# INVESTMENTS & WEALTH MONITOR

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## A BIRD IN THE HAND

# Improving After-Tax Returns for Clients

*By Curt Overway, CFA®*

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At the end of the day, the most important metric for clients is after-tax return, net of fees, which represents the appreciation available to meet investment objectives. This return is a function of pre-tax returns, which may be reduced by both fees and taxes. Positioning client portfolios to achieve attractive returns at appropriate risk levels is a cornerstone of virtually all financial advisory practices. Minimizing fees, or at least ensuring value commensurate with fees paid, is also common practice. What may be less common is a focus on the tax implications of investment portfolios and how tax management can help improve that after-tax, net-of-fees return.

## SEEKING TAX ALPHA

Traditional investment alpha is notoriously difficult to deliver consistently. Choosing strategies, securities, or investments with the objective of generating excess returns is fraught with all kinds of risk and uncertainty. Techniques to mitigate tax drag on investment portfolios also can include some uncertainty, but many actions can be taken to generate a near-certain improvement with no impact on portfolio risk. Tax alpha is the proverbial bird in the hand versus investment alpha's two in the bush.

Tax issues related to portfolio investments are gaining prominence in many clients' minds. In a 2017 survey commissioned by Natixis Investment Managers, U.S. investors identified tax planning as the area where they most wanted professional help, ahead of understanding risk, estate planning, and other concerns (see table 1).

Table 1

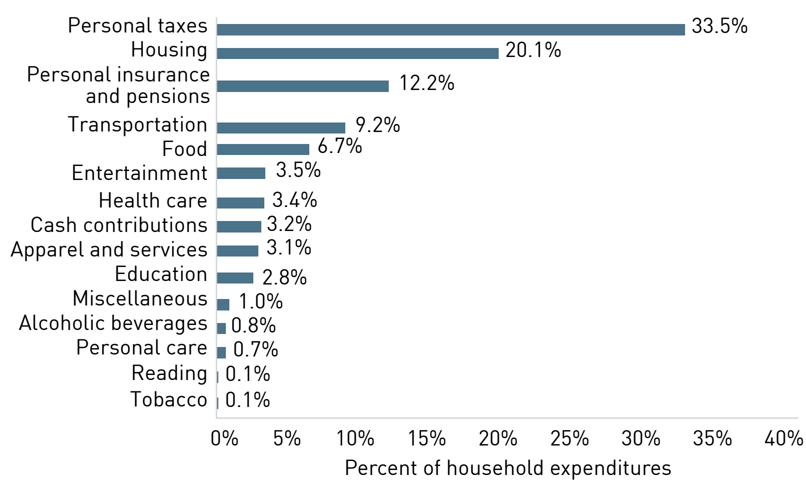
### WHAT DO YOU WANT PROFESSIONAL HELP WITH?

| | Global | U.S. | | Global | U.S. |
|---|---|---|---|---|---|
| Understanding risk | 47% | 40% | Budgeting | 28% | 18% |
| Tax planning | 44% | 41% | Estate planning | 27% | 36% |
| Long-term care planning | 28% | 24% | Managing debt/ Use of credit | 25% | 19% |

*Source: Natixis Investment Managers, "Global Survey of Individual Investors," conducted by CoreData Research, February–March 2017. Survey included 8,300 investors from 26 countries, 750 of whom were in the United States, https://www.im.natixis.com/us/resources/2017-global-survey-of-individual-investors-retirement-report.*

Figure 1

### TAXES ARE LARGEST EXPENDITURE FOR HIGH-INCOME HOUSEHOLDS




*Sources: U.S. Department of Labor, Bureau of Labor Statistics, Consumer Expenditure Survey, 2015; Active Index® Advisors*

This is an encouraging sign, because investors historically have paid too little attention to the effect of taxes on investment returns. In a study conducted by Lipper,[1] the authors observed that taxes often had as large an impact on returns as fees, yet taxes receive much less focus. Other research has found that taxes can erode 2 percent or more of high-income investors' returns (Peterson et al. 2002; Longmeier and Wotherspoon 2006). As shown in figure 1, taxes are far and away the largest single expense for high-income households. Yet, in practice, many investors may not think about their investment portfolios and tax issues holistically. They often seek guidance from one professional for investments and another for taxes.

