

THE TRINITY OF ASSET LOCATION

Taxes, Returns, and Time Horizon

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When it comes to investing, it's not what you make but what you keep. An investment may produce a great return, but after taxes those returns could be reduced significantly. Strategic asset location refers to the idea that certain investments are better suited for taxable accounts but others can be more effectively deployed in tax-deferred or tax-free accounts. By fine-tuning where an investment is held, investors can increase their overall wealth. A number of considerations are required for advisors to effectively implement asset location. Specifically, advisors must do the following:

1. put forth standards of care, including education, effort, and ethical considerations, when implementing a tax-sensitive approach;
2. be able to estimate both pre-tax and post-tax returns;
3. be aware of how the cost of taxes can significantly eat into investment wealth;
4. have a framework for implementing tax-efficient allocations instead of inefficient allocations;
5. understand how the magnitude of returns is important in determining the location of investments;
6. know how the investment time horizon factors into the asset location decision process;
7. understand how investment tax costs, return magnitude, and time horizon each influence asset location priority; and
8. be ready to address the inadvertent consequences (i.e., side effects) of asset location.

Standards of Care

The investment community often uses terms such as “wealth advisors,” “comprehensive advice,” and “coordinated wealth management.” The topic of comprehensive advice often gets talked about, but it's not always put into practice. Tax-sensitive investing is seldom carried out to its fullest extent, usually because of (1) lack of appropriate knowledge, (2) additional analysis and effort required, and (3) conflicts of interest resulting from pre- and post-tax return presentation.

Developing the appropriate knowledge takes study, time, and diligence. Tax laws are in continuous flux, and a true wealth advisor needs to understand tax consequences and stay up to date, ideally through continuing education. Fortunately a number of great resources are available to advisors. IMCA's own Certified Private Wealth Advisor® certification program offers a section on tax strategies and planning. Additionally, the American Institute of CPAs (AICPA) offers a Personal Financial Specialist credential that has a tax-based curriculum.

Beyond having the appropriate knowledge, putting forth the required effort has no substitute. Tax-sensitive investing requires additional analysis and effort on the part of the advisor. It is simply easier to implement a portfolio system that ignores taxes and invests uniformly across all clients and all accounts. This is one danger of the block trading programs offered by many custodians. A genuinely tax-sensitive advisor will not utilize a one-size-fits-all approach.

Regarding conflicts of interest, note that most advisors report pre-tax returns. In fact, Global Investment Reporting Standards (GIPS®) do not require post-tax reporting. This is significant because in presenting investment options or reporting performance to clients, every advisor faces a potential conflict: Investments with great pre-tax returns may be easier to recommend despite having lousy post-tax results. Because post-tax results typically are not shown in performance reports, it may be tempting to underplay the effect of taxes.

Estimating After-Tax Returns

Tax cost can vary significantly from one investor to the next. The first step toward measuring after-tax returns is to understand the individual investor's unique tax situation. We can apply certain measurements of tax efficiency to investment vehicles, but those metrics should be adjusted for the client's specific tax status by considering the following:

- Entity type—individual, trust, corporation
- Federal capital gains rate—ranging from 0–20 percent
- State capital gains rate—varies by state
- Net investment income tax—3.8 percent for income over certain thresholds
- Client's capital-loss carry-forwards
- Client's federal income tax rate—ranging from 0–39.6 percent
- Client's state income tax rate—varies by state

Aside from an individual's tax circumstances, each investment vehicle has tax

pros and cons. Individual stocks may distribute qualified dividends, bonds may produce interest, real estate investment trusts (REITs) may distribute taxable income, etc.

Mutual funds are publicly traded and have legal requirements to provide after-tax information; therefore, mutual funds provide useful metrics for asset location strategies. Mutual funds regularly distribute stock dividends, bond interest, and capital gains to shareholders and investors pay taxes on those distributions. How can we evaluate the tax cost of any given mutual fund? The Securities and Exchange Commission requires mutual funds to report both pre-tax and after-tax returns in their prospectuses. Typically, after-tax returns are shown using the highest individual federal income tax rate but do not reflect the impact of state or local taxes. Returns for one year or less are reported using the highest federal rate and returns greater than a year are reported using the long-term capital gains rate. Not every investor is taxed at the maximum rate, but comparing pre-tax and after-tax returns provides a gauge of the magnitude of taxes for any given fund and allows for relative comparison of the tax efficiencies (or inefficiencies) across a pool of funds or asset classes.

