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Equity Investing in the Presence of Taxes

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Every investor who owns a taxable account should consider taxes as part of their investment decision making process. Research shows that over the decades, the tax impact on taxable investors in actively-managed funds has averaged two percent per annum - or 20% of the stock market's long-term gainsⁱ.

For a taxable investor, there are some tax benefits and potential tax pitfalls of selecting certain investment instruments for their equity allocation. Since taxes greatly affect total return, investors should take a closer look at mutual funds, ETFs, and separate accounts before making their equity allocations to ensure the investment vehicle they choose properly meets the needs of their investment strategy from a tax perspective.

An investor can participate in the equity marketplace in various ways: The investor can choose between active or passive stock selection in their investment vehicle, and also active or passive tax management.

		TAX MANAGEMENT	
		Passive (Tax Indifferent Traders)	Active (Tax Aware Traders)
STOCK SELECTION			
ACTIVE (Information Traders)	Typical Mutual Fund	Tax-managed Active Separate Account	
PASSIVE (Informationless Traders)	Indexed Mutual Fund or ETF	Tax Managed Indexed Separate Account	

Typical Mutual Fund: Active Stock Selection/Passive Tax Management

In 2009, over 14 million households held mutual funds in taxable accountsⁱⁱ. The main culprit in mutual fund tax inefficiency is that by law, funds must pass virtually all capital gains to shareholders each year. These distributed gains are taxable at the individual's capital gains rates, even if the investor never sells the fund. Net capital losses are not distributed; rather they are carried forward to future years to offset future capital gains. Investors are often unaware they are liable for the unrealized gains, undistributed

gains, and undistributed investment income that a fund has accumulated before they invested into the fund. While these distributions reduce Net Asset Value (NAV) when paid out, investors receive a tax bill on these gains even though they did not sell the fund. This can leave a taxable investor with a latent tax liability and may cause an unpleasant surprise at tax time. In 2007, mutual funds distributed \$150 billion in capital gains, on which investors paid a record \$34 billion in taxesⁱⁱⁱ. Astoundingly in 2008 - one of the worst equity market environments since the Great Depression - fund investors still paid \$15.8 billion in capital gains taxes^{iv}!

According to the Investment Company Institute, 75% of investors bought their first fund before the year 2000. Of the 25% of investors who purchased their funds after 2000, 68% of those are in employer sponsored retirement plans with more favorable tax treatment^v. This shows more recent investors may be more aware of the tax implications of holding mutual funds in taxable accounts and also the growth of employer sponsored retirement accounts.

What about the 14 million households who continue to hold mutual funds in taxable accounts, the majority of which may have been initially purchased over 10 years ago? In the field of Behavioral Finance, much research has been performed to understand investor behavior. Could the behavior of these investors be attributed to “status quo bias,” the tendency of individuals to maintain their previous decisions regardless of the changes in their environment? “Status-quo bias may be optimal if there are high transactions costs, but even when no explicit costs are associated with search or switching, uncertainty can lead to status quo inertia.”^{vi} Another consideration could be how the issue is framed, in other words, the investors perception. Investment returns are reported to the investor, but the tax consequence of these investments only materializes for some around April 15th each year. Many investors may not clearly link reported investment returns with their associated tax consequences. “The way a decision is framed will not alter choices if the decision maker is using a comprehensive, wealth-based analysis. Framing does alter choices in the real world because people make decisions piecemeal, influenced by the context of the choice.”^{vii}

Whatever the reasons taxable investors invest in active mutual funds, it appears there remains much opportunity for investor education on mutual fund investing in the presence of taxes. Active mutual funds are generally better suited for tax exempt investors. While there are tax-advantaged mutual funds that offer some level of tax management, due to the current regulatory structure, a mutual fund investor cannot receive the full benefit of the tax management tools that are available in other investments.

