

Tax Efficient Investing

Historically, the investment markets were dominated by institutional investors such as pension funds, foundations, academic institutions, and charitable organizations. These types of entities are typically tax exempt, so investment managers did not worry about the tax consequences of their portfolio management. However, individuals are now major participants in the stock and bond markets, yet many investment managers still manage assets as if taxes were unimportant. These managers argue that focusing on the tax impact of investing will reduce the return potential of their funds.

The reality is taxes are important, and usually represent the single largest expense for taxable investors. While death and taxes may be inevitable, there are ways to reduce the tax bite without sacrificing investment return potential.

Tax Rules: A Brief Review

There are many events that trigger taxes in the investment world. The two most common are the receipt of income and the realization of capital gains. As perhaps an oversimplified review, there are two types of capital gains, long-term gains and short-term gains. Long-term status is granted to a security owned for at least one year and one day. Anything less than this is considered short-term. Long-term gains are typically taxed at a lower rate than short-term gains. Capital losses may be used to offset the impact of capital gains. Excess capital losses may be used to offset up to \$3,000 in ordinary income.

Dividends and bond interest are considered income, and are therefore taxed at the same rate as ordinary income. Ordinary income is taxed on a graduated scale, depending on one's level of income, but generally this rate is higher than the long-term capital gains tax rate.

Reduce Taxes to Boost Returns

Most studies on the subject of investing and taxes show that rather than reducing returns, tax efficient investing actually enhances returns, even on a pretax basis. Indeed, looking at Morningstar data, we can see that tax-efficient funds outperformed less tax-efficient funds over all long-term time periods studied. The results are summarized in the figure below.

Mutual Funds	3 Yr.	Annualized Returns		
		5 Yr.	10 Yr.	15 Yr.
Greater Than 85% Tax Efficient	7.15%	10.88%	13.36%	13.71%
Less Than 85% Tax Efficient	5.28%	8.19%	11.31%	11.48%

Source: Morningstar



The reason that tax efficiency usually leads to stronger pre-tax returns is that the actions that trigger taxes also impact the portfolio in other ways. Frequent trading, for example, not only creates taxable events, but also increases costs in the form of commissions, bid/ask spreads, and other costs. Another advantage of tax-efficient investing is, the benefits of compounding are not allowed to work in a portfolio with large turnover, as any money paid for taxes is money that will not remain in the portfolio to potentially earn additional gains.

Strategies to Ease the Pain

Portfolio turnover and the receipt of investment income are events that may be reduced, eliminated, or planned for in order to diminish taxes. Turnover can be avoided by investing with managers or in vehicles that don't trade frequently. Every time a mutual fund or investment manager rebalances or restructures a portfolio and gains are realized, someone incurs a tax liability. High turnover investments should therefore either be avoided entirely or held in non-taxable retirement accounts where the impact of turnover will be inconsequential from a tax perspective. Likewise, investments such as bonds or high yielding stocks, are often best held in IRAs, 401(k) plans, or other tax deferred portfolios.

For investors that need income from their portfolio, another strategy is to sell stocks, rather than relying on dividend or bond income. Since dividends and bond income are taxed as ordinary income and appreciated stocks that have been held for over one year are taxed as capital gains, tax liability could be reduced through stock sales. Let's suppose an investor needs \$10,000 from her portfolio after taxes. She could rely on the portfolio's bond interest income, in which case she will have to withdraw \$15,384 in order to net \$10,000 after taxes, assuming an income tax rate of 35%. Our investor could also sell appreciated stock. In this case, she would have to withdraw \$12,500 in order to net \$10,000 after taxes. This assumes that the stock she sold has a cost basis of zero and that the capital gains tax rate is 20%. In actuality, it is unlikely that she would have a cost basis of zero, so she would likely have to withdraw even less in order to receive her needed income since her principal investment would not be taxed. Clearly, realizing capital gains, rather than income can be advantageous and could leave more money in your account to compound over time.

Tax Loss Harvesting

Real economic value exists in tax losses, and any material losses that can be realized should be realized. Harvested losses can either offset capital gains (which could help diversify a low basis portfolio) or create a capital loss carry forward that can be used in subsequent years to offset income and gains. The one caveat here is that in order to avoid the "Wash Sale Rule," investors may not purchase any securities sold for a loss 30 days before or after the loss was realized. In other words, you can't sell a stock for a loss and then repurchase it within 30 days. Likewise, you can't buy additional shares of the security, and then sell the original lot for a loss within 30 days. Doing so will result in the IRS disallowing your loss. One important point regarding tax loss selling: one must capture the losses when they exist. Too many investors wait until the year end. If the market is weak in February, then February is the time to harvest losses. The market may recover by November or December, thus eliminating the opportunity.

Drying out the Wash Sale Rule

The Wash Sale Rule says that investors may not purchase a security that is "substantially identical" to the one sold for a loss. While there is no clear definition of what substantially identical means, it is safe to assume that you couldn't sell Intel stock and then buy Intel call options the next day, as this will result in exposure to the same underlying security.

The use of exchange-traded funds (ETFs) allows us to retain very similar market exposure while avoiding wash sale provisions. We refer to these trades as "market neutral tax swaps." For example, certain indices that are very different can be highly correlated: the S&P 500 and the Russell 1000 both provide exposure to the large-cap segment of the market and exhibit similar return characteristics. We could sell the S&P 500, realize our loss, purchase the Russell 1000, and then swap back after 30 days. This way, the advantage of the tax loss is locked in, but the portfolio still retains exposure to the desired segment of the market.

Tax-Efficient Vehicles Drive Down Taxes

Because of strategies like tax swapping, exchange traded funds have become an important part of our tax planning strategy. There are other mechanisms built into ETFs that also contribute to their tax efficient nature, such as their low turnover rates and practice of making in-kind redemptions to institutional investors using low basis stock. This helps avoid making taxable distributions to existing

shareholders when other shareholders sell their positions. Additional investment vehicles, such as tax-managed mutual funds and municipal bonds are also helpful in tax minimization. Taxable bonds should typically be held in tax advantaged accounts.

Taxes may be inevitable, but there are ways to postpone, minimize, or legally avoid some of the impact. Long-term, buy-and-hold investing forms the foundation of a tax-efficient portfolio that aims to accumulate and retain wealth. However, there are other considerations, such as the type of account in which investments should be held and the way income is realized. Trading strategies such as tax swapping can also add value when implemented effectively. Lastly, financial planning techniques can also go a long way toward reducing the tax bite, for both income and estate taxes.

Alesco considers all types of taxes when constructing wealth plans for our clients. We structure accounts that are likely to provide the greatest shelter from taxes, allocate assets in ways that are likely to be tax-efficient, and consider after-tax returns when selecting investment vehicles. After the initial set up is complete, we continually monitor our managed portfolios for any value we can add through tax swaps or the inclusion of new, more efficient securities. We continually work to reduce the tax bite for our clients.



Alesco Advisors LLC
Tobey Village Office Park
120 Office Park Way
Pittsford, NY 14534

P | 585.586.0970
TF | 800.277.3440
F | 585.586.1898

info@alescoadvisors.com
alescoadvisors.com



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