The Costs of Taxes

As an example, table 1 shows the returns published in the most recent prospectus for PIMCO Fundamental Index Plus AR fund. The first line indicates the one-year, five-year, and since-inception annualized returns. The second line (highlighted in yellow) indicates the return after taxes on fund distributions. Notice the difference between the return since inception before taxes and after taxes—nearly 6-percent difference annually (or almost one-half the total return). When the investors receive a performance statement indicating growth from this fund, it's unlikely they realize that potentially 50 percent of those earnings may have been lost in higher taxes owed on April 15th—suddenly \$10,000, \$50,000, or \$100,000 of earnings is reduced to \$5,000, \$25,000, or \$50,000, respectively. This example assumes the highest tax rates, but it nonetheless shows the significant impact of taxes resulting from distributions.

Table 1: Returns for PIMCO Fundamental Index Plus AR Fund

Average Annual Total Returns (for periods ended December 31, 2013)	1 Year	5 Years	Since Inception (6/30/2005)
Institutional Class Return Before Taxes	34.86%	29.88%	12.49%
Institutional Class Return After Taxes on Distributions	26.49%	20.41%	6.50%
Institutional Class Return After Taxes on Distributions and Sales of Fund Shares	19.48%	19.51%	6.93%
Class P Return Before Taxes	34.94%	29.75%	12.37%
Administrative Class Return Before Taxes	34.61%	29.53%	12.20%
Class D Return Before Taxes	34.43%	29.34%	12.04%
Class A Return Before Taxes	29.30%	28.37%	11.53%
Class C Return Before Taxes	32.47%	28.38%	11.23%
S&P 500 Index (reflects no deductions for fees, expenses, or taxes)	32.39%	17.94%	7.55%
Lipper Large-Cap Core Funds Average (reflects no deductions for taxes)	31.52%	16.93%	7.06%

Source: PIMCO

Not all funds produce a large difference between pre-tax and post-tax returns. For example, the Vanguard 500 Index Investor Fund's return before taxes was 32.18 percent in 2013 and the return after taxes was 31.58 percent, a difference of only 0.6 percent. Advisors may serve clients well by recommending that less tax-efficient funds be allocated to tax-deferred accounts, such as individual retirement accounts (IRAs). The value of employing an efficient tax-allocation strategy is compounded year over year, producing an ongoing benefit to the investor.

What causes such large differences in pre-tax and post-tax returns? The primary culprit is significant trading, especially short-term trading. Trading leads to realization of long-term gains and, even worse, short-term trading results in higher-taxed ordinary income. These gains, as well as dividends and interest, ultimately must flow to the end investors, resulting in a tax bite. Note that distributions from investments—whether funds or separate accounts—do not result in additional wealth to the client. In fact, distributions are more likely to result in a loss in wealth, due to taxes.

To illustrate this point, consider that in 2013 the BlackRock Large Cap Growth

Retirement Fund made a distribution of 55 percent of its net asset value (NAV). Figure 1 shows a screen capture of *Yahoo Finance* for what happened when the fund made the distribution. On December 12, 2013, the fund has an NAV of \$8.45 per share. The following day, the distribution of \$4.65 was made and the NAV decreased by exactly \$4.65. The net result to investors was additional cash in their accounts and a likewise reduction in their investment value. Unfortunately, if this fund is owned in a taxable account, the client owes immediate taxes on the distribution (albeit any future unrealized capital gain is now reduced). In that case, actual wealth has declined. It may have made more sense to either hold this fund in a tax-deferred account or perhaps even sell the fund before the distribution. A client who purchased this fund in a taxable account on December 12, 2013, may have been very upset.

Note that one great advantage of exchange-traded funds (ETFs) is that many have very low distributions and provide low-cost market exposure. In 2013, iShares had capital gains distributions on just four of its 299 ETFs. PowerShares kept capital gains distributions to just seven of its 159 ETFs. Only eight of Vanguard's 67 ETFs posted distributions. Other ETF firms had similar

Figure 1: 2013 Distribution from BlackRock Retirement Growth Fund (MKLHX)

Date	3.87	3.87	3.87	3.87	0	3.87
Dec 18, 2013	3.87	3.87	3.87	3.87	0	3.87
Dec 17, 2013	3.81	3.81	3.81	3.81	0	3.81
Dec 16, 2013	3.82	3.82	3.82	3.82	0	3.82
Dec 13, 2013	3.80	3.80	3.80	3.80	0	3.80
Dec 13, 2013	4.656 Dividend					
Dec 12, 2013	8.45	8.45	8.45	8.45	0	3.79
Dec 11, 2013	8.47	8.47	8.47	8.47	0	3.80

Source: Yahoo! Finance

results in 2013. Lower distributions typically equate to lower taxes from investing.