ETFs and Index Funds: Passive Stock Selection/Passive Tax Management

ETF assets totaled about \$791 billion at the close of 2009^{viii}. ETFs and index mutual funds are generally considered to be tax efficient. This is because they typically have lower turnover and only distribute dividend income. Capital gains are minimal, and usually occur due to index reconstitutions or corporate actions. While this is generally true, there are additional considerations worth noting.

Although these are passive investments that are meant to precisely track their benchmark, it’s a misconception that ETFs deliver exact benchmark returns. Expenses, trading costs, and taxes detract from an ETF’s return and ultimately result in tracking error relative to their respective benchmarks.

Funds that track the broadest of market indexes are generally closer to their target. In 2009 the largest ETF, the S&P 500 SPDR (ticker: SPY), fell short of its benchmark by 0.10%. However, some investors don't realize ETF's that track other benchmarks, such as economic sectors or emerging markets for example, often have higher tracking error. In 2009, ETFs in aggregate missed their targets by an average of 1.25 percentage points, a discrepancy more than twice as large as the 0.52-percentage-point average they posted in 2008.^{ix}

The tax efficiency of an ETF presumes a buy and hold strategy. Since few taxes are incurred until the ETF is sold, this makes ETFs attractive to buy-and-hold investors. One would then assume the majority of ETF holders use a buy-and-hold strategy. While this may be true for some investors, the trade numbers tell a different story. "Total ETF notional trading volume in 2009 was about \$18.2 trillion. Using a simple average of the beginning of year and end of year assets as a proxy for average industry assets implies a turnover ratio of 22.9 times (by calculating notional trading volume divided by total assets). It is true the extreme turnover among leveraged ETFs inflates this number somewhat. The ratio still totals 18.4 after excluding the two major leveraged ETF players"^x. It seems most ETFs are not being held for long periods of time, but instead are being used more for shorter term tactical trading – thus eliminating the perceived tax benefits.

Not all ETFs are treated the same by the IRS. ETFs that target alternative asset classes have seen tremendous growth. "The investment researchers at Morningstar track 108 such ETFs with a total of \$80 billion in assets; 42 are less than two years old. These funds are taxed so differently, and at such higher rates than traditional investments, that many investors now wish they had looked before they leaped. Commodity and currency ETFs often aren't "funds" at all, but trusts or limited partnerships that pass income and gains through to their investors. The income or gains may come from foreign currencies or physical commodities -- but also from money-market instruments, forward contracts, swap agreements, futures contracts or other derivatives."^{xi}

Some examples of tax difference include gold ETFs taxed at the collectibles rate of 28%; mark-to-market gains in commodity ETFs which can be taxed as long as 30 days after sale at a blended short and long term rate; and currency ETFs being taxed at ordinary income rates instead of capital gains rates when sold. It is critical to know the various tax treatments of alternative ETFs before making them part of a taxable investment portfolio.

Separately Managed Accounts: Active or Passive Stock Selection/ Active Tax Management

Separately managed accounts (SMAs) have generally been marketed as a tax efficient alternative to mutual funds. It is important to consider the differences between strategies that employ active versus passive stock selection within tax managed separate accounts. Active stock selection accounts have the goal of delivering excess returns relative to the benchmark while passive stock selection accounts have the goal of matching the benchmark return. Whether active or passive, tax managed separate accounts have certain advantages: the securities are individually owned, account holders can request tax loss harvesting, and investors can employ gifting strategies for estate planning if necessary. While these are powerful benefits, a number of managers don't directly consider taxes in their investment strategy.

Unless advisors and clients explicitly request tax loss selling, many managers don't automatically employ this tax reducing strategy. Some SMA platforms have moved to address this issue by employing an overlay management service. The overlay manager will coordinate between the client's separate account managers into one single account. The overlay manager then takes responsibility for rebalancing, tax management, restrictions, and cash management. While overlay management offers real tax advantages, it does have some shortcomings as well. For instance, the overlay manager must interpret whether Manager A's "buy" rating is equivalent to Manager B's "buy" rating (as well as the urgency of the indicated trade), and optimize for taxes under such uncertainty.

