Approaching Zero Taxes

SUMMARY

Investment Tax Tools to Help Maximize After-Tax Wealth

Albert Einstein once noted, "The hardest thing in the world to understand is the income tax."

We concur. Since Congress ratified the sixteenth amendment in 1913 legalizing the income tax, entire industries and professions have been born to eliminate and defer tax. This is reasonable and fair. The investment industry, however, largely ignores the idea. Even worse, most conventional wisdom regarding tax-efficient investing is misdirected, antiquated, or simply wrong!

In their seminal paper on the impact of taxes on investing, Arnott and Jeffrey said, "Taxes matter a lot."[1] They demonstrated that taxes are one of the single largest and most controllable costs of investing. While ignoring taxes is easier in double-digit return eras such as the 1990s, reducing taxes in today's lower expected return environment is more important than ever. This brief summary of our Approaching Zero Taxes white paper provides a high level description of an approach to investing known as "tax-efficient investing."

In the past, the investment industry and academia have largely ignored tax implications and instead focused strictly on risk and return. Tax-efficient investing incorporates tax ramifications as the critical third leg to the investment management stool (risk/return/taxes). This is a complex concept. A host of factors are considered when developing a tax-efficient investment strategy, including current tax law, tax types and rates, and the effects of state and local taxes. We suspect it is both the complexity of these factors and inherent conflicts of interest that have led the industry to largely ignore taxes. In this summary, we introduce a group of concepts and investment tax tools that can be used to form a tax-efficient investment approach, with the ultimate goal of increasing after-tax returns. We can't overstate the importance of after-tax returns. Of critical importance, the paper incorporates the tax law changes legislated in the *Tax Cuts and Jobs Act of 2017*.

As legendary investor Sir John Templeton said, "For all long-term investors, there is only one objective—maximum total return after taxes." We couldn't agree more!

"Active" Investment Management Results in Excessive Tax

In their quest to "beat the market" via speculation and superior stock picking, active managers face an uphill battle. Unlike passive investors, active investors and traders encounter three burdens as a result of their strategies: higher expenses, higher trading costs, and a higher tax burden. While the challenges of high costs are well documented, few people in the money management business understand that the tax cost of trading is just as important. In fact, it may be the single most important expense item. Our analysis shows actively managed strategies are expected to lose up to 3.6% of their return to tax and expenses (compared to about 1.3% for index strategies).[2]

Conventional Tax-Avoidance Products Sabotage Unwary Investors

The art of designing tax-avoidance products is to press a prospective investor's tax "hot buttons" to justify inordinate fees without notice. History offers many examples. For example, popular variable annuity contracts issued by insurance companies are often flawed from a tax perspective, yet they are sold on the premise of being tax favorable. While the investor may pay less tax, it often comes at the cost of lower returns. Investors usually fare best by following sound investment strategies that are not easily sabotaged by politicians or salespeople.

Legitimate Tax Reduction Harnesses Three Key Strategies

Given that tax laws continually change, the secret to tax-efficient investing is having a dynamic and systematic process to structure your portfolio for maximum tax efficiency. It must recognize that today's tax situation will probably be different tomorrow. You must constantly adjust your tactics to new realities using an optimal suite of tax tools to take advantage of current and future tax benefits. In developing these tax tools, investors need to understand that there are three primary investment strategies to reduce or eliminate tax as shown in **Figure 1**.

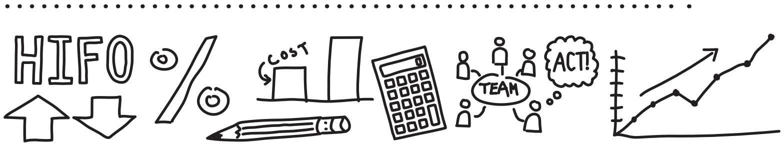
Core and Structured Satellite™ Portfolio Design is Tax Optimal

Tax-efficient investing focuses on portfolio structure as well as low turnover, broad diversification, and adherence to a long-term strategy. Tax-wise, the "ideal" core fund is a marketwide fund which tracks an index such as the *CRSP U.S. Total Stock Market Index*. This "core" holding offers three inherent advantages: 1) broad diversification, 2) perfect alignment with the market with minimal rebalancing, and 3) a long-term buy-and-hold strategy which avoids realizing most gains. The "Structured Satellite" investments diversify away from the large growth bias that is present in the core with exposure to under-represented asset classes such as micro cap stocks, small value stocks, and large value stocks.