Advisors who can help bridge that gap by providing tax advice, offering tax-efficient solutions or collaborating with a client's tax professional to develop a tax-aware investment strategy, have a real opportunity to differentiate themselves.

Tax considerations may be factored into the financial planning process in a variety of ways. We will touch on a few of those ways below, but this is by no means a comprehensive list. Other areas—such as estate planning—offer additional opportunities to help improve after-tax outcomes for clients.

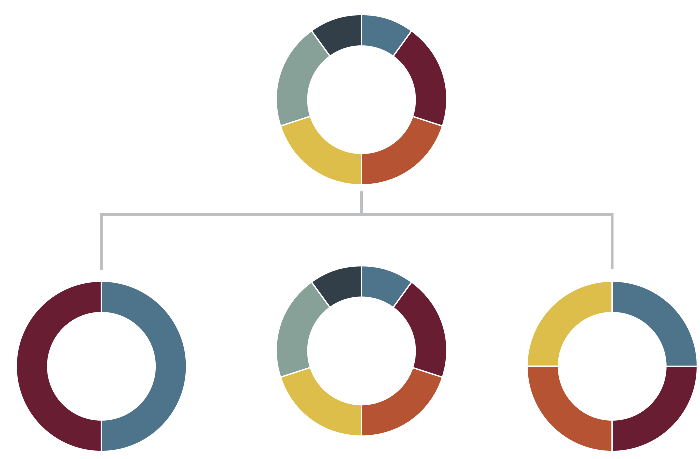
## ASSET LOCATION VS. ASSET ALLOCATION

Taking a household perspective is an important component of a tax-aware investment plan because it provides the opportunity to offer asset location advice. Determining the right mix of assets (i.e., asset allocation) is critical to helping clients meet investment objectives, but deciding where to locate those assets is also important. The most common approach is to first determine the appropriate asset allocation and then place the least tax-efficient investments in the tax-exempt and tax-deferred accounts and the more tax-efficient investments in the taxable accounts (see figure 2). This makes sense and certainly can improve after-tax returns. Optimally sequencing withdrawals from accounts also can contribute to portfolio longevity.

Research by Morningstar estimated that the alpha that can be generated through good asset location decisions and optimal withdrawal strategies could be 0.23 percent per year (Blanchett and Kaplan 2013). Other published research has advocated for a more integrated approach that combines asset allocation and asset location decisions into a single optimization process. One attractive feature of this method is that it considers all assets on an after-tax basis. This includes revising expected returns, risk, and values to adjust for taxes.

Figure 2

HOUSEHOLD LEVEL ASSET ALLOCATION




For example, when thinking about assets in a traditional individual retirement account (IRA), this approach would adjust the account balance to its after-tax value. A $1-million IRA really only provides $700,000 of spending power to a client with a 30-percent tax rate. Though this approach has theoretical merit, adoption has been limited. One reason may be that the optimization process requires a lot of assumptions about current and future tax rates, time horizons, and other inputs that are difficult to predict accurately. It also may have to do with the fact that current algorithms for optimizing tax planning may not be sufficiently nuanced to consider the full complexity of a client's tax situation. There is still a great deal of art to navigating through tax considerations.

## STRATEGIES AND VEHICLES

Tax liability also can be managed in the selection of investment strategies and vehicles. It is no surprise that passive and other low-turnover strategies tend to be more tax-efficient than actively managed and higher-turnover strategies. The choice of investment vehicle, however, can be even more significant. Exchange-traded funds (ETFs) have some tax advantages over mutual funds, but separately managed accounts (SMAs) offer even more tax benefits. In commingled vehicles such as mutual funds and ETFs, all investors share in the cost basis of the underlying positions. That means when a fund manager sells a position that was purchased a long time ago with a large gain, all fund shareholders get a proportional allocation of the distributed gain, whether they've been invested in the fund for that period and benefited from the appreciation of that position or not. Funds and ETFs are also not able to pass through any of the fund's realized losses to shareholders, although those losses can be used to offset other gains.

