Don't Overtax Yourself

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Proactively managing the impact of taxes on your investment portfolio may be the single best action you can take to enhance your investment returns. Too many investors focus on chasing the hope of higher *pre-tax* returns (which is fraught with risk and not ultimately under their control) when there are a number of tactics you can utilize which are far more controllable and will enhance the after-tax return of your portfolio, including:

1. Minimize the impact of any gains you do incur
2. Select tax-efficient funds
3. Shelter tax-inefficient funds in IRAs, Roth IRAs, and 401Ks
4. Proactively harvest losses

Taken together, these four tactics will allow you to keep more of what you make as you pursue your goals.

<u>Minimize the impact of any gains</u>

Taxable gains should be avoided when possible because doing so allows your money to continue to compound. If a gain can't be avoided or it's otherwise prudent to realize a gain, try to minimize the tax cost associated with taking the gain.

One classic error is buying a mutual fund in a taxable account shortly before it makes a large distribution (typically an annual event sometime in December). There is no reason to get hit with a tax liability when you did not benefit from the investment that created the gain in the first place. The simple remedy is to determine if any distribution estimates have been released (typically starting in October) as well as their composition (ordinary income or short-term gains are bad, long-term gains are better). Small levels of capital gains are not worth worrying about (<1% of the fund's value), but for anything over 2-3%, you should consider deferring the purchase until after the distribution has been paid.

Another common mistake is incurring short-term gains on the sale of an investment when the investment is close to achieving long-term gain status (i.e., held for more than one year). Short-term gains should be avoided because they are taxed as ordinary income, which is subject to the highest tax rates. These rates can approach 50% for the highest tax bracket investors in higher tax states. Of course, the benefit of waiting for a gain to go long term and be subject to much lower rates should be weighed against the risk of continuing to hold the investment. Waiting 20 days to take a gain is one thing; waiting 160 days is another.

Select tax efficient funds

You should take care to understand the tax efficiency of any fund you are considering for purchase as that attribute will greatly affect your after-tax return even when the stated, or pre-tax return, is the same. Morningstar's website (www.morningstar.com) offers information on the tax efficiency of funds, so that is a great place to start. In essence, there are two ways to help optimize tax efficiency when selecting funds: the first is by selecting funds where portfolio managers trade less frequently (otherwise known as "low turnover") and the second is buying funds with inherently higher tax efficiency due to the nature of the underlying vehicle or strategy. Higher tax efficiency funds include ETFs and index mutual funds.

Shelter tax inefficient funds in IRAs, Roth IRAs, and 401Ks

You should always look to place your least tax-efficient funds in tax-sheltered savings vehicles like IRAs, Roth IRAs, and 401Ks. This technique is also known as "asset location." Tax-inefficient funds typically include bonds funds for which a high proportion of their long-term return is in the form of current income. Because you pay no taxes until withdrawal, IRAs and other tax-qualified accounts allow your money to continue to compound instead of paying tax on investment returns to the government each year. To be sure, you will pay taxes at withdrawal, but you will have built up more capital in the interim. Further, you may find that in retirement you are in a lower tax bracket, further enhancing the benefit of deferring the payment of taxes.

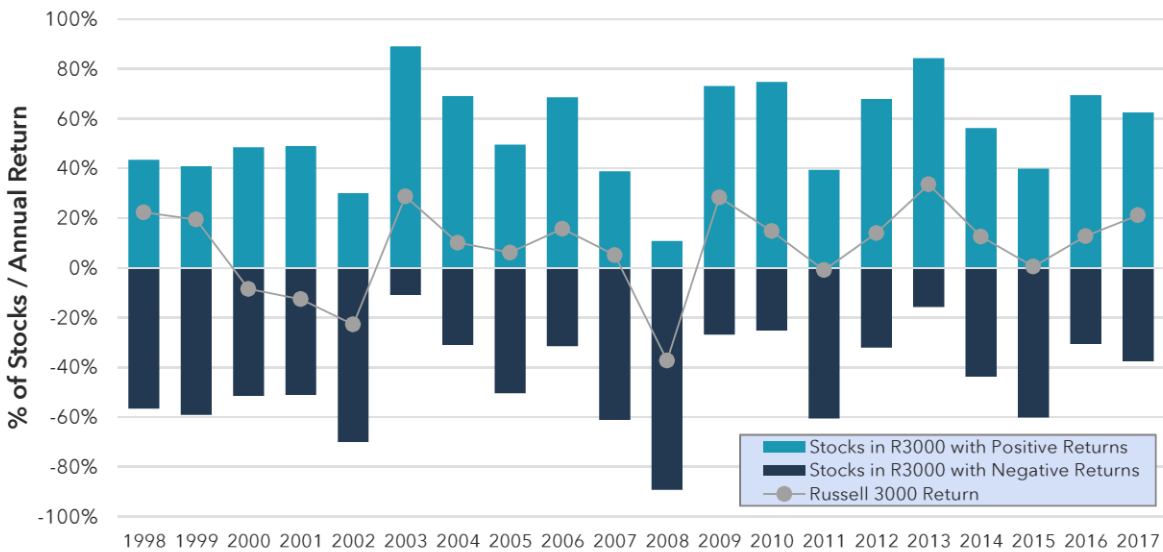
The other side of the coin is to put your most tax-efficient funds in your taxable accounts, such as ETFs and passive funds, which track stock indexes. Other than dividends, these investments normally only trigger taxes when you decide to sell. Because your sell decision triggers the tax liability, you can wait for the gain to go long-term. Doing so allows you to pay tax at the long-term capital gains rate, which is typically lower than the tax on ordinary income (which is what you pay on monies coming out of IRAs). Vanguard estimates optimized asset location can add up to 0.75% after-tax return per year. The amount added by this incremental return is very significant over a long period of time. Over 40 years, for example, that 0.75% per year would mean over 30% more available at retirement.

