The New Three-Legged Stool ....Update

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How To Invest In A Tax-Efficient Way

Let's discuss how to ensure your investment portfolio is efficient not just from a risk perspective, but from a tax standpoint as well. You may not be able to control the market, but you do have a lot of control over your taxes. By understanding basic tax rules and using tax-efficient investment strategies, you can minimize the annual tax bite on your taxable accounts.

The most tax-efficient investment strategy is simple: hold shares for as long as possible, thus deferring the taxes on your capital gains until you sell. An extremely tax-efficient portfolio would therefore be a selection of growth stocks you bought and held for the long haul. In this case, growth stocks would be preferred, because they tend to pay little or no dividends. Your return would be mostly made up of long-term capital gains. Best of all, you'd get to decide when you pay the tax by choosing when to sell them.

However, a portfolio full of growth stocks isn't without problems. For starters, concentration in few securities and the lack of diversification from being in mostly one asset class create volatility. You need the diversification of a balanced portfolio over several asset classes to reduce this volatility. It's important to keep in mind, then, that investing tax-efficiently is a balancing act. Though the reality is there will always be trade-offs, your overarching goal should be to minimize taxes while still attempting to achieve superior investment returns. Another issue with long-term investments is they tend to scare some investors into holding even when it's not wise to do so, since these investors believe selling would trigger additional capital gains. Remember, *the tax decision should never overrule the investment decision*. Assessing the tax consequences of your investments at each stage—contribution, accumulation, and distribution—is the key to success in the world of tax-advantaged investing. Just don't lose sight of the investment return like one of my clients, Joe Mitchell (not his real name), unfortunately did. (see case study on page 2)

(Article continued on the next page)

"Another issue with long-term investments is they tend to scare some investors into holding even when it's not wise to do so, since these investors believe selling would trigger additional capital gains. Remember, the tax decision should never overrule the investment decision." - **Rick Rodgers**

Case Study: Joe Mitchell - Investor

Joe Mitchell had accumulated a large position in a computer company. He purchased most of the stock in the 1990s, and through several stock splits, he'd accumulated over $250,000 worth of the stock with a total cost of $50,000.

The stock had been doing well until 2005 when the stock price started heading south. By the middle of the year, Joe's computer company stock was down over 10%, yet the stock market was still going up. Still, Joe refused to sell any of the stock, because he didn't want to pay capital gains tax. By the end of the year, his stock value had fallen to less than $178,000, and the stock market was up that year by 4.9%.

Had Joe sold the stock when it was down 10%, he would've owed $26,000 in capital gains tax ($225,000 - $50,000 = $175,000 X 15%). He would've been left with $199,000 that could've gained back 4.9% in an index fund.

Joe's mistake is easy to see in hindsight (the perfect vision!). Of course, you won't know at the time if the stock's going to recover or if the investment you choose with the proceeds is going to perform better than the one you just sold. But in Joe's case, the stock was moving at such a sharp contrast to the stock market's overall direction, he should've at least sold part of the position by mid-year. The computer company stock went on to lose 16% in 2006 (S&P 500 +15.8%) and another 2% in 2007 (S&P 500 +5.5%). Again, investment reasons should always trump tax reasons.

Keep in mind that if mutual funds are the building blocks of a portfolio, tax-efficient investing begins with the simple notion that good fund managers who are sensitive to tax issues can make a difference on your after-tax return. A "good manager" from a tax perspective harvests losses, pays attention to the holding period, and controls the fund's turnover rate. Studies show the average actively managed mutual fund operates at 85% tax efficiency. Most fund managers are tasked solely with generating a return. They don't think about working with taxable and non-taxable portfolios, and they don't care about short-term gains. Of course, in your IRA or 401(k), you don't care about short-term gains either, but short-term gains in a taxable account can be disastrous. However, mutual fund managers are often not as concerned as you are with keeping taxes low. These professionals are concentrating on maximizing pre-tax—not after-tax—returns. The difference is an important one.

It's clear the best after-tax returns start with the best pre-tax returns, but even the fund industry itself has come around to the need for examining after-tax returns. Let's dig in with an explanation of the more tax-efficient types of funds: (next page please)

The New Three-Legged Stool

A Tax Efficient Approach to Retirement Planning

By Rick Rodgers

Imagine you're playing a game called Retirement Distribution. Your opponent, the IRS, wrote the rules of the game. The secret to winning this game is to keep the IRS out of your financial affairs before they have the right to interfere. To win, you will need a guide to the fine print in the rule book, and a sound strategy.

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Tax Efficient Types of Funds

Index funds: Index mutual funds are designed to match the performance and risk characteristics of a market benchmark like the Standard & Poor's (S&P) 500 Index. They've long been the easiest way to construct a tax-smart portfolio. Index funds don't need to do much buying and selling, because the makeup of the portfolio changes only when the underlying benchmark changes. Since the portfolio turnover in these funds is low, stock index funds can often reduce an investor's tax exposure. But investors should understand there are few absolutes: index funds can also realize gains. When a security is removed from a fund's target index, stock in the company must be sold by the fund and new stock purchased. Index funds also tend to have lower expense ratios because they aren't actively managed. Lower expenses mean more of the gain goes into your pocket.

