GLOBAL FOCUS CAPITAL LLC
INSIGHT THAT MATTERS

# Leaving Money on the Table? Time to Look at the Tax Implications of Your Investment Strategies


Thinking about taxes implications for your investments often plays second fiddle in fast moving capital markets and for a large number of investors – pension funds and endowments/foundations the issue is moot given their tax exempt status.

But for many investor be they already wealthy or diligently saving for retirement on their own the issue of taxes is incredibly important. **Proper tax management can dramatically alter financial outcomes especially over long periods of time.**

Tax management can be complicated and should encompass the full financial and human capital picture and goals of the household or multi-generational family entity. Investments are one aspect of this view but properly evaluating the tax implications of different investment strategies is an important component to the long-term success of an entity's financial plan.

## Taxable investors are not generally able to capture the full potential return of an investment for a number of reasons.

**The most obvious and frequently discussed reason are fees and expenses**. Investment management charges usually based on assets under management and the explicit cost of trading represent the bulk of this category. In recent years investors have flocked to index tracking strategies such as ETF's in part to capture a larger proportion of potential stategy returns.

**The second and often more significant drag on realized long-term strategy returns is due to taxes.** While tax structure and rules vary across geographic domiciles (across countries but also by states ) there are generically speaking two types of taxes that subtract from investor returns – taxes on periodic income received (dividends and coupons) and taxes paid upon the sale of a security.

## In the US two types of tax rates generally apply.

A **short term rate** based on the entity's marginal tax bracket applied to investments held less than a year and income generated from non-qualified dividends and taxable bond coupons. For most investors there are two types of applicable short-term taxes – Federal and State.

Tax Foundation.Org (http://taxfoundation.org/) estimates the <u>average</u> 2015 short-term rate in the US at 28.6%. Short-term rates are determined by Ordinary Income tax brackets. The highest <u>average</u> rate of 33% applies to California residents. The highest Federal short-term tax currently stands at 39.6% plus the recently enacted Unearned Medicare Contribution Tax of 3.8%. State taxes are paid on top of these two taxes and vary from a low of zero (Florida and Texas for instance) to a high of 13.3% in California.

In the event of a sale long-term rates applicable to investments held over one year are taxed in the US and in most locales at a lower rate than short-term gains and income. In the US taxes on qualified dividends (paid by mostly US domiciled corporations) are taxed by the Federal Government at the same rate as long-term capital gains at 20% plus relevant state taxes and if appropriate the Unearned Medicare Contribution tax. In some states, qualified dividends are taxed at the higher short-term rate.

## Measuring the tax bite of an investment strategy depends on individual circumstances but it is still useful to look for generalities to assess the likely impact of different strategies on after-tax portfolio returns.

We resort to evaluating four different hypothetical strategies using the theory of tax management as outlined in Chincarini and Kim (Journal of Portfolio Management, Fall 2001).

The four strategies that we evaluate for tax implications are shown below. All strategies assume an annual gross return of 8% and a management fee of 1% per year. The strategies vary by the type of trading incurred.

| CATEGORY | TRADER | TAXABLE 1 | TAXABLE 2 | TAX DEF |
|---|---|---|---|---|
| EQUITY | $100.00 | $100.00 | $100.00 | $100.00 |
| LT CAP GAINS | 20.00% | 20.00% | 20.00% | 20.00% |
| PERSONAL INC TAX | 35.00% | 35.00% | 35.00% | 35.00% |
| PORTFOLIO RETURN | 8% | 8% | 8% | 8% |
| MGT FEE | 1.00% | 1.00% | 1.00% | 1.00% |
| PROP OF GAINS ST | 100% | 60% | 10% | 0% |
| PROP OF GAINS LT | 0% | 30% | 30% | 0% |
| LT GAINS DEFERRED | 0% | 10% | 60% | 100% |

- We have the **Trader** willing to buy and sell his/her portfolio frequently. All profits are assumed to be taxed at the short-term rate of 35%
- A slightly more tax aware investor – **Taxable 1** – engages in primarily short-term trading (60%) but is also taxed at the long-term capital gains rate of 20% for 30% of his/her portfolio. This strategy is also able to defer long-term gains on 10% of the portfolio
- **Taxable 2** is even more tax aware. The strategy delays recognizing capital gains on 60% of the portfolio. Short-term gains are limited to 10% of the portfolio along with 30% taxed at the long-term capital gains tax rate.
- Finally **Tax Def** constitutes a strategy where 100% of gains are deferred. This strategy is analogous to a government sanctioned tax-advantaged approach such as a 401K or IRA

## For the four generic strategies how much is left of the 8% assumed gross return?

The first thing that comes right of the top are **management expenses**. We have assumed a 1% fee based on AUM which is close to the typical advisor fee. Robo-advisors would exhibit lower fees while comprehensive wealth management solution providers would be command a higher fee than that assumed in this exercise.