Framework for Efficient Allocations

Many advisors will recommend an allocation of investment uniformly across all accounts owned by the client. An identical allocation among taxable and tax-deferred accounts, however, would leave money on the table in the form of extra taxes paid because certain investments are better suited for tax-deferred accounts.

Suppose a client has a \$1-million portfolio consisting of four funds, which respectively represent U.S. equities, international equi-

ties, REITs, and commodities. Table 2 shows a hypothetical basket of funds held by this client, with pre-tax and after-tax return as well as the calculated average annual tax cost. If this investor has a taxable account and a tax-deferred account, the advisor could enhance the overall returns by placing the less tax-efficient funds in the IRA.

An inefficient recommendation would be to hold each fund equally in each of the client’s respective accounts, essentially ignoring the tax costs of each fund. Table 3 shows our hypothetical client with an inefficient allocation incurring average tax

costs of \$7,875 each year from this allocation (for illustrative purposes, this assumes the client has \$500,000 in taxable assets and \$500,000 in IRA assets).

A better approach is illustrated in table 4, where the advisor has recommended placing the funds with higher tax cost into the IRA, taking advantage of the IRA’s tax-deferred nature and thereby essentially eliminating the immediate tax costs. As you can see, the overall household allocation to each fund has not changed, with each fund still representing \$250,000 of the client’s total portfolio. Yet the tax costs incurred by the client have been reduced to \$3,875.

In this example, the average tax savings amounts to 0.40 percent of additional after-tax return annually. Each client’s situation will be different and the potential savings will vary. The client’s relative balances in the various types of accounts will also vary, so the advisor will need to rank funds from most tax-efficient to least tax-efficient and set priorities accordingly.

Many tools are available to gauge the tax efficiency of investments. As noted above, most mutual funds are required to publish pre-tax and after-tax returns in the annual prospectus. It is recommended to review

Table 2: Pre-Tax and After-Tax Returns for Selected Funds (For Period Ending August 31, 2014)

Fund Name	Ticker	5-Year Pre-Tax Return	5-Year After-Tax Return	Tax Cost	Desired Household Allocation for \$1 Million
Vanguard 500 Index	VFIAX	16.85%	16.34%	0.51%	\$250,000
Fidelity International Equity	FTIEX	8.98%	7.94%	1.04%	\$250,000
Vanguard REIT Index	VGSLX	18.88%	17.57%	1.31%	\$250,000
PIMCO Commodity Real Return	PCRIX	4.20%	0.76%	3.44%	\$250,000
					\$1,000,000

Table 3: Inefficient Tax Allocation

Fund Name	Ticker	Tax Cost	Taxable Brokerage Allocation	Tax Deferred IRA Allocation	Average Annual Tax Costs
Vanguard 500 Index	VFIAX	0.51%	\$125,000	\$125,000	\$638
Fidelity International Equity	FTIEX	1.04%	\$125,000	\$125,000	\$1,300
Vanguard REIT Index	VGSLX	1.31%	\$125,000	\$125,000	\$1,638
PIMCO Commodity Real Return	PCRIX	3.44%	\$125,000	\$125,000	\$4,300
			\$500,000	\$500,000	\$7,875

Table 4: Efficient Tax Allocation

Fund Name	Ticker	Tax Cost	Taxable Brokerage Allocation	Tax Deferred IRA Allocation	Average Annual Tax Costs
Vanguard 500 Index	VFIAX	0.51%	\$250,000		\$1,275
Fidelity International Equity	FTIEX	1.04%	\$250,000		\$2,600
Vanguard REIT Index	VGSLX	1.31%		\$250,000	\$0
PIMCO Commodity Real Return	PCRIX	3.44%		\$250,000	\$0
			\$500,000	\$500,000	\$3,875

the tax costs over a series of years, such as a five- or 10-year period, to better estimate long-term tax costs. In addition to the prospectus, Morningstar reports after-tax returns for open-end mutual funds, closed-end mutual funds, and ETFs. Morningstar's Tax Cost Ratio measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. No tool is perfect, but these can be useful in comparing the tax efficiency of two or more funds, or even assessing the general tax costs of a particular strategy or asset class.