Alternatively, there are managers who offer active tax management within individual SMA accounts. An optimal tax-managed strategy incorporates not only active tax management, but also considers the client's actual cost basis, individual tax rate, and requested investment restrictions. Additionally, the optimal tax-managed strategy includes a tax-sensitive transition from the inherited portfolio, and tax-sensitive handling of withdrawals. Given this comprehensive list of considerations, the optimal treatment of such accounts excludes model-based solutions, even if the model is tax-sensitive.

Many investors require systematic withdrawals from their portfolios for income needs. When using an ETF or mutual fund strategy, the only way to accommodate systematic withdrawals is to liquidate some portion of shares at the current market value. In a tax efficient SMA account, high-cost basis securities or tax lots can be liquidated to minimize tax impact.

SMA accounts can be optimized for client-directed restrictions. Investors may restrict certain holdings for various reasons. Examples include restricting investment in the stock of their current employer or current industry of employment, or restricting investment in industries or companies which engage in activity counter to the investor's belief system. In fact, a report on Socially Responsible Investing (SRI) trends in the US released in 2007 by the Social Investment Forum shows that one of every nine dollars under professional management in the US is driven by socially responsible investment objectives^{xii}.

Frequently-employed methods for handling such restrictions include simple negative screening for restricted securities, industries or activities. The negative screening approach typically entails diverting account proceeds allocated to the restricted investments in the model portfolio either to an increased cash position or pro-rata allocation to the remaining unrestricted securities. Either of these methodologies results in sub-optimal portfolios with unintended biases.

Select tax-managed strategies have the capability to better handle these restrictions. Such strategies rebalance each account individually and re-optimize the respective portfolios around indicated restrictions. This allows the manager to efficiently incorporate restrictions while conducting tax management at the individual client level while remaining fully invested.

Tax-Sensitive Account Transition

When an investor is funding their investment with cash, initially choosing the proper investment vehicle is simplified as there are no immediate tax consequences associated with the initial investment. Therefore, one can more easily weigh the investment merits of any alternative vehicle and their

associated future expected tax efficiency. However, when existing investment positions are used for funding an account, the decision is more complex.

If a taxable investor wants to fund their new investment strategy using existing positions, taxes must be considered. Investing in mutual funds and ETFs requires full liquidations of existing holdings, creating a taxable event.

Separate account managers may keep a limited amount of existing positions. However, if the existing assets are not in the new manager's model portfolio, they will usually be liquidated without additional consideration. Some tax managed strategies provide transition management, which is a valuable tool in controlling capital gains incurred during the initial transition to a new investment account. This is a distinct advantage of using a tax managed separate account. The economic benefit derived from a reduction in taxes paid by using a transition strategy remains in the account and continues to compound in the portfolio.

Let's look at a simple example of the benefits transition management can provide to the portfolio value over time:

Assume an investor holds \$500,000 in equity securities which they would like to transfer to a new managed account. The current portfolio has \$250,000 in unrealized gains, half of which are short term and half of which are long term. In scenario L, the existing portfolio is liquidated, and the proceeds are reinvested into a new portfolio. In scenario T, the re-allocation is implemented using a transition management strategy which only liquidates 50% of the existing portfolio. By using a transition strategy the tax bill in this example is reduced by half. This amount (taxes not paid) remains invested in the portfolio going forward. **If each portfolio then earns 8.00% per year, the portfolio which was transitioned has \$45,916 in additional value after 5 years.** The liquidated portfolio would have to earn 1.50% more each year to match the value after 5 years in this example. This is a simple example, but shows the value that can be derived by reducing the initial tax bill and compounding those tax savings over time.