Figure 1: Investment Tax Tools Leverage Three Key Tax Reduction Strategies

Tax Strategy	Tax-Managed Index or ETF	Core and Structured Satellite™	IRA's Annuity and 401(k)	Section 529 Plans	Health Savings Account (HSA)	Roth IRAs	Tax Engineering	Tax Loss Harvesting	Tax-Free Municipal Bonds	Step-Up in Basis	HIFO Accounting	Charitable Strategies
1 Permanently Eliminate Tax	✓	✓	—	✓✓	✓✓	✓✓	✓✓	✓	✓✓	✓✓	—	✓✓
2 Defer Taxes	✓✓	✓✓	✓✓	—	✓	—	✓✓	✓✓	—	—	✓✓	✓
3 Time Tax in Low Income Years	✓	✓	✓✓	—	—	—	✓	✓	—	—	—	✓

✓✓ Primary Strategy **✓ Secondary Strategy** **— Not Applicable**



Tax-Managed Index and Exchange Traded Funds are Tax-Efficient

Many investors mistakenly assume that owning mutual funds results in higher taxes. This is a myth. While it is true that most actively managed funds, and even some index funds, frequently trigger unnecessary tax, most passive mutual funds and exchange traded funds (ETFs) are extremely tax efficient. In particular, tax-managed index funds sidestep many of the common tax traps associated with traditional funds while taking advantage of the established tax law to accomplish optimal tax efficiency.

Proper Asset Location is of Paramount Importance

In the quest for maximum tax efficiency, asset location (also known as tax engineering) is nearly as important as the actual investments you make. To understand, imagine that you hold your portfolio in three different tax buckets (taxable, tax-deferred, and tax-exempt). These buckets catch and hold your growth. Understanding how, when, and at what rates your investments are taxed is essential in deciding which investment you should hold in which bucket. Though effective tax bucket management can be counter-intuitive and complex, the benefit of getting it right is significant. It requires making coordinated investment decisions on a portfolio-wide basis. An illustration in our full white paper shows that a portfolio using tax-inefficient funds without proper asset location can result in a shrinkage in after-tax return of almost 20%.

Tax Loss Harvesting and HIFO Accounting Can Save Tax

Recognizing capital losses is never fun. While we would prefer to never lose money, as in contests and sporting events, you can't win all the time. Fortunately, the investment world does offer taxable investors a consolation prize. Tax loss harvesting allows us to recapture some of the loss from Uncle Sam. Loss harvesting is not complex, but requires diligence. Investors have the ability to control the timing and recognition of gains and losses. Ideally, losses are harvested in a disciplined and systematic manner that continually captures tax benefits and preserves them for current and future use. Furthermore, HIFO (highest in, first out) accounting elections can be instrumental in maximizing loss harvesting opportunities, as well as minimizing gains realized. Importantly, there is no additional cost or risk in choosing which lot to utilize—it is merely an accounting election.

Municipal Bonds Can Offer Higher After-Tax Yields

While Treasury, government agency, corporate, and international bonds are all taxed at ordinary income rates, bond interest paid by most state and local governments (municipalities) is exempt from federal taxation. Thus, the tax-exempt yield they offer is generally lower than that paid by corporations or the U.S. Treasury. The yield reduction is generally well worth it for high bracket investors (i.e. 32% tax bracket or higher). While municipal bonds are most appropriate for high bracket investors, low bracket investors often use them inappropriately and when taxable bonds would make more sense. Use of these bonds requires continual monitoring of tax brackets, yield curves, and personal tax circumstances.

