

## TAX-EFFICIENT WEALTH MANAGEMENT



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**Peter Mladina**  
Director of  
Portfolio Research,  
Wealth Management

**Charles Grant, CFA**  
Senior Analyst,  
Portfolio Research

Gross returns grab the headlines, but private investors consume after-tax returns. Taxes can represent a meaningful proportion of gross return that can compound into the future as foregone wealth, so it pays to be tax-efficient while pursuing an optimal investment strategy. We offer five principles for tax-efficient wealth management:

1. Minimize ordinary income;
2. Minimize short-term capital gains;
3. Employ asset location to maximize the net return contribution of otherwise tax-inefficient assets;
4. Realize long-term capital gains when the investment portfolio is suboptimal and assets will eventually be liquidated for personal consumption;
5. Use after-tax portfolio optimization to test whether the diversification benefit of certain assets outweighs an otherwise less-efficient tax profile.

The fifth principle is the gold standard for tax-efficient wealth management, and we will demonstrate how it can occasionally override the other principles.

To simplify and isolate the relative effects of different tax scenarios on after-tax returns, our hypothetical examples employ gross expected returns and tax assumptions that include a 20% tax rate for dividend income and realized long-term capital gains and a 39.6% tax rate for ordinary income and realized short-term capital gains.<sup>1</sup>

For private U.S. investors, the tax-exempt status of municipal interest income is one of the few “free lunches” in investing. Ordinary income tax presents a significant drag on the

returns of assets that produce taxable interest income. For example, the pre-tax and after-tax expected return for municipal bonds is 3.2%, based on Northern Trust’s five-year capital market assumptions (CMAs). In contrast, the pre-tax expected return for corporate high-yield bonds is much higher at 5.5%. For a high-net-worth investor in the 39.6% marginal federal income tax bracket, the after-tax expected return for high yield drops to 3.3%. The after-tax expected returns for both investment grade municipal bonds and corporate high yield bonds are similar, but corporate high-yield bonds carry much more risk. Principle 1 is to minimize portfolio exposure to ordinary income.

A passive, low-turnover strategy to owning diversified equities can be very tax-efficient, as these strategies often completely avoid short-term capital gains – and they defer long-term capital gains. Realized short-term capital gains are a significant headwind on after-tax returns. For example, the pre-tax expected return for global equity is 7.4%, based on Northern Trust’s current CMAs. Assuming a 10-year holding period before liquidation, the after-tax return is 6.1%.<sup>2</sup> In contrast, if the investor employed a high-turnover stock trading strategy where all gains are realized each year at short-term capital gains rates, the after-tax return falls to 5.0%. In this example, the active trader pursuing additional return from skilled trading (alpha) would need to generate alpha in excess of the 1.1% tax differential to break even because alpha is itself taxed. Principle 2 is to minimize portfolio exposure to short-term capital gains.

<sup>1</sup> Fees and other expenses are not included, though they can affect after-tax returns.

<sup>2</sup> The expected dividend yield for global equity is 2.5%. In this example, deferred capital gains are taxed at long-term gains rates at the end of a 10-year holding period.



Investors can employ asset location to maximize the net return contribution of otherwise tax-inefficient assets and strategies. Annual interest income and realized capital gains (short- or long-term) are not taxed in tax-deferred accounts such as IRAs. So the tax issues we identified in our first two examples are irrelevant to investors who locate these assets and strategies in tax-deferred accounts. (Investors pay income tax on distributions from tax-deferred accounts.) However, investors should employ asset location within a broader framework that considers overall portfolio diversification, liquidity needs and financial goals over time.

#### EXHIBIT 1 – TAX SCENARIOS

Horizon	Scenario 1	Scenario 2	Scenario 3
10 Years	6.1%	6.0%	6.9%
20 Years	6.3%	6.0%	6.9%
30 Years	6.4%	6.0%	6.9%

Some investors are allergic to paying any and all investment-related taxes. In so doing, they may be sub-optimally invested, which carries its own costs. A common scenario involves avoiding the realization of long-term capital gains for equities. Exhibit 1 compares the compound annualized after-tax returns associated with four hypothetical capital gains tax scenarios over 10-, 20- and 30-year investment horizons using our 7.4% pre-tax expected return for equity. The first scenario represents an equity investment that incurs only dividend income taxes annually and defers the realization of all capital gains until the end of the investment horizon, when gains are realized and taxed at long-term rates. Scenario 2 represents an equity investment that incurs annual dividend taxes and realizes all deferred capital gains every three years at long-term rates. This scenario is analogous to 33% annual turnover,

but where all capital gains are long-term. Scenario 3 is the same as Scenario 1, except the deferred gains are never realized. In Scenario 3 we assume the assets will never be consumed by the investor, but gifted to the investor's heirs with a step-up in tax basis, or gifted to philanthropies.

Exhibit 1 shows that the compound annualized return benefit of deferring long-term capital gains tax into the future (Scenario 1) is surprisingly small relative to Scenario 2, where all capital gains are realized every few years but at long-term tax rates. We believe the small benefit over very long time horizons from deferring long-term gains to postpone a tax event does not justify maintaining a suboptimal investment portfolio. An optimal portfolio occasionally requires taking some long-term capital gains to reallocate and maintain an appropriate risk profile, ensure broad and robust diversification, target risk premiums or employ new managers. The risk-and-return benefits of these activities almost certainly outweigh the marginal after-tax return differences between Scenarios 1 and 2. Therefore, investors should realize long-term capital gains when the investment portfolio is suboptimal and the assets will eventually be liquidated for personal consumption (thereby incurring a future realized capital gains tax event regardless). The key is not to avoid taxes by deferring long-term capital gains per se, but rather to minimize short-term capital gains, as we noted. Tax-efficient wealth management can also mean incurring tax when it is prudent to do so.

