Tax-Managed Investing in an Era of Rising Tax Rates

FQ Insight

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Introduction

The first round of fiscal legislation for 2013 and beyond was cobbled together at the last minute with much partisan wrangling. Most observers were dissatisfied with both the meager result and the divisive process needed to get there. While the outcome averted near-term severe fiscal tightening, it failed to address in a meaningful way the ballooning federal budget deficit or the rapidly approaching debt ceiling. Many of the same issues, and some even more contentious ones, will have to be addressed soon.

As expected, tax rates on equity investment returns increased, though not by as much as many had feared. The levy on long-term capital gains and dividends for high earners rose to 20.0% from 15%. Furthermore, the addition of the 3.8% Medicare Contribution Tax raises the effective rate on dividends and capital gains to as high as 23.8% for some high-income taxpayers. With fiscal pressures still very high, and tax rates on equity investment returns low by historical standards, it would be surprising if those tax rates did not rise further, although the timing is uncertain.

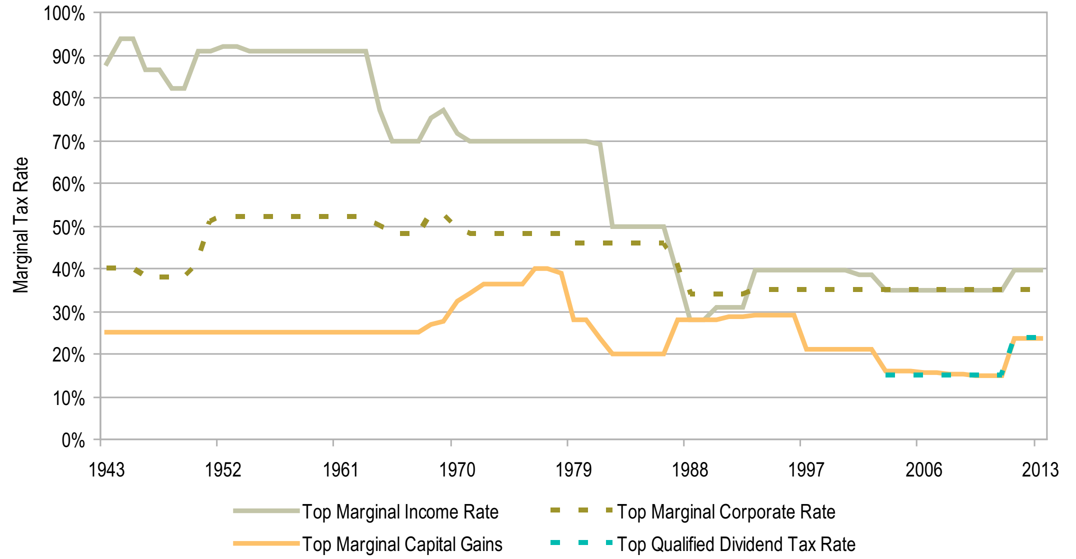
So what should investors do? We know that taxes are practically unavoidable, but the vast majority of equity investors neglect well-established techniques for minimizing the tax bite without sacrificing expected returns. Savvy investors have been using these techniques for years, and the result tends to be significantly higher after-tax returns. This paper explains how stocks can be managed in a tax-efficient way within a mutual fund, allowing investors to gain access to those techniques.

Federal Tax Rates Over Time

As shown in Figure 1, tax rates have been trending down since 1943 and are currently at historical lows. As a result of the financial crisis which began in 2008 and the subsequent economic recession, tax revenue has declined. At the same time, spending increased in order to bail out financial institutions and stimulate the economy. This unsustainable trend is illustrated in Figure 2 which shows the federal deficit as a percent of GDP. Politicians are under pressure to get our country's fiscal house in order. While the federal government allowed tax rates to rise beginning in 2013, the additional revenue raised, on its own, is not sufficient to make much of a dent in the national debt. Nor did the government convincingly address the spending side of the equation. We believe there will be future spending cuts and probably further increases in tax revenue.