The second item to subtract from gross returns are **taxes on short-term capital gains**. We have assumed a 35% tax rate on ordinary income.

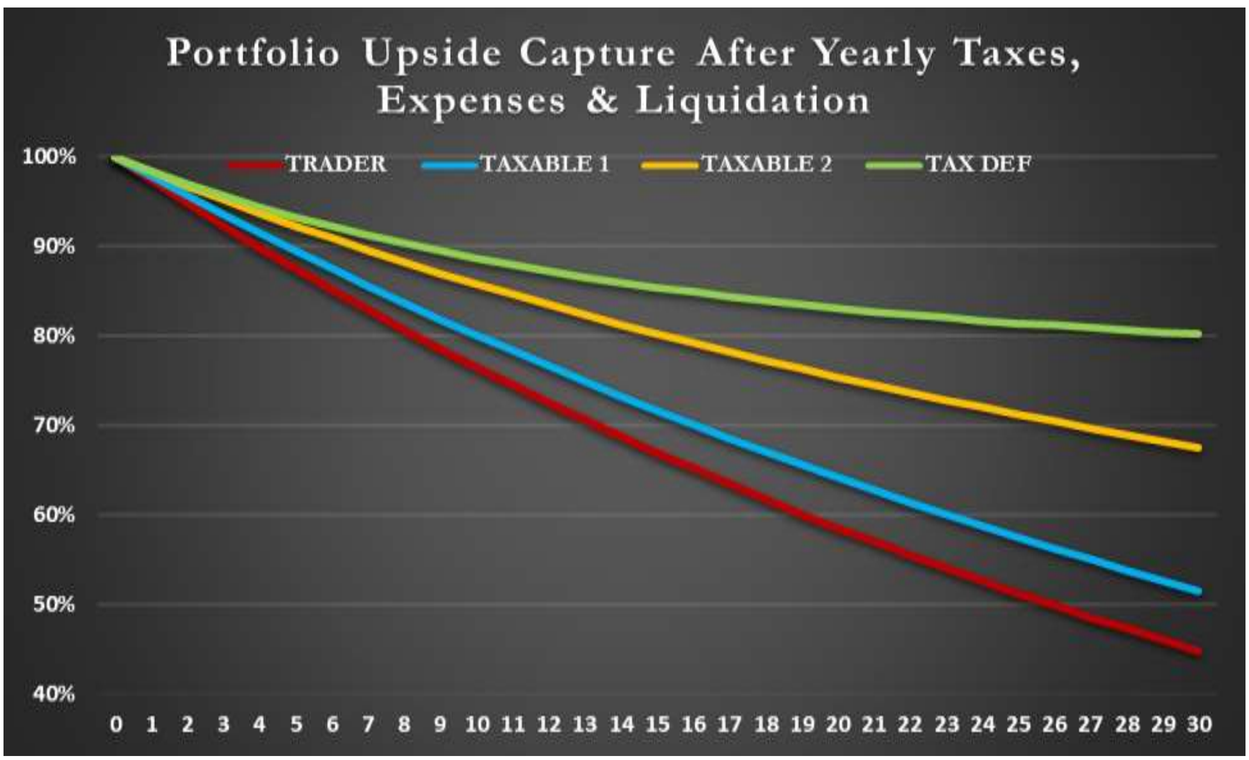
The third item that must be subtracted are **taxes on long-term capital gains**. We have assumed a 20% tax rate.

Finally, to present all strategies on an equal footing we have assumed a **liquidation tax on the portfolio** equal to the long-term capital gains rate.

These four line item expenses are subtracted from the hypothetiocal gross return of 8% to arrive at the net return to the investor. We explore holding periods ranging from one to thirty years out.