Long-Term Planning Strategies Eliminate or Reduce Tax on Appreciated Investments

Long-term planning opportunities for appreciated assets are available that benefit investors, their families and charities. Most people don't know that unrealized capital gains can be completely forgiven at death, known as a "step-up in basis." Gifting strategies (to family or charity) can also provide an earlier opportunity to achieve the same result as the step-up in basis. There are also many tax-efficient charitable gifting strategies available (i.e. Donor Advised Funds, CRUTs, CLATs, and CRATs). Their benefits vary with your tax rate, charitable intent, and estate planning needs.

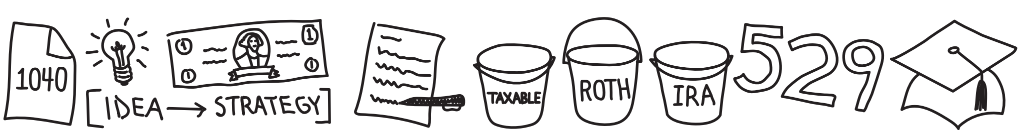
Tax-Efficient Investing is a Disciplined and Systematic Process—Not a Product or Event

Making investment decisions in light of tax consequences is both an art and a science. While many tax management techniques are small, collectively they add up to real value. Some decisions are straightforward and clear, while others require difficult judgment calls. These decisions require the investor to quantify the tax benefits and be aware of currently available strategies.

Key Points to Remember:

- Be open to tax education
- Active management is inherently tax-nasty
- Avoid gimmicky tax-advantaged products
- Tax laws are continually changing
- Evaluate your portfolio as a whole
- Proper asset location = tax efficiency
- Harvest losses
- Be wary of outdated beliefs
- Weigh tax benefits against marginal risk/cost
- Only after-tax returns matter

We believe that tax-efficient investing requires a knowledgeable coach. To add value, an investor needs to use a disciplined, systematic, and integrated process. This process may be the single most valuable contribution offered by a financial advisor.



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References and Methodology

1. "Is Your Alpha Big Enough to Cover its Taxes?", Robert H. Jeffrey and Robert D. Arnott, The Journal of Portfolio Management - Spring 1993

2. To calculate expected after-tax return on tax-managed index and active strategies, we assumed that investors earned gross equity returns of 10.16% reduced by fund expenses, trading costs, and taxes on dividends and capital gains. Starting gross return of 10.16% is based on the historical total return of the S&P 500 from 1/1/1926-12/31/2017. While there is the possibility of reduced expected equity returns in the future, it is beyond the scope of this paper to address those and accordingly, we simply assumed that equities perform at their historical return levels. The estimated after-tax returns for tax-managed index funds or ETFs are calculated using the following assumptions based on the 12/31/2017 data of a marketwide index proxy accessible to most investors, the Vanguard Total Stock Market Index Fund-Admiral Shares (VTSAX), which reduce the gross return: expenses (0.04%), turnover (4%), 30-day SEC dividend yield (1.75%), capital gains distributions (0.12% long-term, 0.01% short-term). For the estimated after-tax returns on actively managed strategies, we used assumptions from the Morningstar Large Core category of actively managed open-end funds and ETFs as of 12/31/2017: expenses (0.88%), turnover (49%), 30-day SEC dividend yield (1.00%), capital gains distributions (3.94% long-term, 1.31% short-term). For both sets of assumptions, the percentage of dividends assumed to be qualified (taxed at 20%) is 100% for simplicity purposes. For both sets of assumptions, we estimate total trading costs are equal to 0.50% per annum per 100% portfolio turnover. This is based on an industry study of commissions, bid-ask spreads, and market impact. While the average equity fund turnover as of 12/31/2017 was 49% per annum, we arbitrarily assumed low turnover funds averaged 25% turnover while high turnover funds averaged 200% turnover. We further assumed that, in each year, investors realized both long- and short-term capital gains based on the category average figures cited above. For all strategies, we assumed the investor liquidates his entire position at the end of twenty years and pays the maximum long-term capital gains tax (20%) on any unrealized appreciation.

Source of data is *Morningstar Direct* unless otherwise noted.

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