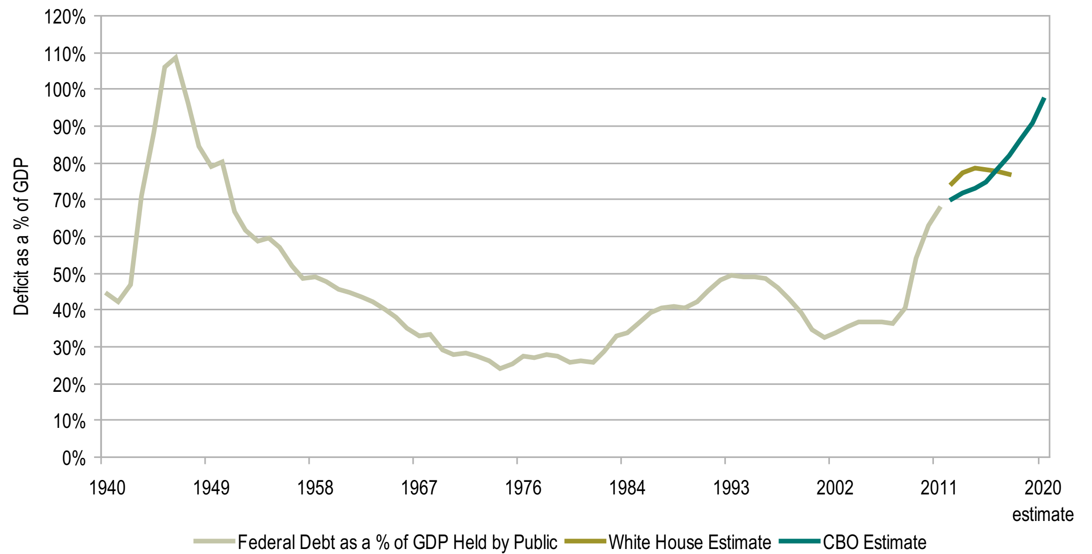
Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

Figure 1: Top Marginal Tax Rate for Income, Corporations and Capital Gains 1943-2013



Sources: Tax Policy Center-Urban Institute and Brookings Institution, Tax Foundation and IRS

Figure 2: Federal Debt as a Percentage of GDP Held by Public 1940-2011; Estimates: 2012-2020



The federal government raised the maximum tax rates for ordinary income, qualified dividend income and long-term capital gains beginning in 2013 [see Figure 1]. For high income mutual fund investors, capital gains and dividend income distributions will be taxed at higher rates.

The maximum rate on long-term capital gains is scheduled to increase from 15% to 20% in 2013. Individual taxpayers in the 10% and 15% ordinary income tax brackets previously paid no tax on long-term gains, and that will continue to be the case. Additionally, the 3.8% Medicare contribution tax will increase the effective rate of tax on long-term capital gains for some higher-income taxpayers to as high as 23.8%.

Table 1

Maximum Rates	2012	2013	2013 (Including Medicare Contribution Tax)
Long-Term Capital Gain	15.0%	20.0%	23.8%

Source: IRS. The 3.8% Medicare contribution tax is a tax on certain unearned income and was enacted as part of the Patient Protection and Affordable Care Act (PPACA).

Prior to 2003, all dividend income was taxed as ordinary income. Taxpayers in the highest marginal income tax bracket who previously paid the 15% rate on qualified dividend income will now be taxed at 20.0%. As in the case of long-term capital gains, the 3.8% Medicare contribution tax will increase the effective rate of tax on dividend income to as high as 23.8% for some higher-income taxpayers.

Table 2

Maximum Rates	2012	2013	2013 (including Medicare contribution tax)
Qualified Dividend Income	15.0%	20.0%	23.8%
Ordinary Dividend Income	35.0%	39.6%	43.4%

Source: IRS. The 3.8% Medicare contribution tax is a tax on certain unearned income and was enacted as part of the Patient Protection and Affordable Care Act (PPACA).