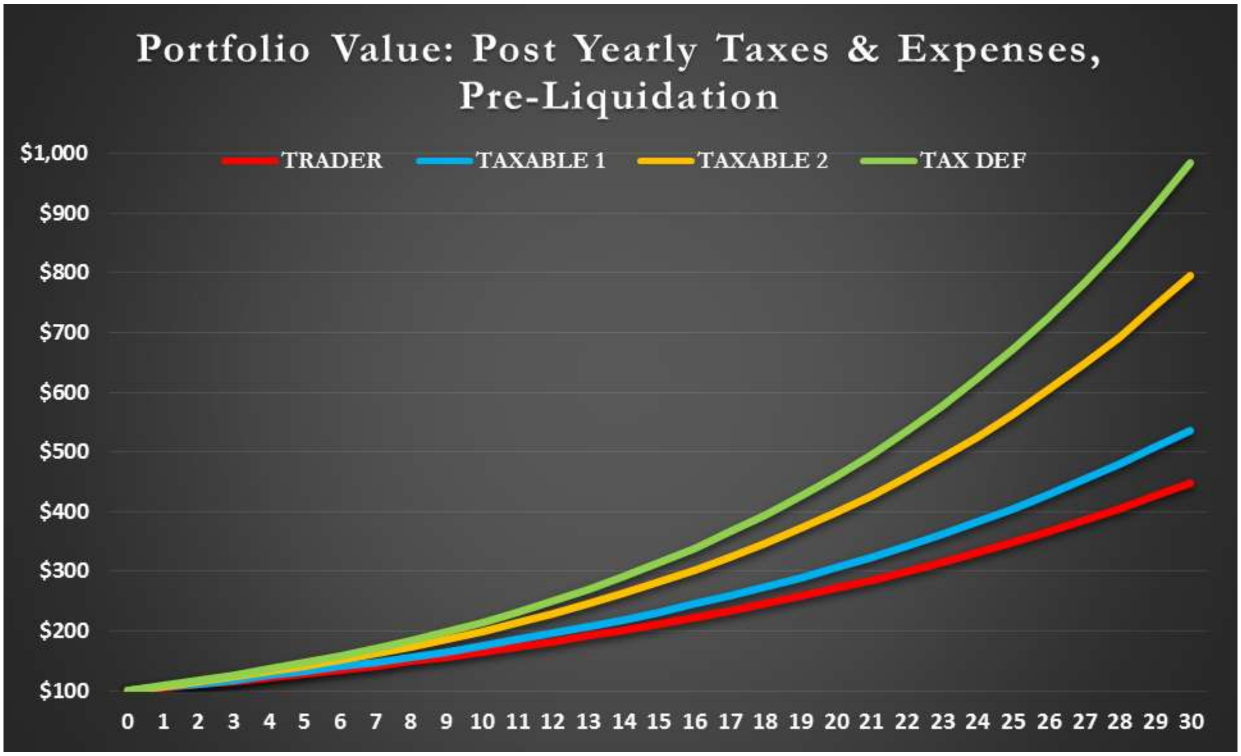
In a world devoid of fees and taxes net and gross returns would be equal. The portfolio upside capture would be 100%. In the face of expenses and taxes the upside capture of a portfolio will trail the theoretical upper limit of 100%. The higher the expenses and taxes the lower the upside capture.

In the chart below we illustrate the upside capture of our four hypothetical strategies. The longer the time horizon the less of the assumed 8% return that the investor gets to keep. Post portfolio liquidation the best the investor can do is keep 80% of total cumulative portfolio gains. Investors in the **Trader** strategy do the worst. They retain only 45% of the theoretical 8% annual return.