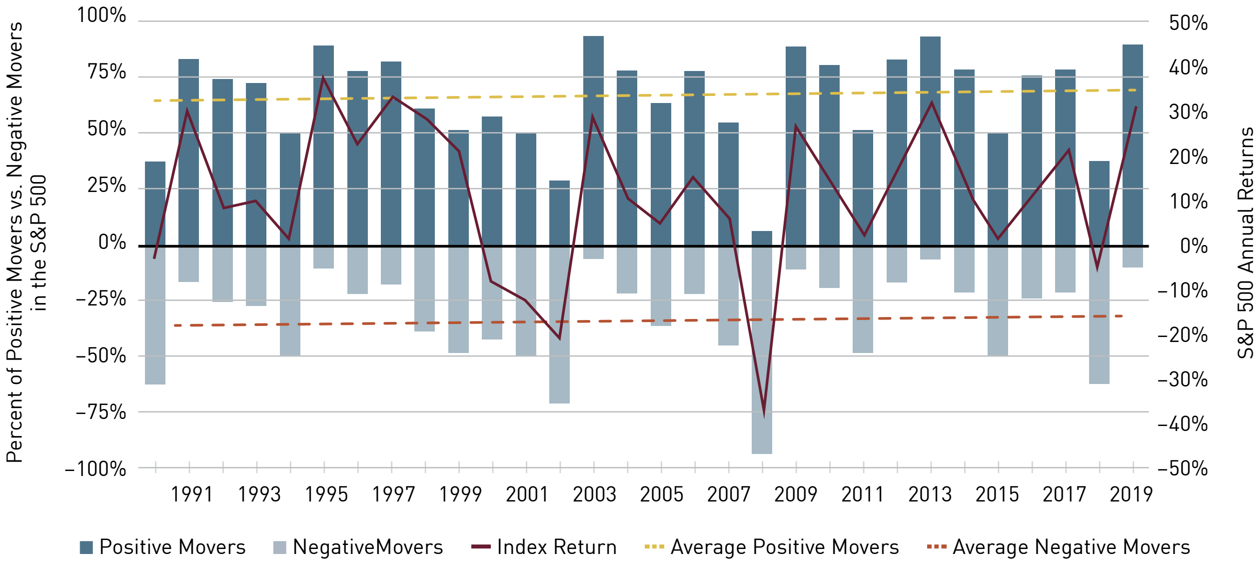
SMAs offer much more opportunity for customization at the account level to improve after-tax returns for clients. One advantage right out of the gate is that clients establish their own cost basis for each position in the portfolio and don't share that with others invested in the same strategy. This avoids the issue of buying into a pooled vehicle with embedded capital gains, which can happen with funds. One study found that on average, equity mutual funds have around 10 percent in embedded unrealized capital gains (Clemens and Zhang 2020).

Owning individual positions also creates more opportunities for tax-loss

Figure 3

## TAX-LOSS HARVESTING (AND GIFTING) OPPORTUNITIES

Winners and losers in S&P 500 (12/31/1990–12/31/2019)