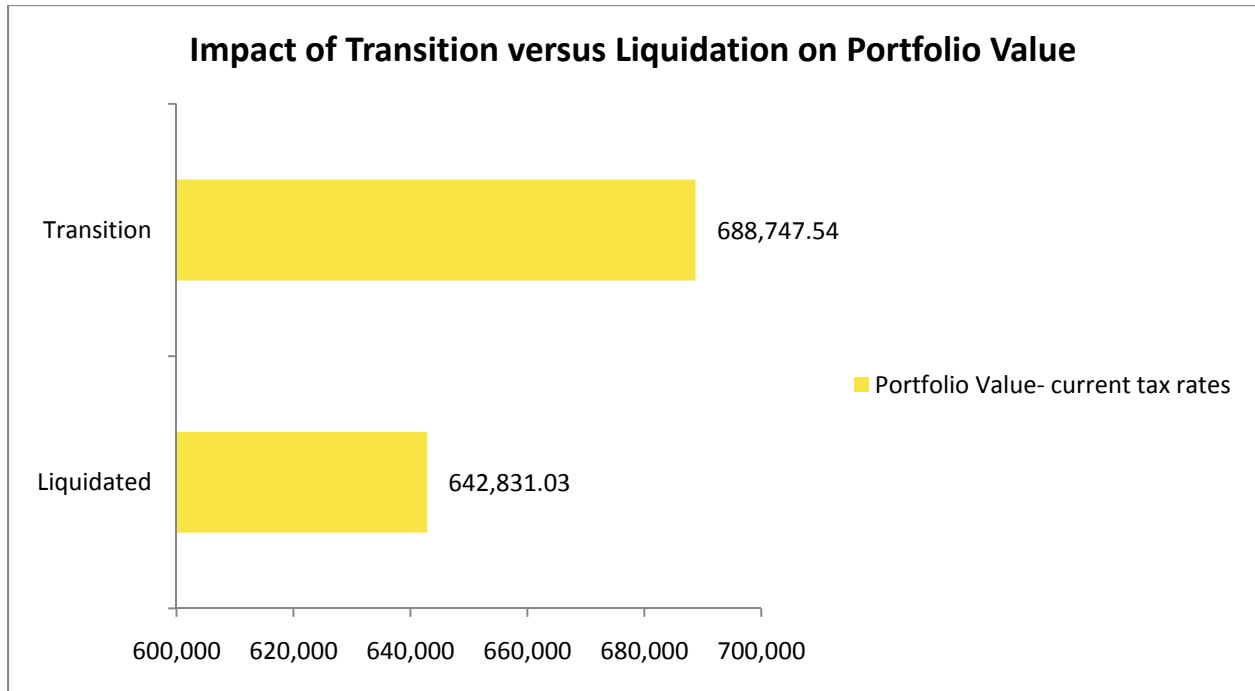


Figure 1: Initial portfolio value \$500,000. Assumes taxes paid are removed from account. ST gains taxed at 35%, LT gains taxed at 15%.

Why pay attention to taxes now?

During 2008 when equity markets were down over 30%, bringing up a conversation about tax management was somewhat like talking to my eight year old son about why taking the time to do well on his math homework tonight is important so he can become a pilot in fifteen years. It sounds great in theory, but the future benefits seem too far off to consider it very important right now.

Fast forward to today and the tax conversation is relevant once again. Since early March 2009 the markets have rebounded significantly with the S&P 500 increasing upwards of 80%. In addition, tax rates are scheduled to revert to higher levels at the end of 2010. With the current state of debt and increased deficit spending, most are certain that tax rates will only increase further in the future, but what is uncertain is exactly where the rates will settle in for the near future. If Congress does nothing once the tax cuts expire, dividends would revert to being taxed at ordinary income rates with the top rate at 39.6%. Long term capital gains are set to be taxed at 20%, with short term rates rising to a maximum rate of 39.6%. Does this have any significance to the taxable investor? In 2007, tax filers with income between \$500,000 and \$1 million derived 22 percent of their income from dividends and capital gains^{xiii}.

Let's take another look at the transition example to understand how the new short term and long term rates affect the numbers.

