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Reflections

TAX-ADVANTAGED INVESTING

Christopher G. Luck

Partner

Tax-Advantaged Investing

Published in the *Journal of Private Portfolio Management,* Spring 1999.

For taxable investors, tax considerations should have a tremendous impact on their investment strategy. Unfortunately, it is not uncommon to observe taxable investors completely ignoring the impact of taxes. Even for investors who do consider taxes, it is not uncommon to see them treating taxes on an *ad-hoc* basis. In almost all cases, this leads to poor tax decisions. Tax costs can easily swamp the other costs associated with managing assets – transaction costs, management costs – and can even swamp the total return of the portfolio. It is no fun to pay the government taxes, especially when those taxes can be avoided!

Ben Franklin once commented that the only two things in life that cannot be avoided are death and taxes. Taxes can, however, be minimized, deferred, and for individuals at least possibly avoided altogether[1], with prudent, careful attention to the tax consequences of investing.

For in essence, taxes are another cost of investing. And, especially with respect to equities, because of the market appreciation we have enjoyed over the last dozen years, it is by far the largest cost an investor faces.

Taxes matter – and matter a lot! It is simply amazing that taxes are ignored by so many taxable investors. Almost all mutual fund management, for example, is very tax inefficient. I find it shocking (and dismaying) that many mutual funds serve two distinct constituencies – tax-exempt investors through such vehicles as 401(k) contributions and IRA contributions, investors who do not care at all about tax considerations, and taxable investors, who of course care very much about taxes. The goal for tax-exempt investors is to maximize risk-adjusted pre-tax returns; the goal for taxable investors is to maximize risk adjusted after-tax returns. Those goals can be, and typically are, hugely different.

Hence, it is questionable that any single mutual fund can serve two such distinct groups optimally. I would argue that both are served poorly, and I think it's clear that taxable investors are served poorest of all. Unfortunately for taxable investors, pre-tax returns are what sell in the marketplace. Hence, in the mutual fund arena, the focus is almost exclusively on pre-tax returns. But taxable investors should not care one whit about pre-tax return to the portfolio, but should only care about after-tax return. Although pre-tax and after-tax returns are not unrelated, the gap between the two can be huge, and the strategy to maximize each is very, very different.

For taxable investors, the consideration of taxes should underlie every investment decision. For in essence, taxes are another cost of investing. And, especially with respect to equities, because of the market appreciation we have enjoyed over the last dozen years, it is by far the largest cost an investor faces, with very few exceptions. The remainder of this article will focus on the tax implications for equity strategies, but the implications are in essence consistent for all other taxable investment strategies.

Tax Efficient Strategies

One obvious implication is the incentive for taxable investors to hold index funds, because index funds are relatively tax-efficient, compared to almost all mutual funds. I would argue this (often overlooked) reason, along with the far more publicized failure of active managers in general to even outperform the index funds on a pre-tax basis, has fueled the popularity of index mutual funds. The tax efficiency of index funds is driven by their inherently lower turnover rates, compared to traditional active funds. With low turnover, stocks have a much longer average holding period, so unrealized gains are not converted into realized gains, and the accompanying taxes are postponed into the future[2].

[1] Although this is a tax avoidance strategy which an investor is unable to personally enjoy, the IRS code does allow a tremendous tax advantage for heirs in the case of death, in that the cost basis of the securities inherited is stepped up to the market value at the time of death. Hence, all those unrealized gains (taxes that have been avoided), have been miraculously wiped out through this cost step-up. Maybe this shows the IRS has a heart after all.

[2] For an excellent and ground-breaking discussion of the impact of turnover on after-tax return, see "Is Your Alpha Big Enough to Cover Its Taxes," Jeffrey and Arnott, **Journal of Portfolio Management**, Spring 1993.

In fact, the overwhelming reason almost all mutual funds realize far too high a level of taxes for their investors is quite simple – stocks are not held nearly long enough in the portfolio. A buy and hold strategy, in the face of a rising market, is almost impossible to beat from a tax perspective.