Magnitude of Returns

Tax savings should not be the only consideration when determining asset location. Projected returns play a critical role because sheltering higher-returning assets is more valuable than sheltering lower-returning assets. For instance, suppose an investor owns a low interest-bearing fund (such as an ultra-short-term bond fund), earning 0.5 percent annually. The interest earned is taxable, but it's hardly worthwhile to place such a low-return investment in a long-term tax-deferred account such as an IRA. When returns are too low, the benefits of immediate tax savings do not warrant using up the limited and precious space of a tax-deferred account with an investment that will compound slowly.

For instance, suppose an investor has two investment assets: (1) a lower-returning bond fund and (2) a higher-returning stock fund. The lower-returning bond fund has a pre-tax return of 5 percent and annualized post-tax return of 3.5 percent. The higher-returning stock fund has a pre-tax return of 10 percent and an annualized post-tax return of 9.5 percent. Therefore, the stock fund gives up 0.5 percent to taxes each year

Table 5: Economic Value of Tax-Free Growth over 30 Years

Assumptions	Bond Fund	Stock Fund
Annual Pre-Tax Return	5.00%	10.00%
Annual After-Tax Return	3.50%	9.50%
Annual Tax Cost	1.50%	0.50%
\$100,000 Invested in Roth IRA for 15 Years		
After-Tax Final Value of Roth IRA	\$432,194	\$1,744,940
\$100,000 Invested in Taxable Account for 15 Years		
After-Tax Final Value of Taxable Account	\$280,679	\$1,522,031
Benefit of Tax-Free Growth	\$151,515	\$222,909

compared to the bond fund, which gives up 1.5 percent.

To continue with this example, the investor has \$200,000 equally split between a taxable account and a Roth IRA and wishes to invest in both funds equally. Which account should the advisor recommend for the bond fund? At first pass, it appears the bond fund is less tax-efficient and should be placed in the Roth IRA. After all, don't we want to defer the greatest amount of taxes each year (1.5 percent annual tax savings vs. 0.5 percent)?

Table 5 shows that the compounded benefit of placing the stock fund in the Roth IRA actually exceeds the benefit of placing the bond fund in the Roth IRA, even though the bond fund has higher tax costs. Sheltering the bond fund results in additional wealth of \$151,515. Sheltering the stock fund, however, results in additional wealth of \$222,909. Even after accounting for taxes, the economic benefit of investing the stock fund in the Roth IRA is \$71,394 greater than using that account for the bond fund (\$222,909 – \$151,515). Although counter-intuitive, and despite having a higher annual tax cost, the bond fund

should not supplant the stock fund in the Roth IRA.

Time Horizon

So, how does an advisor distinguish what is more important: annual tax cost or magnitude of return? Clearly, both play a role. The answer lies in a third factor that tips the scale toward one or the other: the client's time horizon. As the time horizon increases, the focus for tax-sheltered accounts should tilt toward relatively higher investment returns rather than annual tax savings. This is due to the exponential nature of compounding returns.

If we take the exact same example from above, but reduce 30 years of compounded growth to 15 years, it becomes more beneficial to place the bond fund instead of the stock fund in the Roth IRA (see table 6). In other words, changing the time horizon has reversed the recommendation. Although not shown in this example, the breakeven is approximately 22 years. If the investment horizon is less than 22 years, it is more beneficial to place the bond fund in the Roth IRA; if the investment horizon is greater than 22 years, it is more advantageous to

Table 6: Economic Value of Tax Free Growth over 15 Years		
Assumptions	Bond Fund	Stock Fund
Annual Pre-Tax Return	5.00%	10.00%
Annual After-Tax Return	3.50%	9.50%
Annual Tax Cost	1.50%	0.50%
\$100,000 Invested in Roth IRA for 15 Years		
After-Tax Final Value of Roth IRA	\$207,893	\$417,725
\$100,000 Invested in Taxable Account for 15 Years		
After-Tax Final Value of Taxable Account	\$167,535	\$390,132
Benefit of Tax-Free Growth	\$40,358	\$27,593

place the stock fund in the Roth IRA. The breakeven year will vary by situation.

Location Priority

Accounts fall into three basic categories: (1) taxable, (2) tax-deferred (i.e., traditional IRA and annuities), and (3) tax-free (i.e., Roth IRA). The advisor will need to weigh the three critical factors to determine asset location—tax efficiency, return magnitude, and time horizon. The interplay of these three components will determine which account is best funded with which asset (see figure 2).

