Challenges and Opportunities for the Taxable Investor Marketplace

An Interview with Robert N. Gordon

Investments & Wealth Monitor recently asked Robert Gordon, chief executive officer of Twenty-First Securities, for his thoughts about the top issues and/or challenges facing taxable investors today. This article summarizes his responses.

The marketplace has grown more sophisticated and open to other asset classes and investment strategies, mostly due to the continuing education of the advisor community. Wall Street products have tried to keep pace. There certainly are a lot more choices than there were 20 years ago. The investor base has evolved from individuals who invest on their own to family offices and wealth management firms where investing is a full-time operation.

If you’re looking at investing with a taxable eye, you have all the same problems of a tax-exempt investor—choosing asset classes and the proper allocation among those investments. But on top of that individuals have to worry about the tax impact and thus the after-tax results should influence their decisions. Still, most analysis of money managers is being done on a pre-tax basis. There really isn’t that much information out there that ranks managers or styles on an after-tax basis, and that really is the bottom line for the taxable investor.

Here are what I see as the top issues and/or challenges facing investors today.

Asset location: Putting assets in their best “pocket.” Growth stocks should be in your name not in your individual retirement account (IRA) or other tax-deferred account. If the investment is profitable any gains could be taxed at the 15-percent long-term gain rate (or maybe never taxed if the shares are held till death). In contrast, profits in an IRA are taxed as ordinary income upon withdrawal. If the growth stocks prove to be a losing proposition, any loss can be used to offset realized gains. Losses in an IRA do you no good.

More analysis on the after-tax returns of money managers. The standards have been set, now we need the analysis. There are CFA Institute global investment performance standards (GIPS) to report after-tax returns but the standards are considered difficult to administer. This certainly was true in the implementation of the pre-tax standards and we hope reporting software and market acceptance are soon coming.

Investors must take into account the possibility that tax rates may be higher when they withdraw money from a deferred savings account or annuity. If you really think that over the long term tax rates are going higher, you should give serious study to the “benefits” of deferral strategies.

Municipal bonds should become that much more valuable as tax rates increase. For those that are somewhat more adventurous, I’m familiar with a structured note that is engineered to pay off if tax rates are higher.

Market trends to watch: Structured notes. Structured notes can be a great tool for investors, but there are some structures I’m concerned with. Structured notes can be attractive when they offer access to asset classes

Biggest dilemma in this area: Uncertainty. The constant changing of tax laws (e.g., the estate tax that disappears one year and then returns thereafter) and tax rates can cause havoc to the individual investor. As an example, when I started as a broker investment income was taxed at 70 percent; President John F. Kennedy brought it down from 90 percent. (Yes, in the United States investment income was taxed at 90 percent, and not that long ago.)

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or “bets” that investors couldn’t easily get elsewhere (e.g., a bet on tax rates). They also can offer potential tax savings because many exchange-traded notes can defer profits until a client exits and only then realize taxable income at the favorable long-term gains rate. This advantage may not last much longer because this difference has been noticed in Washington.

The possible negative is that some investors are being confused, thinking

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that these instruments are “notes” in the classic definition of a note. These are not principal-guaranteed, fixed-income securities all paying a coupon. In fact most structured notes offer very little in the way of principal protection. Investors may not really understand what they are buying. My biggest concern here is the “reverse convertible note,” which really is just naked put writing.

My other concern is with the very popular notes (or CDs) tied to the stock market. These offer a payoff if the stock market goes up, but if the market goes down, we guarantee your principal back. From a standpoint of an investment my mother would like, I think that’s great because you’re guaranteed your money back and you’ve got all the upside of the market. By the same token, I find that many of these notes are done where the return is calculated to the average return of the S&P 500 over the five years. It doesn’t mean that if at the end of the five years the market is up 40 percent they’re going to pay you 40 percent; it means they’re going to pay you the average of how much it went up each of the five years, which is very different. But when the note is discussed with investors, it’s sold as all the upside of the market and none of the down side. This could easily cause investor disappointment in the near future. The devil is in the details and everyone would be well-suited to look into those details.

Biggest challenge: A lot more work has to be done on the optimum withdrawal strategy. After retirement, where do you take the money from? Your IRA, Roth IRA, taxable account (bonds or stocks)? I’m chairing a symposium at NYU’s Stern School of Business on this topic on May 1, and although I’m finding the issues extremely complex we’re hoping to develop the algorithm that the marketplace could use to assist retirees in deciding which pocket might best be harvested for needed cash. I’d suggest work done by Bill Reichenstein and Steve Horan for those who want to take a closer look at the issues.

Robert N. Gordon is president of Twenty-First Securities in New York, NY. He is an adjunct professor at New York University’s Stern School of Business and has served as both a lecturer and the chairman of The Wharton School’s Security Industry Institute. Mr. Gordon is the author (with Jan Rosen) of Wall Street Secrets for Tax-Efficient Investing and author or co-author of chapters of Tax Planning for the Affluent, Market Shock, and The Investment Think Tank. He serves on the editorial advisory boards of the Journal of Wealth Management, Derivatives Report, and Journal of Taxation and Investments. Contact him at bob@twenty-first.com.

Endnotes
1 For information about this symposium, The Optimal Retirement Withdrawal Strategy, visit http://w4.stern.nyu.edu/salomon/salomon.cfm/doc_id=8012.

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