Gage Wealth Management Group

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TAX EFFICIENCY AND PASSIVE AND INDEX INVESTING

Passive and index investment strategies are not only superior to active strategies in performance, but are particularly advantageous in taxable accounts which are subject each year to pass-through of capital gains and dividend taxes at the Federal level and in most States. Active managers must "turn over" money far more rapidly than passive managers as they try to boost performance by trading stocks or timing markets. Consequently, investors in actively managed funds or portfolios are likely to realize higher capital gains taxes than passive and index investors. Though there is wide variation, the average actively managed portfolio has a turnover rate of roughly 80% per year, while it is around 10% for passive and index portfolios. There is substantial yearly variation in capital gains depending upon market returns.

Several studies have examined the deleterious effect of high turnover rates on after-tax portfolio returns, and their effect is substantial. A Stanford study compared median pre-tax and after-tax performance for 62 actively managed stock mutual funds over a 30 year period, 1963-1992. A high tax bracket investor received less than half of the pre-tax performance, 45%, and a medium tax-bracket investor, 59%. Further, assuming they cashed out at the end, paying further capital gains upon liquidation, these figures dropped to 42% and 55% respectively. Over even short time frames, the effects of high turnover and taxes on returns is still substantial. Morningstar looked at returns for actively managed U.S. equity funds for 1992 through 1996, five years. Investors in the highest Fed and capital gains tax rates received, on average, a little over 70% of the total returns they would have received had the monies been in a tax-deferred account. Of course, Wall Street and mutual funds report performance figures before taxes and liquidation. In fact, mutual fund managers are hired or fired by firms and clients naively comparing their absolute performance with other managers, and tax consequences and real after-tax returns are often ignored. A study by David Booth of DFA compared the after-tax performance of two stellar active funds, Janus and Fidelity Magellan, for the 15 year period ending in 2000. Both funds outperformed the S & P by 2% annually, but, after taxes trailed it by 0.4%. Tax-efficiency matters and passive portfolios maximize it.

Another study published in 1993 looked at the pre-tax and after-tax performance of 72 funds classified by Morningstar as large growth or growth and income. This analysis included funds in existence for the 10 year period from 1982 through 1991, and included the Vanguard S & P 500 index. On a pre-tax basis, the Vanguard index outperformed 79% of the actively managed funds. On an after-tax basis, it outperformed 86% of the active funds. Add in mutual fund expenses, and only 2 of the 71 funds, 2.8%, outperformed the index. It is obvious from the above studies that investors with equity assets in taxable accounts will benefit significantly from using indexes. It's also important to note that capital gains taxes and tax-efficiency will vary from year to year in both active and passive portfolios.

Some advisory firms recommend tax-loss harvesting. We do not promote the practice but will tax-loss harvest upon client request. This strategy involves micromanaging index funds by realizing losses in index funds that have gone down in value, and using them to offset pass-through gains in funds which have produced them. There are potential problems with this approach, discussed in more detail in "Tax Loss Harvesting" on this site. It creates additional risks and transaction costs, may not be defensible in an IRS audit, and the amount of tax-reduction it produces long-term may be zero or worse than zero for investors.

Also, it is worth noting that tax-management strategies in active or passive portfolios rely primarily upon controlling the realization of capital gains and minimizing the pass-through of dividends. Retrospective statistical data presenting the advantage of tax-managed funds generally assumes high cap gains and low dividend pay-outs, conditions which are primarily found in the last 30 years of market history and this may not occur in the future. Historically, for a much longer time frame the majority of returns on stocks came from dividends, and should capital gains diminish or disappear in a protracted bear market, selecting low dividend stocks within a given asset class, typical for passive tax-managed portfolios, might produce lower returns along with lower taxes. There is some evidence this may have occured in 2000-2002. Perhaps more critical, delaying capital gains for ten or twenty years means that the gains could be realized in a much higher tax environment. Capital gains taxes are still historically quite low in 2013 and the U.S. government has unfunded liabilities running many multiples of US GDP and higher taxes is one way to address this imbalance.

What pass-through of capital gains taxes might an investor expect to pay in a well-diversified portfolio containing both taxable and tax-efficient equity index funds? Capital gains will vary year to year. Assuming that the few equity asset classes with high tax pass-throughs of capital gains can be held in tax-qualified retirement accounts or a no-load annuity, a rough estimate might be that about 1.0% in capital gains might be passed through by funds in the average year. This would be taxed at 20% for most investors, plus State capital gains taxes if applicable. Thus, a modest 20% of 1% would be taxed, equivalent to $200 on $100,000 in equities. As of 2013, average dividend yields are historically low, under 2% in the US and 3% internationally for almost all asset classes. With dividends currently taxed at the same rate as capital gains, then a $100,000 portfolio might pass-through $2000 annually in dividends resulting in an additional tax on capital gains of $400 or $600 annually on a $100,000 equity portfolio for total capital gains plus dividend taxes. How much in capital gains is realized depends in large part on market returns and turnover in a given year. On a few occasions tax-managed funds have passed through 8% or more in capital gains. But, overall, passive and index strategies are a certain way to reduce the erosion in returns produced by actively managed portfolios in taxable accounts.