Why Tax-Managed Investing?

For any investment held outside of a tax exempt or tax deferred plan, taxes matter a lot. The negative impact of taxes on mutual fund performance has been documented and studied extensively by researchers at First Quadrant [ref1, ref2, ref3]. These studies found that taxes impose a significant performance drag on returns, averaging 1 to 3 percentage points per year, which often exceeds the value added by the manager's skill in selecting stocks. These costs are mainly due to many managers ignoring the tax consequences of frequent trading and the resulting short-term capital gains taxes.

An important outcome of these studies was the development of techniques managers can employ to reduce the impact of taxes on mutual fund returns [ref4].

- Defer realizing gains
  - > Avoid realizing capital gains, unless this can be offset by an equivalent capital loss.
- Delay gains from short term to long term
  - > Delay selling shares held less than one year in order to take advantage of lower long-term tax rates.
- Harvest losses to offset realized gains
  - > Shares sold for a capital loss can be used to offset realized gains.
- Use highest-in-first-out (HIFO) tax lot accounting
  - > Selling highest cost basis shares first will reduce realized capital gains.
- Lower dividend yield
  - > There is an immediate tax cost for dividends distributed to investors. Reducing dividend yield reduces this tax burden.
- Avoid wash sales
  - > Shares sold for a capital loss cannot be bought back for 31 days if the loss is to be used to offset capital gains.

First Quadrant (FQ) has been at the forefront of using these techniques in equity portfolio management. FQ began managing taxable U.S. assets in October of 1997 and global taxable assets in January 2004. There is currently approximately $1.3 billion in taxable assets under management as of December 31, 2012 which include separate accounts and a sub-advised mutual fund. The approach to stock selection is fundamentally based and risk management is an integral part of the investment process.

Table 3 shows the performance since inception of a representative tax-managed US equity sub-advised mutual fund. The representative fund performance is benchmarked relative to an investment in the iShares Russell 3000 ETF (IWV)[1]. Even relative to a vehicle known for its tax efficiency, we believe the First Quadrant fund performance is compelling.

[1] iShares Russell 3000 Index Fund seeks investment results that correspond generally to the price and yield performance, before fees and expenses, of the United States equity market, as represented by the Russell 3000 Index.

Table 3[1]

	GROSS OF TAX			NET OF HIGHEST FEDERALTAX RATES		
	Fund Return	Benchmark Return	Value Added	Fund Return	Benchmark Return	Value Added
Last 3 Years (Annualized)	12.91%	11.08%	1.83%	12.83%	10.77%	2.06%
Last 5 Years (Annualized)	0.38%	2.01%	-1.63%	0.28%	1.71%	-1.44%
Last 10 Years (Annualized)	7.84%	7.53%	0.30%	7.75%	7.25%	0.50%
Since Inception[2] (Annualized)	4.16%	3.13%	1.04%	4.06%	2.80%	1.26%

Source: Bloomberg, LP
[1]Supplemental Information. [2]Inception date: January 2001.
Representative Tax-managed US equity sub-advised mutual fund monthly performance summary, gross and net of highest federal tax rates. The benchmark is the iShares Russell 3000 ETF (IWV). All returns assume the reinvestment of dividend distributions. Performance updated as of December 31, 2012. All returns assume the reinvestment of dividend distributions and are net of all fund management fees and operating expenses.

The fund has out performed IWV on an annualized basis since inception by 1.04% pre-tax and 1.26% after-tax. The pre-tax outperformance of 1.04% reflects the benefit of active management compared to the index. The additional 0.22% annual "tax alpha" is mainly due to the tilt toward stocks with lower dividend yields. Any increase in dividend tax rates in the coming years will make this component of return larger. Furthermore, the First Quadrant sub-advised fund has never distributed a capital gain to investors.

Conclusion

Because tax rates on equity investing have risen, and are likely to rise further in the future, this is a good time for investors to pause and take a fresh look at how they invest in stocks. While tax-efficient investing has always made good sense, higher tax rates have made it a virtual necessity.