Pro-actively harvest losses

Harvesting tax losses may be the most powerful tool in the investor's toolbox, yet many investors either don't know about it or fail to take full advantage of it. Harvesting tax losses means to realize the loss by selling a fund or security at a loss and using that loss to offset (typically) investment income elsewhere in your portfolio. Simultaneously you reinvest the proceeds in your portfolio. Harvesting tax losses can be pursued either opportunistically, e.g., selling an energy fund after oil went from $100 to $30 per barrel, or systematically.

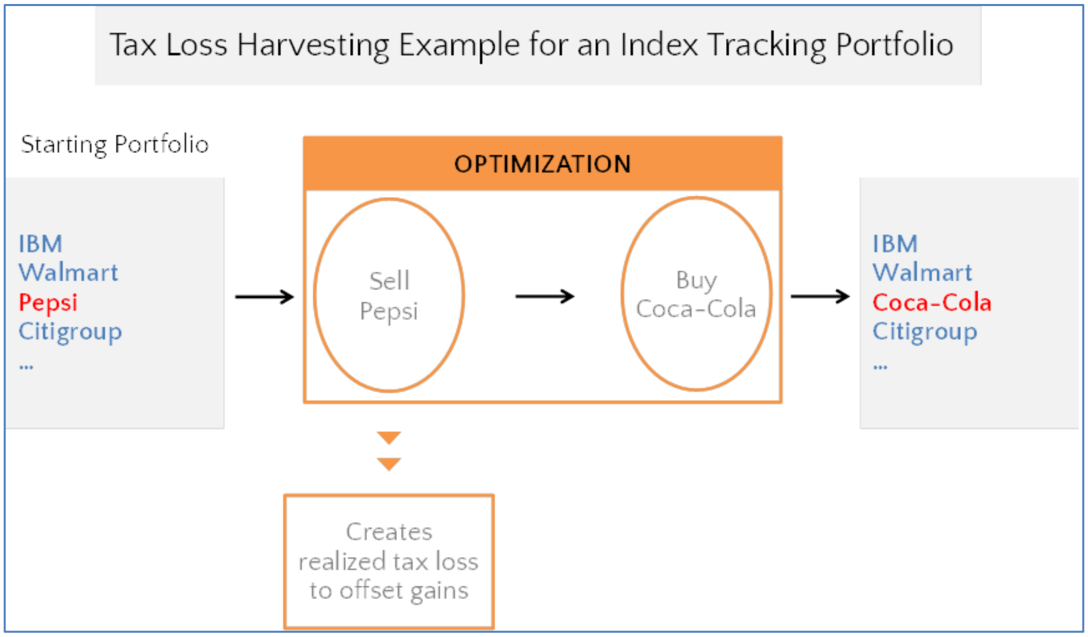
While you can benefit from opportunistic tax loss harvesting, a better approach is to *systematically* harvest losses from your portfolio, particularly your stock portfolio, This approach is known as tax-efficient equity management (TEEM). The goal is for the portfolio to outperform the underlying index over time on an *after-tax* basis. Historical experience, as well as simulations, show TEEM equity portfolios funded with cash generate between 0.75% and 1.75% per year in excess of the index over a ten-year period on an after-tax basis. One source of the improved after-tax returns is deferring gains, which allows returns to compound simply by doing nothing. The more important source of higher returns is harvesting previously unrealized losses. The tax savings generated from the resulting tax loss can then be reinvested in the portfolio. The fuel for this approach is stocks that have declined in price. Somewhat surprisingly, on average, 41% of the stocks in the U.S. equity market decline each year even though the long-term market return is positive.

Returns for the Russell 3000 Index from 1998 to 2017–Every Year Has Stocks with Negative Returns



Source: Aperio

TEEM portfolios use a separately managed account (SMA) structure, in which you directly hold a diversified portfolio of individual stocks in your name. When a stock is sold to harvest a loss (creating a tax benefit), the manager will replace the position with a different company's stock in order to avoid the IRS' "wash sale" rule that would void the tax benefit. The new position allows the portfolio to stay invested and continue to track or even exceed the underlying index. A typical example of tax loss harvesting in action would be selling Pepsi at a loss and replacing it with Coke.



Source: Aperio

TEEM can be enhanced with systematic charitable gifting of appreciated stock out of the portfolio. According to a recent Aperio Group white paper, if you already plan to regularly give a certain amount to charity, systematically gifting the most highly appreciated stocks out of this portfolio creates additional tax loss harvesting potential. The additional tax loss harvesting opportunities can further add to your after-tax advantage versus the index.

It is not hard to see why many wealthy families and individuals pursue TEEM strategies. It is a far more certain, more controllable path to a robust return than trying to pick one of the few truly talented active managers.

Conclusion

While many investors come up short chasing pre-tax returns with active managers, utilizing all of the tax management tools at your disposal is a time-tested, and likely more fruitful, path to enhancing your portfolio's after-tax returns. The old adage, "It's not what you make, but what you keep," should be adopted as a guiding principle for all investors managing a portfolio subject to taxation. By following these simple concepts, you will be in a position to enhance your investment returns.

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