Exchange-traded funds (ETFs): Exchange-traded funds (ETFs) are a popular alternative to mutual funds due to their tax efficiency and lower operating fees. The fact ETFs offer more control over management of gains is very attractive to the tax-efficient investor. ETFs look like index funds but trade like stocks. The most popular ETFs use broad market benchmarks such as the S&P 500 Index or the Nasdaq 100 (QQQQs or Qubes). There are ETFs that represent nearly all parts of the market (midsized value, small growth, and foreign companies) as well as various sectors (telecom, utilities, technology).

Most ETFs have even lower expenses than their index fund counterparts. Unlike mutual funds, ETFs can be bought and sold throughout the day, rather than just at the end of trading. ETFs tend to have little turnover, few capital gains distributions, and a low dividend yield—making them very tax-efficient.

In addition, ETFs aren't as vulnerable to the hysteria of other investors because liquidity is provided through the stock market. When the stock market declines, many investors panic and pull out. Mutual fund managers are then forced to sell positions to provide cash to the sellers. Those shareholders that keep their shares suffer a double whammy—a loss of market value and taxable gains created by the manager selling securities in the fund. Many investors have no idea this can happen. Yet ETFs don't have to sell securities to meet redemptions.

Despite their benefits, ETFs pose a problem for individual investors in the sense ETFs aren't no-load. Rather, you have to pay commissions to buy and sell them. If you're investing regular sums over time, those costs can easily negate any break you get on annual expenses. ETFs are a better bet for those with a lump sum to invest.

Tax-efficient mutual funds: Some types of mutual funds are more tax-friendly than others. Tax-efficient mutual funds, for example, are managed by professional fund managers who attempt to minimize the buying and selling of securities and thus are less likely to pass along taxable gains to individual investors. These professionals use a variety of strategies and objectives, including indexing and careful security selection, to offset most capital gains with capital losses.

These funds are actively managed, but by managers who pay attention to the tax ramifications of their trading. Some simply keep turnover low, minimizing the capital gains they have to realize. Others try to match the sale of any winners with dumping their losers, so gains can be offset by losses.

Keep in mind that of course you can still rebalance in a taxable account. As long as you've held the stocks or stock funds at least a year, you'll benefit from a lower capital gains rate. This allows you to improve your investment portfolio without major suffering at tax time. Many investors unknowingly expose themselves to unnecessarily high rates of income taxes when they sell shares from their taxable investment account at a profit and haven't held the position for 12 months. One strategy for rebalancing in taxable accounts is to take all distributions in cash instead of reinvesting the distributions back into the original fund. The cash can be used to invest in the underweighted parts of the portfolio. This can avoid the need to sell positions to rebalance.

Recommendations for Investing in a Tax-Efficient Way:

- Investing tax-efficiently is a balancing act between diversified asset classes that minimize taxes yet still achieve superior returns.
- The tax decision should never overrule the investment decision.
- Index funds, exchange-traded funds, and tax-efficient mutual funds can all be good tax-efficient investment choices.
- In terms of your retirement accounts, tax efficiency shouldn't be your goal; your retirement account investments should be more aggressive so they have the potential to result in bigger returns over the long haul.
- Review your portfolio regularly, and don't be afraid to harvest losses—especially since you may be able to take the losses as a tax write-off.

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Rick's Tips – Review your portfolio

Tax-efficient investing requires active involvement. That starts with looking for tax-efficient mutual funds as discussed above. You also need to monitor the portfolios so losses are harvested to offset gains. In addition, you must pay attention to holding periods to ensure the asset has been held at least 12 months.

Start by screening your funds for performance and then for tax efficiency. Separate your list of funds that meet your performance criteria by tax efficiency. You don't want to completely exclude funds that aren't tax-efficient, because these can be held in your tax-deferred accounts. You don't need or want to be in a tax-efficient fund with your qualified retirement plan. Remember the trade offs I mentioned earlier between performance and tax efficiency? Returns tend to be lower in tax-efficient funds. Inside a qualified plan, you want the managers to be more aggressive and make moves in the portfolio that if they considered the tax consequences, they might choose not to make.

One of the biggest mistakes investors make is failing to harvest losses in their portfolio. A lot of people think just because an investment is worth less than they paid for it, they haven't really lost any money, because they didn't sell it. Tell that to the holders of Enron stock! You should start by evaluating the investment. If you had cash today, would you still invest in that same position, or are there other opportunities that look better? If you wouldn't purchase your original position, take the loss and reinvest elsewhere. The loss could be worth thousands in saved taxes. The reason most investors don't use this strategy is because loss harvesting is labor intensive—and nobody wants to admit to taking a loss.

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