In this note, we have summarized a number of techniques for managing equities in a tax-efficient way. Each technique on its own is reasonably straightforward, although to generate the full benefit, they must all be used continuously in a highly disciplined manner. We are advocates of using stock selection skills to enhance returns further, but it is important that the approach used to select stocks is compatible with tax-efficient management. For this reason, we believe the best results are likely to be obtained from a manager with experience in tax-efficient management and with proven stock selection skills.

References

1. Jeffrey, Robert H., and Robert Arnott. 1993. "Is Your Alpha Big Enough to Cover Its Taxes?" *Journal of Portfolio Management* 19, no. 3 (spring): 15-25.
2. Arnott, Robert D., Andrew Berkin, and Jia Ye. 2000. "How Well Have Taxable Investors Been Served in the 1980s and 1990s?" *Journal of Portfolio Management* 26, no. 4 (summer): 84-93.
3. Arnott, Robert D., Andrew Berkin, and Jia Ye. 2001. "The Management and Mismanagement of Taxable Assets". *Journal of Investing* 10, no. 1 (spring): 15-21
4. Berkin, Andrew, and Jia Ye. 2003. "Tax Management, Loss Harvesting, and HIFO Accounting". *Financial Analysis Journal* 59, no. 4 (July/August): 91-92.

COMPOSITE INFORMATION

US Tax-Advantaged All Cap Equity Composite	Total Net Return Before- Tax	Benchmark Total Return Before-Tax	Value-Added Net Before-Tax[1]	Anticipated Individual Income Tax Rates	Anticipated Individual Long-Term Capital Gains Tax Rates	Number of Portfolios[4]	Composite Dispersion *(%)*	Total Composite Assets[3,4] *(Millions USD)*	% of Firm Assets[4]	Total Firm Assets[4] *(Millions USD)*	Actively Managed AUM[1,4,5] *(Millions USD)*	Total Firm Assets (Including Notional Values)[1,4,6] *(Millions USD)*
2001	-8.7%	-8.9%	+0.2%	39.6%	20.0%	< 5	-	5	0.1	4,767	9,124	14,470
2002	-19.7%	-24.7%	+5.0%	39.6%	20.0%	< 5	-	9	0.2	5,277	8,745	13,293
2003	+28.6%	+29.7%	-1.1%	35.0%	15.0%	< 5	-	54	0.7	7,336	11,300	17,697
2004	+11.4%	+11.7%	-0.3%	35.0%	15.0%	< 5	-	48	0.5	9,323	14,150	21,041
2005	+16.3%	+6.1%	+10.2%	35.0%	15.0%	< 5	-	61	0.6	9,852	20,519	26,644
2006	+15.4%	+15.6%	-0.2%	35.0%	15.0%	< 5	-	87	0.6	14,404	26,301	34,839
2007	+10.9%	+4.6%	+6.3%	35.0%	15.0%	< 5	-	131	0.9	14,594	31,025	37,283
2008	-40.6%	-37.1%	-3.5%	35.0%	15.0%	< 5	-	59	0.6	9,508	20,043	24,478
2009	+21.1%	+28.1%	-7.0%	35.0%	15.0%	< 5	-	52	0.7	7,867	17,342	17,427
2010	+24.7%	+16.9%	+7.8%	35.0%	15.0%	< 5	-	49	0.6	8,558	18,713	18,789
2011	+2.3%	+0.7%	+1.6%	35.0%	15.0%	< 5	-	41	0.5	7,967	16,725	16,725
2012 (Jan-Dec)[2]	+14.5%	+16.5%	-2.0%	35.0%	15.0%	< 5	-	41	0.5	7,893	17,105	17,105