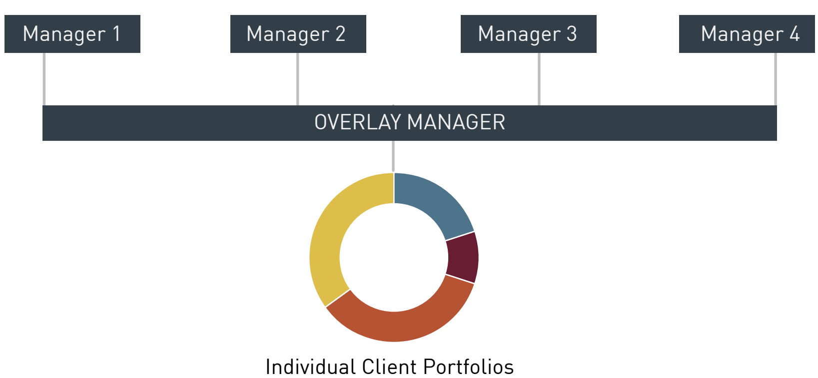



*Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.*

*Source: Thomson Reuters and Standard and Poor's*

Figure 4

## OVERLAY MANAGER




harvesting to offset gains as well as for gifting highly appreciated securities. As shown in figure 3, there are always individual stocks with returns much higher or lower than the overall market. By owning a portfolio of individual securities, investors can take advantage of the worst-performing stocks to harvest losses and the best-performing ones to consider for gifting.

### TAX-LOSS HARVESTING

Proactive and systematic tax-loss harvesting can meaningfully enhance after-tax returns for clients, even after fully liquidating a portfolio. Other techniques also can be applied to customize decision-making at the individual account level. Deferring the sale of positions, when appropriate, until they qualify as long-term gains can help reduce tax liability, as can specifying optimal tax lots when selling part of a position. In an ongoing study we've been conducting for eight years, we've found the increase in annualized after-tax returns for an equity-oriented portfolio for high-income investors can approach 1 percent on a pre-liquidation basis by applying these and other tax-management techniques. Even after fully liquidating the portfolio, we've found the benefit can exceed 0.5 percent annually.

Even if SMAs aren't being used, tax-loss harvesting still can be employed by advisors managing client portfolios. Positions in stocks, funds, or ETFs that have declined in value all can be sold to realize losses and offset gains. Positions with short-term losses are particularly valuable because short-term losses can be used to offset short-term gains.

Portfolios of individual municipal bonds also can contribute to tax efficiency, even beyond the tax-advantaged nature of the interest payments. Capital gains and losses associated with municipal bonds are still taxable events. This provides an opportunity to employ a technique sometimes referred to as a tax swap. When interest rates rise and bond prices fall, a tax swap can be conducted by selling out of a bond with an unrealized capital loss. The proceeds then can be reinvested into a new bond that likely is generating a higher level of interest income. The client gets the tax benefit

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of the realized loss as well as a higher rate of tax-advantaged income. Some municipal bond managers employ this technique as part of their investment process, but advisors can implement the same technique if managing bond ladders or other portfolios holding municipal bonds.

## THE BENEFITS OF UNIFIED MANAGED ACCOUNTS

SMAs offer a number of tax advantages that may make them worth considering for taxable accounts, and they are more accessible now than ever. Historically, SMAs could be cumbersome to deal with administratively. Furthermore, to take full advantage of their tax-management potential requires a sophisticated process that can tailor investment decisions at the individual account level, factoring in each client's unique cost basis and acquisition date information. Fortunately, the advent of unified managed accounts (UMAs) has helped make it easier for both clients and advisors to use SMAs by accessing a diversified portfolio of SMAs, funds, and ETFs in a single account. UMAs typically use an overlay manager to coordinate the implementation of the underlying SMA strategies (see figure 4). Although capabilities vary widely by program, some overlay managers can incorporate sophisticated and customized investment decision-making into the implementation process to optimize portfolios for after-tax returns.

## MARKET DOWNTURN PRESENTS OPPORTUNITIES

The market downturn presents a rare chance to reposition portfolios into more tax-efficient investments and vehicles without having to generate large realized gains. Market volatility can serve as a catalyst for reviewing risk tolerance and investment objectives, but it also provides an opportunity to reevaluate the overall tax strategy associated with a client's investments. Positioning portfolios thoughtfully with respect to taxes may be more important now than ever. The federal budget deficit already was growing to unsustainable levels before the COVID-19 crisis. The initial stimulus bill of $2 trillion combined with reduced tax revenues means the previously projected deficit of $1 trillion could more than triple. At some point that deficit will have to be reckoned with, and part of the solution is likely to be increased taxes.

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## ENDNOTE

1. Tom Roseen, "Taxes in the Mutual Fund Industry - 2010," Lipper, a Thomson Reuters company.

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