SERVO

Factors In Focus

Tax-Efficient Investing

by Eric D. Nelson, CFA

For most of the year, you are focused on the return and risk aspects of your investment portfolio. But April is the one time when taxes take center stage. A large capital gain distribution or a significant amount of unwanted ordinary income can change your overall tax profile and force you to not just pay more in taxes, but pay at a higher rate than you otherwise would. One of the ways we address and try to prevent this is through our tax-efficient approach to investing.

Tax Considerations

First, some background. By their nature, stocks tend to be more tax efficient than bonds. Qualified dividends are taxed at the long-term rate of 15% (or less) and shares of stock that are held for more than one year are also taxed at long-term rates. Contrast that with bonds, whose interest payments are taxed at ordinary income tax rates (currently up to 39.6%), and you can quickly see why. Municipal bonds are free from federal (and sometimes state) taxes but have coupons that are proportionately lower than the comparable corporate bond, so there's no free lunch.

The tax efficient nature of stocks can be compromised when they are held inside of an actively managed mutual fund where the manager buys and sells frequently. The net gains are passed through to fund owners and that can result in higher taxes even if the investor in the fund has not sold any shares. Traditional mutual funds are often agnostic to how long they've held their stocks, meaning that the capital gains can sometimes be classified as the more costly short-term variety.

Tax-Efficient Design

Our Asset Class approach to investing is tax efficient by design. First, because most of our clients have long-term, multi-generational goals, we tend to hold more in stocks than bonds. Second, we only use a small number of broad-based "core" stock asset classes, which reduces the amount of rebalancing we have to do to keep portfolios on target. This is in direct contrast with most brokers, investment advisors, and "robo-advisors" who use a dozen or more products and an ever changing "kitchen sink" approach to portfolio construction that is also laden with expensive, tax inefficient "alternative" assets. The complexity may snooker a few unsuspecting souls into paying a fee, but they are soon left with confusion, not to mention a lot of unnecessary trading, leading to unexpected and unwanted tax bills.

Tax-Efficient Implementation

The institutional-based mutual funds that we use from Dimensional Fund Advisors (DFA) to manage our Asset Class portfolios are also naturally tax efficient. Only about 10% to 20% of the stocks in the funds need to be sold every year, typically because they have grown to be too large or too growth-oriented and no longer qualify to be in the small cap or value asset classes. Dimensional prioritizes the sale of shares that have been held for more than a year, qualifying for the preferential long-term gains treatment. Stock-like

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shares with tax inefficient dividends, like Real Estate Investment Trusts (REITs), are excluded from the funds, further enhancing tax efficiency.

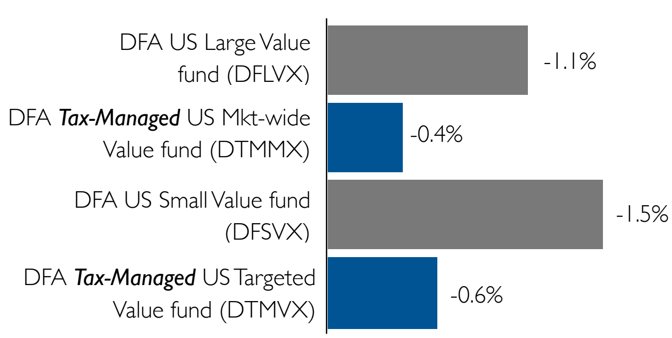
Tax-Managed Funds

But we take tax efficiency one step further by utilizing Dimensional's "tax-managed" stock funds when investing in taxable accounts. These tax-managed funds have similar overall asset class exposures to their standard taxable versions, but also seek to minimize capital gains distributions. Throughout the year, Dimensional will sell holdings that have lost value since purchase, which can be used to offset gains on other holdings that need to be sold. In almost all circumstances, sales will be postponed until the holding period is greater than one year. Dimensional also considers the tax consequences of stock dividends, and if tax rates rise to levels seen before the 2003 Bush tax cuts, they would consider reducing exposure to companies that pay the highest dividends.

Tax-Efficient Outcomes

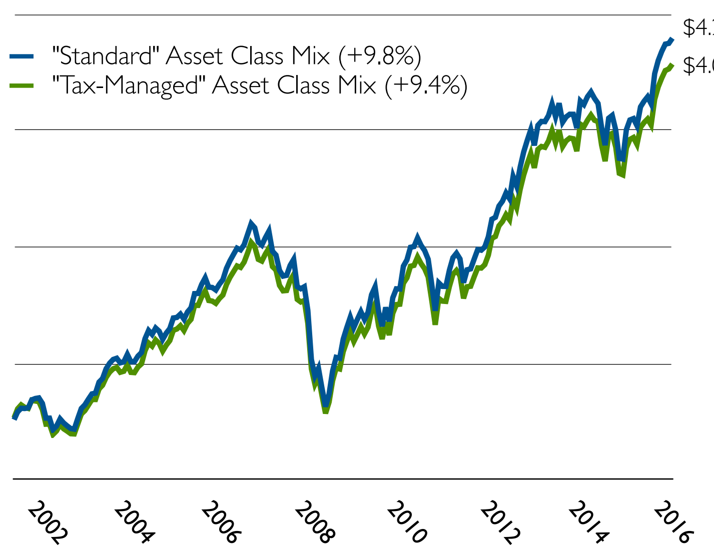
Looking at the "standard" and "tax-managed" versions of the DFA US large and small value strategies in Chart 1 illustrates the benefits of tax-sensitive investment implementation. Over the 18-year period from 1999-2016 (1999 was the inception of the tax-managed funds), the DFA US Large Value Fund lost -1.1% per year to taxes, while the Tax-Managed US Market-wide Value Fund lost only -0.4%. The DFA US Small Value Fund lost -1.5% per year to taxes, the Tax-Managed US Targeted Value Fund lost -0.6%.

Chart 1: Percent of Return Lost to Taxes (1999-2016)



Comparing the long-term performance of a "standard" asset class portfolio with one that uses "tax-managed" versions of the asset class funds in Chart 2, we find that returns are almost identical and short-term results track very closely from year to year.

Chart 2: Growth of $1 (October 2001 to April 2017)



"Standard" Asset Class Mix = 21% DFA US Large Cap Equity fund (DFA US Large Company fund prior to 7/2013), 21% DFA US Large Value fund, 28% DFA US Small Value fund, 18% DFA Int'l Value fund, 12% DFA Int'l Small Value fund

"Tax-Managed" Asset Class Mix = 21% DFA TM US Equity fund, 21% DFA TM US Market-wide Value fund, 28% DFA TM US Targeted Value fund, 18% DFA TM Int'l Value fund, 12% DFA Int'l Small Value fund

A portfolio using tax-managed funds can be tailored to achieve similar long-term results as our traditional asset class allocations with significantly reduced taxable consequences. Both asset class mixes (standard and tax-managed) outperformed a portfolio with the same asset allocation using "retail" indexes from Russell and MSCI by about 1% per year, before considering the additional 0.2% to 0.4% annual cost of the iShares ETFs or Vanguard index funds that track these indexes. Compared to the S&P 500 Index, the Asset Class mixes performed about 2% per year better.

While taxes typically come into focus for you in April, you can rest assured knowing that we think about them and manage them proactively throughout the year.

Contact Eric Nelson, CFA at eric@servowealth.com with any questions, comments, thoughts, or to discuss your own personal financial situation.