To illustrate the advantage passive funds have for taxable corporate and individual investors (Figures 1 and 2, respectively), even in the face of active managers who can add value, let me use several examples. I will use the following assumptions:

- The equity portfolio returns 10% a year, 8% in capital appreciation, 2% in dividends.
- The passive manager engages in no turnover at all (admittedly a slightly unrealistic assumption, since even passive portfolios have some turnover due to corporate actions like mergers and takeovers), and charges a fee of 20 basis points per year.
- The active manager turns the portfolio over once a year, or 100%, whereby *all* capital gains qualify for long-term rates (also a slightly unrealistic assumption, since almost all mutual funds engage in some trading of securities held less than one year, even when their *average* holding period is greater than a year), and charges a fee of 50 basis points per year.
- For tax rates I assume, for individuals, a 40% rate on dividends, and 20% on long-term capital gains (stocks held a year or more); for corporations I assume a flat 35% rate on dividends and capital gains.
- The "evaluation" period is 20 years.

The advantage to passive investing, even relative to successful active managers, is significant. Active management has to deliver pre-tax alphas of 2.5% per year or greater to compensate for the increased tax cost.

Figure 1

Corporate Investor
Pre-Tax and After-Tax Return Comparison

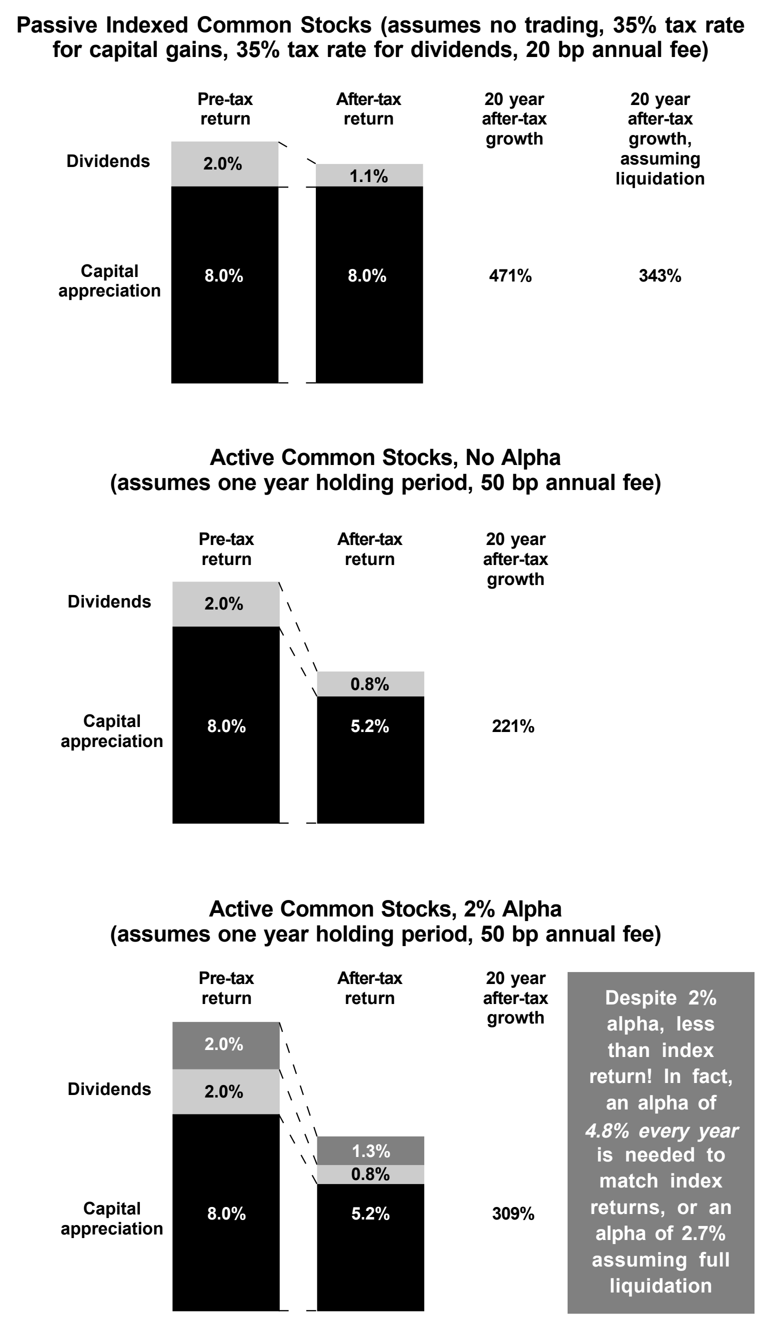
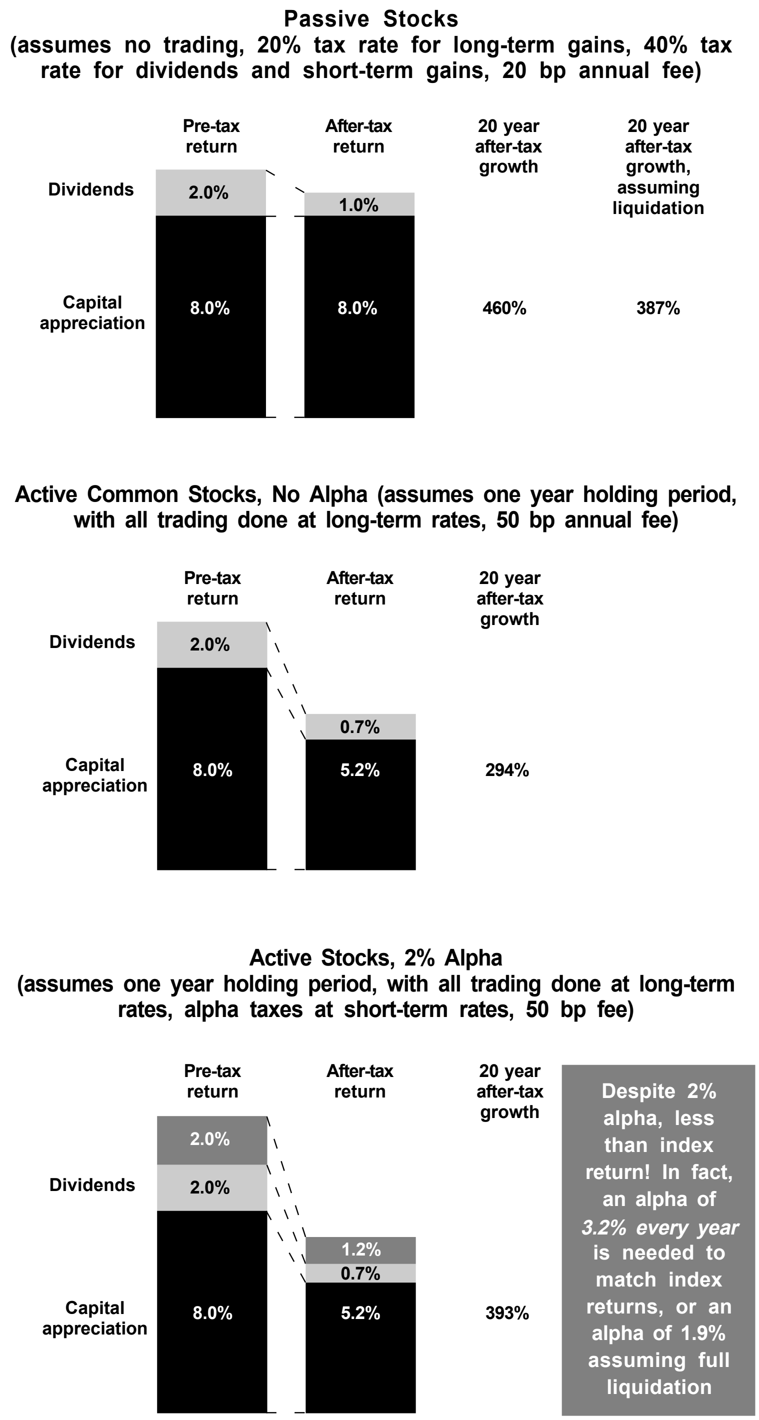


