – greater than inflation, transaction costs or management fees.

Vanguard Research studies show that on average domestic stock funds lost about 1% annually to taxes over the past 15 years through September 2014.

[1]

[2]

In 2016, the U.S. equity market returned 12.7% as measured by the Russell 3000 Index. The average capital gain distribution for all of the funds represented in Morningstar's U.S. equity categories in 2016 was 6%, reducing investor returns by approximately 13% when owned in non-retirement accounts.



Market Return: Russsell 3000® Index. Average Taxable Distribution includes average capital gain distribution for all Morningstar U.S. equity categories for listed year (no ETFs). Distribution is assumed to be made at last day of year and reinvested. *Tax rate is assumes 89% LYCG / 11% STCG. LTCG = 23.8% (Max LT Cap Gain 20% + Net Investment Income 3.8%) STCG = 43.4% (Max ST Cap Gain 39.6% + Net Investment Income 3.8%).

Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Indes are unmanages and cannot be invested in directly.

Source: Russell Investments: Economic and Market Review 2017: Off and running - First Quarter 2017

[1] Source: Morningstar, Inc., and Vanguard. Average tax cost is calculated based upon Morningstar data for all domestic equity stock funds with 15 years of performance history as of September 30, 2014. Calculations assume account is not liquidated at the end of the period. When after-tax returns are calculated, it is assumed that an investor was in the highest federal marginal income tax bracket at the time of each distribution of income or capital gains. State and local income taxes are not reflected in the calculations. After-tax distributions are reinvested, and all after-tax returns are also adjusted for loads and recurring fees using the maximum front-end load and the appropriate deferred loads or redemption fees for the time period measured. Tax cost = (Before-tax return) – (Preliquidation after-tax return).

[2] See footnote 1, supra.

TAX EFFICIENCY

Tax efficiency is the measure of how much of an investment's return is left after taxes are paid. Effective tax strategies work to reduce or defer taxes to create more after-tax wealth in the long run. With the capital gains tax rate increasing to 20%, the top tax bracket increasing to 39.6% and the new 3.8% Medicare surtax in place for high-income earners, it is now more necessary than ever to think about an investment not just from a real return perspective, but also from an after-tax real return perspective.

Moreover, managing assets in a tax-efficient manner not only enhances returns but does so independent of investment selection or by adding additional risk to a client's portfolio.

So how can we create tax alpha, or additional performance/return, for an investor through the efficient management of the tax impact on his or her portfolio? Two common sense strategies we see grossly underutilized are employing asset location and selecting funds that minimize exposure to taxes simply through the management style of the investment.

ASSET LOCATION

Once an appropriate investment strategy and asset allocation mix have been identified for an individual's goals, risk tolerance, investment horizon and unique circumstances, asset location is utilized in implementing that asset allocation to minimize the impact of investment taxes.

Asset location is the logical distribution of investments to the most tax-efficient account type. For example, the more an investment relies on investment income – rather than a change in its price – to generate a return, the less tax-efficient it is for the investor. Assets producing ordinary income or bond-type investments should be held in tax-deferred accounts, and securities with the least impact on tax should typically be held in fully taxable accounts, such as low-turnover, tax-managed or passive mutual funds. Vanguard research has shown that placing the most tax-inefficient holdings into the most sheltered tax accounts can retain up to 0.75% of additional return in the first year without increasing the investor's risk.[3]

[3] Vanguard: Putting a value on your value: Quantifying Vanguard Advisor's Alpha. See https://www.vanguard.com/pdf/ISGQVAA.pdf

MANAGEMENT STYLE AND TAX DRAG

Another component that significantly impacts the tax consequences of an investment is the management style of the investment: Is it active or passive, and from a tax standpoint, what is the difference?

Passive investing involves following market benchmarks or indices such as the S&P 500. The goal of passive investing is to track or mirror the market for a particular asset class. Active investing involves a human portfolio manager working to outperform an index or benchmark through research, stock selection, market timing or other techniques in managing the fund's holdings.

Mutual funds, both active and passive, regularly distribute stock dividends, bond dividends, and long and short capital gains to their shareholders, on which investors must pay taxes in the year they were received. It stands to reason that broadly based index or passive funds are typically more tax-efficient because they change their holdings less often and so generate relatively few capital gains. Active managers, in attempting to add value and capture alpha, are generally actively buying and selling equities, thereby increasing capital gains exposure for the fund shareholder who holds these assets in taxable accounts.

Most active mutual fund managers are not concerned with the tax implications of their trading.

An exception to this is if a fund is specifically marketed as tax-efficient and the prospectus states tax efficiency as part of the fund management objective.