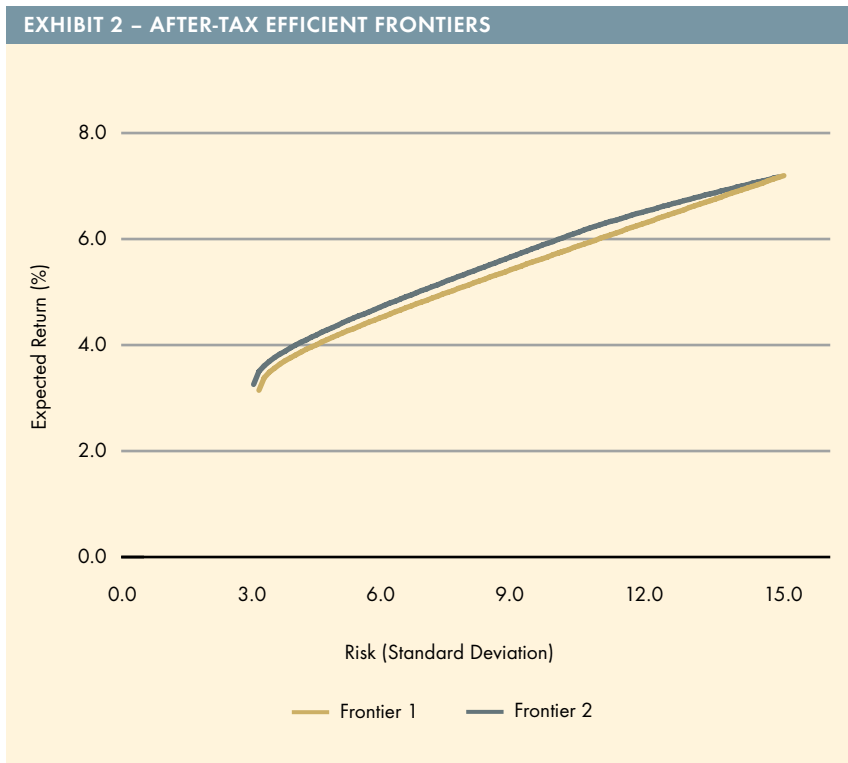
Scenario 3 produces the highest after-tax returns, as capital gains are never realized. The investor will never personally consume the assets but intends to gift them to philanthropies or heirs with a future step-up in tax basis. In this scenario, deferring long-term capital gains indefinitely may be reasonable. However, the risk-and-return benefits of

maintaining an optimal investment portfolio can still outweigh the after-tax return benefit of never realizing gains. This depends on the investor's unique circumstances, including his or her age and the desire to keep future options open regarding the assets (i.e., uncertainty about future consumption versus gifting).

The first four principles offer general guidance, but a more sophisticated perspective requires employing after-tax portfolio optimization. In particular, after-tax portfolio optimization can show whether or not an asset's diversification benefit outweighs an otherwise less-efficient tax profile, thereby contributing net positive value to the total portfolio. After-tax portfolio optimization is a key component of Northern Trust's strategic asset allocation process for taxable investors.

Let us consider Asset A, which has a pre-tax expected return and standard deviation (volatility) that sit halfway between that of municipal bonds and global equity. Municipal bonds are tax-exempt, and we will assume global equity is managed tax efficiently, with no realized gains until liquidation at the end of a 10-year holding period. In contrast, we assume Asset A realizes all gains each year at 60% long-term and 40% short-term capital gains tax rates. The pre-tax return of Asset A is easily achieved by blending municipal bonds and global equity, and clearly Asset A is less tax-efficient. But importantly, Asset A can still improve a taxable portfolio if it contributes a unique and powerful diversification benefit. To illustrate this concept, we will also assume that Asset A is uncorrelated with stocks and bonds. Exhibit 2 displays the after-tax efficient frontier of municipal bonds and global equity (Frontier 1) with the after-tax efficient frontier of municipal bonds, global equity and Asset A (Frontier 2).<sup>3</sup>

Frontier 2 (with Asset A) dominates Frontier 1 for all portfolios except the single highest risk/return portfolio (100% global equity) where the two frontiers join, indicating that portfolios that include Asset A offer higher risk-adjusted after-tax returns than portfolios comprised of only municipal bonds and global equity. Asset A contributes a powerful diversification benefit to taxable portfolios of municipal bonds and global equity, and this diversification benefit outweighs its less-efficient tax profile to contribute positive net value to taxable portfolios. Perhaps surprisingly, the more-sophisticated perspective of after-tax portfolio optimization can sometimes override our more-generalized principles of tax-efficient wealth management.



<sup>3</sup> After-tax optimizations require certain adjustments to CMAs, including tax adjustments to expected return and risk and geometric-arithmetic conversions. The after-tax returns plotted in Exhibit 2 are arithmetic. Expected return and risk for global stocks and municipal bonds represent Northern Trust CMAs.

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