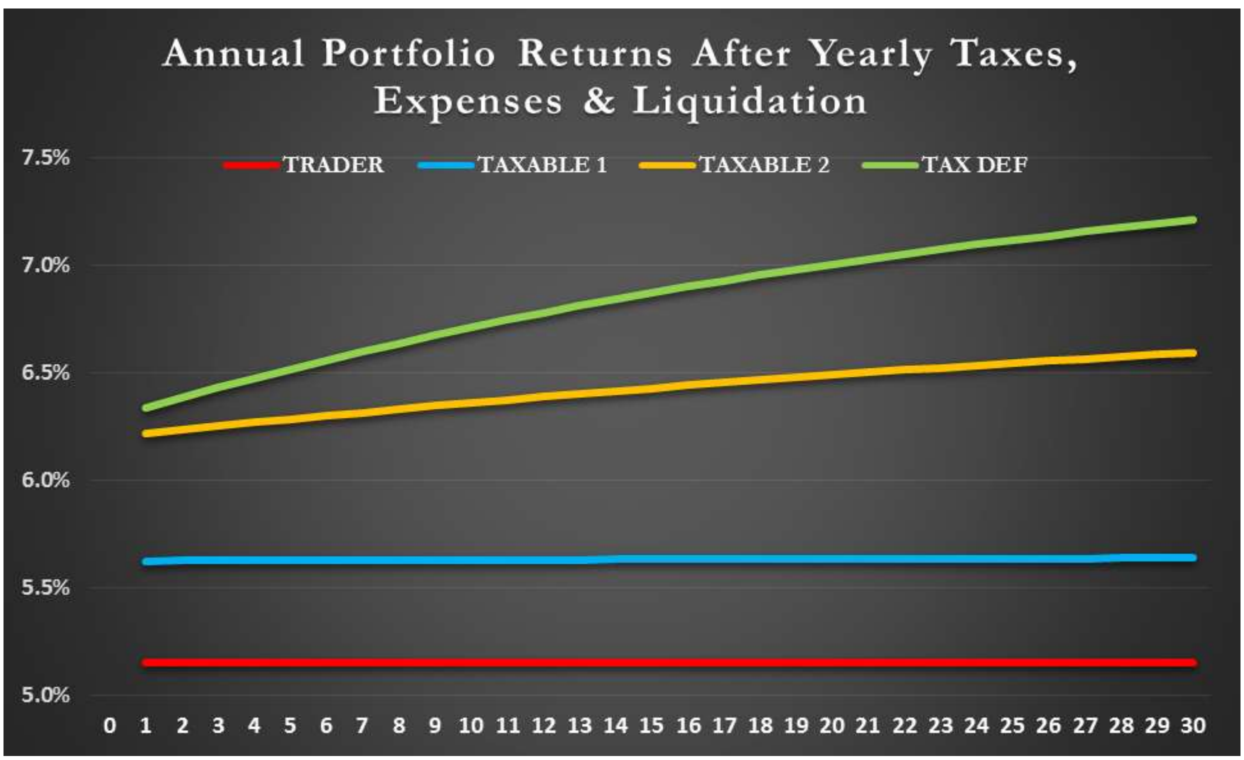



Another way to look at the same implications for net portfolio returns is to look at the pre-liqiidation value of a portfolio growing at a gross return of 8% but employing different trading and tax strategies.

The advantage of the more tax efficient strategies for creating wealth for investors are clear especially as one extends the holding period. Tax efficient strategies compound at a higher rate because of a smaller proportion of gains paid out as short-term taxes and the deferral of trading events leading to fewer taxable consequences.




Another way to illustrate the power of deferring taxes and allowing a higher asset base to compound at a higher rate of return is by looking at average holding period returns. A strategy that defers the payment of taxes due to a lack of a trading event (as in **Taxable 2** and **Tax Def**) will exhibit higher average returns.