See additional disclosures for important information concerning this composite and the effect of fees. [1]Supplemental Information. [2]All performance and AUM data is preliminary. [3]Includes market values for fully funded portfolios and the notional values for margin funded portfolios, all actively managed by First Quadrant. [4]At end of period reported. [5]Includes market values for fully funded portfolios and the notional values for margin funded portfolios, all actively managed by First Quadrant and non-discretionary portfolios managed by joint venture partners using First Quadrant, L.P. investment signals. First Quadrant is defined in this context as the combination of all discretionary portfolios of First Quadrant, L.P. and its joint venture partners, but only wherein FQ has full investment discretion over the portfolios. [6]Includes market values for fully funded portfolios and the notional values for margin funded portfolios managed by First Quadrant and non-discretionary portfolios managed by joint venture partners using First Quadrant, L.P. investment signals. First Quadrant is defined in this context as the combination of all discretionary portfolios of First Quadrant, L.P. and its joint venture partners, but only wherein FQ has full investment discretion over the portfolios.

US Tax-Advantaged All Cap *Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.* **GENERAL DISCLOSURES:** First Quadrant, L.P. claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. First Quadrant, L.P. has been independently verified for the period 1995-2011. The verification reports are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. 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The benchmark displayed is the iShares Russell 3000 Index (IWV), since this most closely reflects the effect of tax on the returns of the Russell 3000 Index, which measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. [iShares Russell 3000 Index Fund (the Fund) seeks investment results that correspond generally to the price and yield performance of the Russell 3000 Index (the Index). iShares® is a registered trademark of BlackRock Institutional Trust Company, N.A. Russell Investments is the owner of the trademarks, service marks and copyrights related to its indexes.] The strategy may be customized in consideration of the individual clients' circumstances, with the goal of delivering superior after-tax returns. **Portfolio Criteria:** There is no minimum balance requirement for a portfolio to be included in a composite. None of the portfolios included in the composite utilize leverage. **Calculation Methodology:** Valuations and returns are computed and stated in U.S. dollars. The tax rate assumptions used to calculate after-tax performance are based upon the clients' own anticipated tax rates. Gains and losses are calculated on a HIFO basis (highest-in, first-out). Monthly portfolio returns are calculated using a dollar-weighted rate of return formula. Annual portfolio returns are calculated by linking the monthly returns using the linked internal rate of return formula. Additionally, individual contributions and withdrawals falling below 10% of a portfolio's market value are time weighted during the month. When contributions or withdrawals exceed 10% of a portfolio's market value, an intra-month performance calculation is made for the period prior to and subsequent to the contribution or withdrawal. These intra month calculations are linked together using the internal rate of return formula to calculate the monthly return. Monthly composite returns are calculated by weighting each portfolio's monthly return by its beginning market value as a percentage of the total composite beginning market value. Dividend and interest income is accounted for on an accrual basis. The dispersion of a composite is calculated using the asset-weighted standard deviation formula. Only portfolios managed for the full calendar year are included in the dispersion calculation. Where a composite contains five or fewer portfolios, a measure of dispersion is not statistically representative and is therefore not shown. The three-year annualized standard deviation measures the variability of the composite and the benchmark returns (if applicable) over the preceding 36-month period. The standard deviation is not presented for periods in which 36 months of historical composite returns are not available. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request. **Investment Management Fees:** Performance results presented net of investment management fees are based upon the actual average-weighted management fee charged each portfolio in the composite. These net of fee results also reflect the effect of any negotiated fee arrangements, which are different than FQ's fee schedule. All performance results presented include trading commissions. The FQ investment management asset-based fee schedule (assets managed in millions) for this strategy, which if negotiable, is as follows: $10–$50, 0.95%; $50–$100, 0.65%; $100–$300, 0.40%; and more than $300, 0.30%. Asset-based fees are charged incrementally. For example, a $100 million portfolio will be charged 0.95% for the first $50 million and 0.65% for the remaining $50 million. Incentive fee arrangements are available and negotiable. **Market Impact on Returns:** Performance in 2010 was unusually strong, as the portfolio benefited from tilts to smaller stocks and stocks with positive price momentum. Positions in Dillards, American-Italian Pasta and Freeport-McMoRan Copper and Gold were notable positive contributors.

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