FACTORS IN FOCUS

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Are Taxes Taking Your Portfolio's Profits?

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With April 15th now behind us, it's safe to bring up the frustrating topic that agitates most investors for months—***taxes***.

We expect to owe taxes on income earned while working and on the cash flow we take from our investment portfolios in retirement. In many cases, we have taxes withheld to prevent big liabilities at the end of the year. But significant tax payments can still surface if our investment portfolios produce unexpected additional income in the form of capital gains, dividends and interest.

Fortunately for our clients, this is far less of a concern than it is for most investors. We go to great lengths to minimize your ongoing tax liabilities without compromising your portfolio's expected returns and ability to achieve your long-term goals. Here's how.

Tax-Managed Asset Class Strategies

Most investors own "actively-managed" mutual funds believing that skillful managers will help them beat the market or avoid significant drawdowns. Of course we know this is all marketing hype—managers don't outperform markets or avoid bear markets with any consistency. But they do trade frequently and pay very little attention to the capital gains implications of doing so. Table 1 looks at the amount of returns lost to taxes on actively-managed funds. On average, active investors lose at least 1% of their returns each year to taxes, in some cases this figure rises to 1.4% or more.

Index funds are often portrayed as more tax-efficient alternatives, which is true. But not all index funds are the same in this regard—the bottom 25% of index funds ranked by tax efficiency lose as much (-1.0% per year) as the average actively-managed fund.

Table 1: % of Returns Lost To Taxes (15yrs ending 9/2014)

	Average	75th Percentile
Actively-Managed Funds	-1.0%	-1.4%
Index Funds	-0.7%	-1.0%
Tax-Managed Fund Mix*	-0.4%	

Source: Vanguard, "Tax-Efficient Equity Investing" March 2015

*30% DFA TM US Equity, 30% DFA TM US Market-wide Value, 40% DFA TM US Targeted Value (since 10/01)

Table 1 also reports the results of an example US stock allocation we use consisting of the tax-managed "asset class" mutual funds from DFA. On average, the amount lost to taxes is considerably less than actively-managed mutual funds and has even resulted in a smaller tax impact than most traditional index funds.

Tax-Efficient Location

Until now we've only discussed stocks, but not every investor wants to or needs to be 100% in equities. Adding short-term bonds to the allocation is an obvious move if the goal is to reduce portfolio volatility (and returns) or increase liquidity for withdrawals. This presents a tax challenge however, as the interest from bonds is taxed at higher ordinary income tax rates.

Tax-free municipal bonds are an option and we use them selectively after a detailed discussion with clients about their added risks. An under-appreciated alternative is to stick with taxable bonds, but "locate" them in tax-deferred IRA accounts. This allows for higher returns (taxable bonds earn higher interest than tax-free bonds) and also dampens the long-term returns on IRAs, reducing Required Minimum Distributions (RMDs) which are based on the owner's life expectancy and the accumulated IRA value.

If your bond-heavy IRA has grown more slowly then forced withdrawals will be smaller, resulting in less ordinary income taxes owed. Taxable accounts benefit more from stock appreciation due to their stepped-up cost basis feature at death.

Tax-Sensitive Management

On an ongoing basis, we also consider the tax consequences of portfolio changes.

Periodically, asset classes will drift beyond their target weightings, which triggers the need to rebalance. But we can "preemptively" refresh the portfolio by directing the regular dividend and interest income (and any year-end capital gains) into the asset classes that are most underweighted at that time.

Further, clients typically are adding to their portfolios (pre-retirees) or are drawing from them (retirees). We use cash inflows and outflows to buy more or sell some of the asset classes that are the most under/overweighted relative to their targets.

Finally, from time to time, the value of our asset class holdings dips below their average cost basis. When this "paper" loss becomes large enough, we may consider selling the position and recognizing the loss, using the proceeds to buy a similar asset class fund temporarily. These losses can be used to offset current or future capital gains as well as earned income. "Tax-loss harvesting" isn't always beneficial, but when approved by a CPA who knows our client's current and future tax situation intimately, it's a strategy we're willing to execute.

Unfortunately, there's no way to completely eliminate taxes from investing while still earning acceptable returns. But by employing several tax-savings techniques on an ongoing basis, we can minimize the amount of your profits that are lost to taxes, leaving more wealth for you to live on and pass on to your loved ones.

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