Those assets with the longer investment horizons, highest returns, and highest inefficiencies generally should be placed, to the extent possible, in tax-free accounts (i.e., Roth IRAs). Next in line would be tax-deferred accounts (i.e., traditional IRAs and annuities). Taxable accounts would be well-suited for those assets that are taxed very efficiently with moderate to lower return levels. Examples of asset classes that may be well-suited for tax-free

accounts include REITs and infrastructure, both of which have enjoyed strong returns but also have inefficient tax characteristics.

For a shorter investment horizon, return magnitude plays a lesser role because of the shorter time for compounding. Therefore, it is more likely that investments with high tax costs, regardless of return level, would be better placed in tax-free or tax-deferred accounts. High-yield bonds might be a good example in this case.

Keep in mind that certain accounts may be better off excluded completely from the asset location decision. For example, a college savings plan that will fund college costs in the next few years will have separate goals and withdrawal needs and should be isolated from the overall household allocation.

Side Effects of Asset Location

The purpose of this article is to focus on the framework of asset location, but the advisor also must consider the consequences of asset location strategies. In particular, advisors need to be able to recognize the following three notable side effects of asset location:

- The potential to theoretically change the after-tax asset allocation
- The potential to theoretically change the after-tax risk and return profile of the portfolio
- Mental accounting challenges for the client

Aside from viewing investments purely from the standpoint of after-tax costs, asset location calls us to consider the nature of risk for assets held in different accounts. This is particularly true with tax-deferred

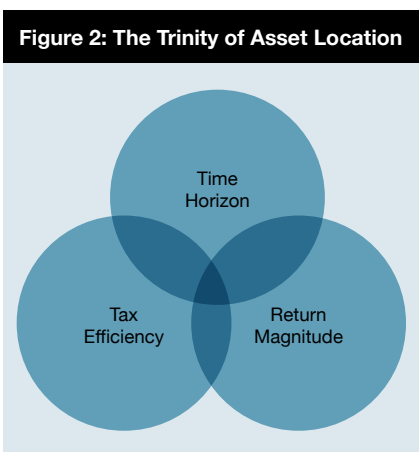
accounts (i.e., traditional IRAs), which can be thought of as a partnership with the government, in which the government “owns” a portion of the account in the form of a deferred tax liability.

For instance, \$250,000 in a traditional IRA is theoretically both an individual’s and the government’s money. If we assume an ordinary tax rate of 25 percent, then the government has an eventual claim of \$75,000 of the IRA. By moving specific assets into an IRA the advisor may inadvertently reduce the after-tax allocation to a particular asset class. Recognizing that a client/taxpayer has claim to a portion of an IRA may change the allocation decision.

Similarly, assets held in a taxable account have both future returns and volatility reduced by the applicable tax rate. Assuming a 15-percent capital gains rate, the investor keeps only 85 percent of the growth and the government (sooner or later) will get 15 percent. If the investment falls, the investor suffers only 85 percent of the losses and passes 15 percent on to the government. Effectively, the investor is sharing both the risk and return with the government. The result of this risk and return sharing is that both return and volatility is muted in a taxable account. The advisor should understand that by moving assets into (or out of) a taxable account, they likely are changing the risk characteristics of the portfolio.

The other side effect worth mentioning is a client behavioral issue of “mental accounting” that may show up when assets are moved from one account to another. This is particularly true when household accounts of different individuals are combined for allocation purposes but may be viewed, to some degree, individually. Consider a husband and wife both in their second marriage. The husband owns a \$500,000 IRA and the wife owns a \$500,000 taxable account. If we view the couple as one economic unit, it may make sense to have all the higher-returning assets in the husband’s IRA and all the lower-returning assets in the wife’s taxable

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account. Significant differences in the compounded returns of each account may occur over time, causing a sense of disparity between the couple. Or perhaps this leads to one spouse wanting for more risk and the other wanting for less, because they view each of their respective accounts as misallocated. Advisors need to use caution when managing accounts as part of a combined household when those accounts may be looked at individually by the client(s).

Conclusion

Research generally has found that good asset location decisions can generate 0.15 percent

to 0.25 percent of additional return. Daryanani and Cordaro (2005) estimated that asset location strategies could add value up to 0.25 percent annually. Blanchett and Kaplan (2013) found the benefits of asset location to be approximately 0.23 percent per year.

Ultimately, good asset location can indeed add value and requires only extra effort on the advisor's behalf. It is critical that advisors consider annualized tax savings, long-term returns, and investment time horizons when implementing asset location strategies. As wealth advisors continue to compete against low-fee platforms and robo-advisors, the ability to demonstrate additional value-added services will become more critical. Client-tailored asset location

strategies are one way quality advisors can distinguish themselves. ●

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