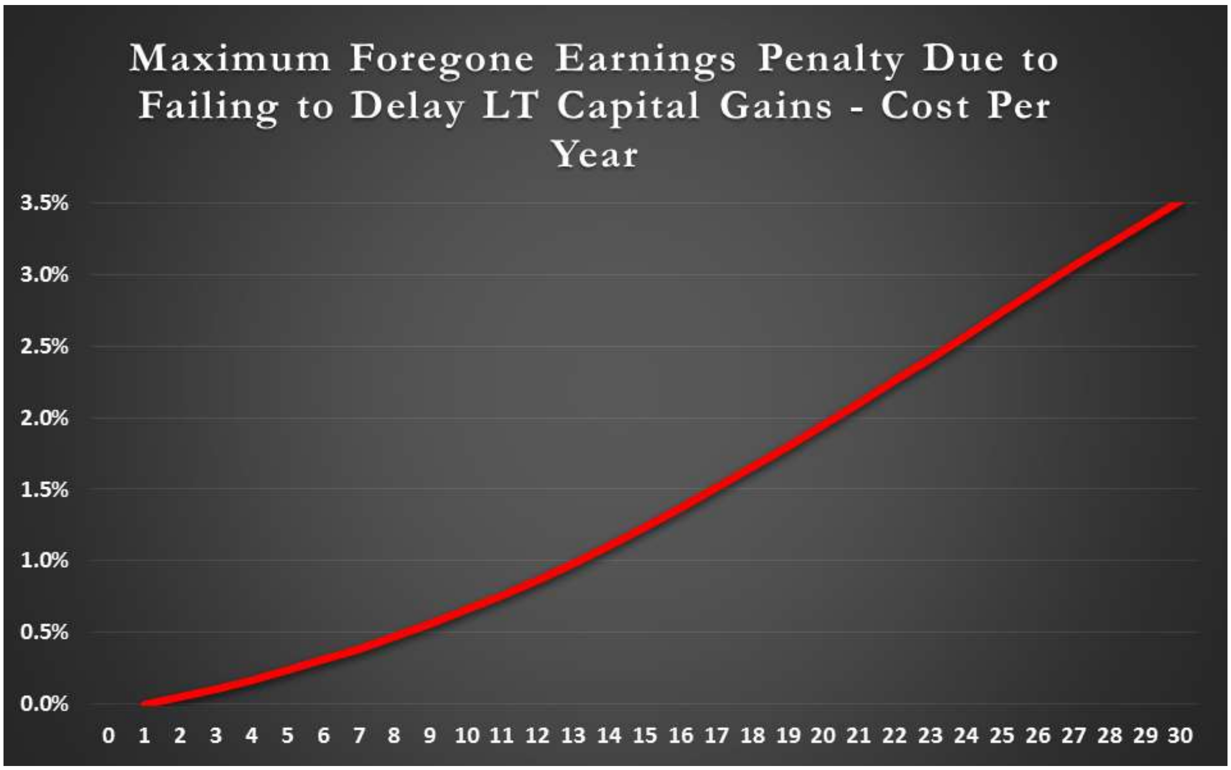


Tax deferral such as illustrated in the **Tax Def** strategy or in a 401k/IRA account is a very powerful concept in maximizing after-tax returns.

## How much is this tax deferral worth?

Chincarini and Kim show that theoretically the difference in returns between an investor that postpones all capital gains (such as in a 401K/IRA) and someone who incurs a taxable event each year and pays taxes at the long-term capital gains rate compounds with time and depends on the rate of re-investment.

The higher the returns (we have assumed 8%) and the longer the period of tax deferral the more of a return advantage for the tax aware investor. Using our assumptions for tax rates and investment returns we estimate the value of tax deferral at an annualized 0.66% over 10 years, 1.95% over 20 years and 3.5% over 30 years.




## Managing taxable investments requires an investment plan aligned with a tax management strategy.

The theory of tax management is unambigous as to what investors should do to maximize after-tax returns. **The first thing is to do in a trading sense is to attempt to minimize short-term taxable events** and instead pay taxes at the long-term capital gains rate. Not incurring significant trading activity and holding investments for over a year is key to this aspect of a smart investment strategy.

**The second component of a smart tax strategy is to attempt to defer taxable events for as long as possible.** This could take the form of maximizing investments in government sanctioned tax advantaged structures such as 401K, IRA and variable annuity products (hopefully with low imbedded fees).

Also, investors should adopt more of a buy and hold approach to investments and thus avoid a high incidence of taxable events. As Warren Buffet has alluded to many times his favorite holding period is *forever* – the avoidance of taxable events no doubt influences his views on the subject.

Finally, taxable investors should minimize the portion of total return originating from income payments (dividends in the case of stocks and coupons in the case of bonds). The loss of the full tax deferral is one reason why academic researchers have concluded that the value premium (low valuation stocks outperform) looses some advantage once taxes are taken into account (see Israel and Moskowitz, Chicago Booth Working Paper, No 12-20, Fama-Miller Working Paper, 2012).

Value stocks tend to exhibit higher levels of dividends relative to growth stocks. Assuming equal annual rate of return for value and growth approaches the implication is that over long periods of time the tax deferral effect will yield higher levels of wealth for the portfolio with fewer income distributions over its life.

**Effective tax management requires an integrated approach to portfolio construction and trading that recognizes the potential returns, risks and tax implications of a strategy.** Simply reducing turnover or matching winning with losing positions once a year yields some gains but leaves a signficant portion of the potential tax alpha on the table.

Tax aware optimization techniques while complicated on the surface are commercially available but require customization to account for individual circumstances. In many instances such programs create voluntary losses to offset current investment gains and the more sophisticated applications encompass security positions across different asset classes. It is also very important to properly account for the intended final disposition of investment assets. Finally, we would remiss to not point out that tax policy is not only highly specific to geographic areas (say countries and states) but also subject to significant rule changes over time.

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