Figure 2

Individual Investor
Pre-Tax and After-Tax Return Comparison



The results are similar, if not quite as disappointing, for individual investors.

The after-tax return advantage to passive investing is significant, even in the unlikely scenario the portfolio is fully liquidated at the end of twenty years, and the possibly even more unlikely scenario that the active manager can consistently outperform the market by 2% (or more) each year over 20 years. In fact, the active manager would have to deliver value-added of over 3% each year, year after year, to just match the after-tax return of the passive fund (if the portfolio is not liquidated) for an individual investor, and a still remarkable value-added of almost 2% if the portfolio was liquidated after 20 years. That is a very high hurdle for most, if not all, active managers managing in a *conventional* fashion.

The advantage of passive investing for a corporate taxpayer is even greater, as corporations cannot take advantage of lower long-term rates – they pay a single capital gains rate.

However, although passive indexing is relatively tax efficient, it is *not* fully tax efficient. Passive investing can be improved upon by active tax management.

The goal of a taxable investment process is to deliver the optimal risk-adjusted after-tax return, taking into account the tax structure of each investor. Again this goal is not the same goal as the one for tax-exempt investors, which is to deliver the maximum risk-adjusted pre-tax return. The difference between the focus on after-tax return and pre-tax return is substantial.

It is also true that because of the focus on after-tax returns, however, the scope to exploit inefficiencies in the equity marketplace, the scope for conventional portfolio valuation, is more limited, with the limits consisting primarily of the unrealized capital gains in the individual stocks in the portfolio. The higher the unrealized capital gains, the more important tax management, and the more limited the opportunities offered by equity market inefficiencies. At the (theoretic) limit, as unrealized capital gains grow increasingly larger, the portfolio would exhibit almost no trading at all, and would be a passive portfolio from a trading context.

Management of Tax Impact

By far the most important component of the active tax-advantaged strategy is the management of the potential tax impact. Taxes in an equity portfolio consist of dividend payments, which are typically taxed at ordinary income tax rates, and capital gains and losses. Different tax regimes apply to individual and corporate investors, and even individual investors are faced with potentially different tax structures, depending on tax brackets, holding periods, and state income tax rates.

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It is critical that the actual tax structure to which the investor is subject be applied in making tax decisions. Because of this, separate account management offers a clear advantage over commingled or mutual funds. Mutual funds, even those managed on a tax-efficient basis, have one specific disadvantage relative to separate account management. As assets in the mutual fund grow, the investor is actually in an advantageous position, as the underlying dividends and capital gains that are realized get spread across a wider group in terms of distributions, so that the impact to existing investors is diluted. Unfortunately, the opposite occurs when the mutual fund is faced with investor withdrawals. The manager of the fund will need to sell holdings to meet the withdrawals, which will typically generate capital gains. Those gains will be distributed to those shareholders who remain in the fund. So the remaining shareholders end up paying taxes even though they did not themselves initiate any investment action!

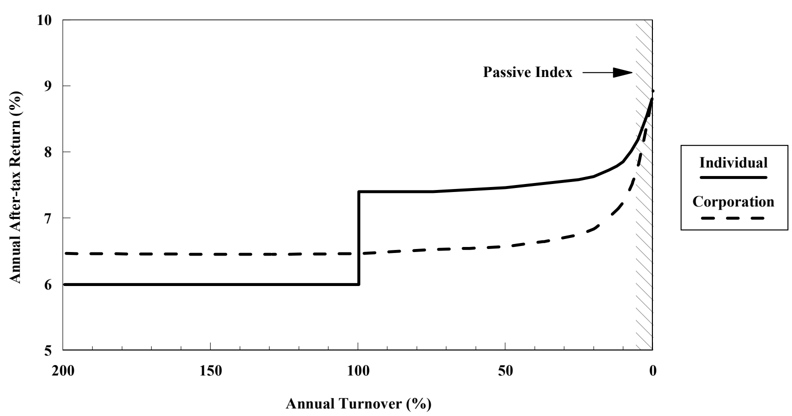
The tax impact of a trade essentially introduces another "cost" to the portfolio management process, similar to any other transaction cost. The tax cost involves the tax impact of a potential trade. The tax impact of any sell decision involves a capital gain/loss realization decision.

Unrealized capital gains represent an option to the taxpayer, since the taxpayer has the right to exercise (or not exercise) the realization of that gain. The exception is corporate actions, like mergers and acquisitions, in which case the stock has to be sold, and any unrealized gains are by definition converted into realized gains. There are typically relatively few of these each year. For example, the turnover of an index like the S&P500 is generally 2-4% per year.

This embedded "option" inherent in capital gains has tremendous value, as taxpayers have the option of postponing gain recognition into the future, and the option of realizing losses currently to offset other gains. For corporate investors, since they are generally faced with a single tax rate on capital gains irrespective of holding period, there is a clear preference to postpone the realization of capital gains as long as possible, all things being equal. For individual investors this postponement is more complex, as they are subject to different tax rates depending on holding period. Managing the realization of capital gains is by far the most valuable piece of the tax management strategy.

What tends not to be well understood in managing turnover is that to be effective, turnover has to be reduced to very low levels. The average level of turnover for active mutual funds is close to 100% per year, which means the average stock is held for slightly over a year, and then sold. Although for an individual this does qualify for lower long-term rates, it still involves paying taxes to the government on an almost annual basis (and of course, although the average stock is held for over a year and qualifies for long-term capital gains treatment, there will be stocks held for less than a year taxed at higher short-term rates). To be far more effective, turnover rates must be reduced so that average holding periods are more like 8-10 years or greater, so that taxes are paid far less often than annually.