According to Morningstar, over the past 15 years, losses due to taxes range from 0.70% to 1.20% per year for active funds, depending on asset class and fund manager type, versus 0.51% annualized for passive funds.[4] A good tool to determine the tax efficiency of a particular fund is the

Morningstar Tax Cost Ratio, which measures how much a fund's annualized return is reduced by the taxes investors pay on the fund's distributions.[5]

For example, if a fund had a 2% tax cost ratio for a three-year time period, the investor lost 2% of his or her assets each year to taxes, on average. Thus, if the fund had a pre-tax return of 10%, the investor in the fund took home about 8% per year on an after-tax basis, or a 7.8% compounded annual return over the three year time period.[6] The Morningstar tax cost ratio assumes taxes are paid at the Federal level and at the highest tax bracket and demonstrates the impact of taxes and management style on fund performance.

[4] See footnote 1, supra.
[5] See http://www.morningstar.com/InvGlossary/tax_cost_ratio.aspx.
[6] See footnote 4, supra.

IMPACT OF SMALL CHANGES

Why are these small efficiencies important? Can a 0.5% to 0.75% difference in cost really make a significant impact on an investor's success or lack thereof?

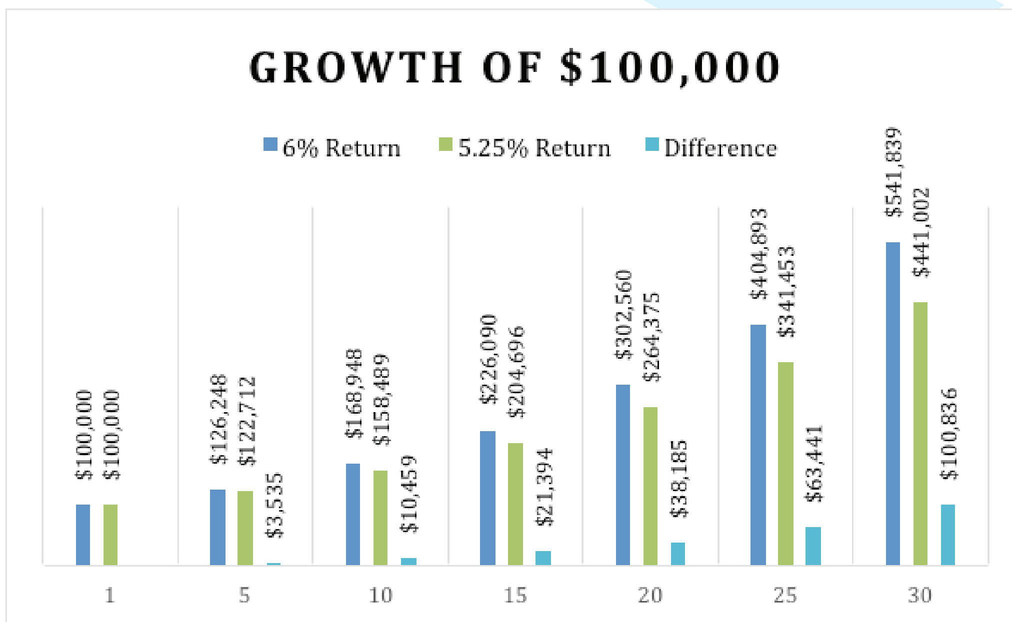
The chart below illustrates how significantly costs can obstruct long-term portfolio growth. It depicts the impact of a 0.75% cost differential over a 30-year time horizon in which a hypothetical portfolio with a starting value of $100,000 grows 6% annually which is reinvested. The potential impact on the portfolio balances over three decades is striking – a difference of almost $100,000 between the low-cost and high-cost scenarios.

It is worth noting as well that the impact of additional cost in the retirement or income distribution phase of an investor's life cycle is even more pronounced.

Retirees dependent on retirement income from their investment portfolios should be especially conscious of their portfolio's tax cost and withdrawal strategy.

The more their portfolio value is reduced by cost, the less retirement income they receive and more pressure is placed on the portfolio to outpace distributions and inflation before spending down principal.

At a minimum, the tax consequences of investments and strategies should be considered when building a portfolio or changing a portfolio. The higher after-tax real return of tax-aware investing can create a significant result.



Source: Hardy Reed
Note: This chart assumes a starting balance of $100,000, and a yearly return of 6%, which is reinvested. The portfolio balances shown are hypothetical and do not reflect any particular investment. The final account balances to not reflect any taxes or penalties that might be due upon distribution.

CONCLUSION

In the midst of market volatility, it can be tempting to focus on the components of investing that we cannot control: market timing, picking of winning stocks and the financial press, to name a few. Yet it is an opportune time for greater clarity on and strategies for managing what we can control: diversifying portfolios, reducing expenses, minimizing taxes and exercising discipline.

These are areas where as financial advisors we can have the greatest impact and position our clients for greater long-term success. Questions to consider:

1. Do I have an intelligent tax strategy?
2. Are tax impacts minimized within my portfolio and among my investment accounts?
3. Is there active and ongoing management of the taxability of my investment portfolio for wealth enhancement?

If you are unsure of the answers to these questions, let us help. Our goal is to build partnerships with our clients and the other advisors they trust.

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CITATIONS

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