Figure 3
Turnover and Taxation



The trade-off faced by taxable investors is graphed in Figure 3 (using the same return assumptions as in the prior example.)

There are several obvious lessons from the graph. One, at a minimum individual investors want to hold all stocks so that they qualify for long-term capital gains rates, which provides a huge cost savings relative to short-term rates. However, after qualifying for long-term rates, turnover must be reduced dramatically to realize further tax savings – notice how flat the curve is between 100% annual turnover and 20% annual turnover.

For corporate investors, the trade-off is simpler – to realize any significant tax savings they must delay turnover (alternatively said, increase their holding period) as much as possible to realize tax savings.

A focus on tax management leads to the following portfolio strategy implications:

A focus on tax management leads to the following portfolio strategy implications:

- *Turnover is minimized*
- *Dividends are actively managed*
- *Capital losses are aggressively harvested*

- Turnover is greatly reduced from pre-tax turnover levels – typically to the 10-15% per year range, depending on tax rates and holding periods, to limit capital gains realization.
- For individual investors dividends are reduced below benchmark levels, to avoid current tax recognition. Typically, tilts away from dividend paying stocks are modest, since significant tilts can lead to undesired risk relative to the benchmark. And for corporate investors, since they are able to take advantage of the dividends received exclusion, depending on the effective holding period, they may well be have a preference for a modest dividend tilt.
- Active loss harvesting is encouraged, in order to offset "involuntary" gain realization.

This last point, for example, is one obvious way to improve on passive indexing. Passive indexing is not tax efficient *per se,* but rather is tax efficient because it is a low turnover strategy.

Passive indexers have a simple (for the investment world) job - they mimic the index. They basically have no discretion; they merely buy or sell as the index buys or sells. However, an active manager who properly considers taxes does not have to "blindly" follow the index. The tax-efficient manager explicitly focuses the strategy on tracking the index *and* minimizing taxes. One obvious way to minimize taxes is to reduce turnover on the portfolio drastically, or to be more precise, to reduce turnover in stocks with unrealized capital gains. Tax efficiency can be further enhanced by harvesting losses to offset gains. Improvements can be made by postponing sales caused by index realignment. If something is removed from the index, it is not absolutely necessary that the investor immediately sell that stock from the index. Again, the investor should explicitly consider the tax impact.

The rewards to tax-advantaged investing are tremendous, and the taxable investor actually does end up with a much bigger pile at the end of the game.

Portfolio Construction

For taxable investors the portfolio process becomes much more complicated. Instead of merely considering the risk of the portfolio in the form of the stocks in the portfolio, the investor must consider the tax lots for each individual stock as separate holdings. So for a taxable investor, every stock is essentially a series of different holdings, each with a different tax basis and potential tax cost. Because of that, the portfolio construction process is far more complicated, and needs to be properly managed.

There is a very clear preference to using specific identification as a tax lot identification method to maximize the tax savings. Other tax lot identification methods (the most common being average cost) are sub-optimal in terms of tax avoidance. Coordinating with the manager on the tax basis, based on the specific identification method, leads to a more optimal tax avoidance strategy.

Customized Solutions

Tax-advantaged strategies are designed to focus on after-tax returns.

Unfortunately tax-advantaged investing is not nearly as glamorous an endeavor as traditional active management. The returns on such strategies, measured on a *pre-tax* basis, are very similar to index returns. These are not the "shoot the lights out" kind of returns that bring managers fawning press coverage, nor are they likely to be prominently recognized as the best performance funds. And managing such a strategy is more difficult than managing a tax-exempt strategy, since there are so many potential decisions required to optimally construct the portfolio based on the multiple tax lots for each stock.

The rewards, however, are tremendous. Every tax dollar saved is a dollar in the investors pocket, and better yet, those extra dollars, if reinvested, continue to generate additional return in the portfolio. All of which contributes to a very virtuous circle, and the taxable investor actually does end up with a much bigger pile at the end of the game.

FIRST QUADRANT, L.P. | 800 E. COLORADO BLVD. SUITE 900, PASADENA, CALIFORNIA 91101
MARKETING SERVICES INFO@FIRSTQUADRANT.COM | OFFICE 626 683 4223 | WEB FIRSTQUADRANT.COM