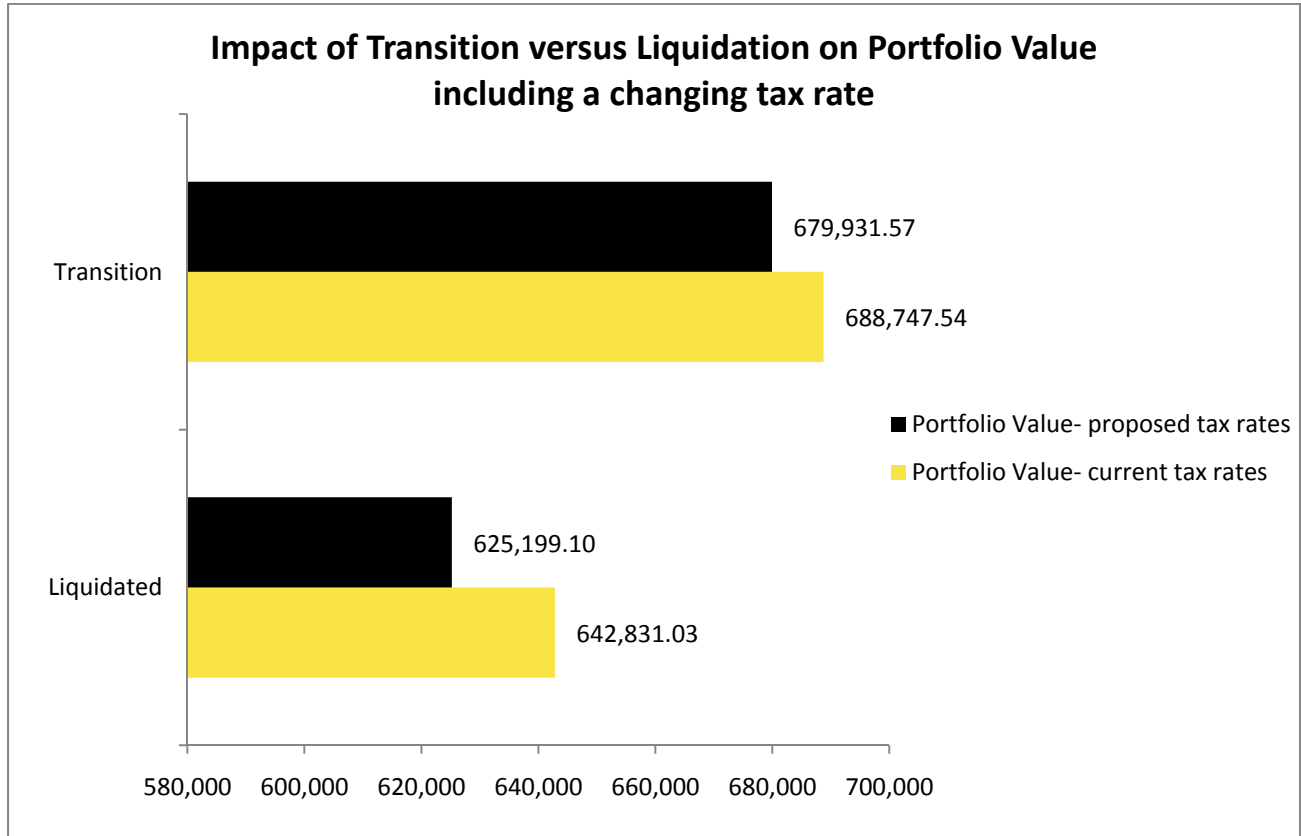


Figure 2: Initial portfolio value \$500,000. Assumes taxes paid are removed from account value. ST gains taxed at 35%, LT gains taxed at 15% for current tax rates. Rates for the proposed tax rate scenario include ST gains taxed at 39.6%. LT gains taxed at 20%.

Adjusting for proposed tax increases, a transition strategy can add even more value. In the presence of higher taxes, each portfolio still earns 8.00% per year yet now the portfolio which was transitioned has \$54,732 in additional value accrued from tax saving after 5 years. The liquidated portfolio would have to earn 1.83% more each year to match the value in this example. The tax rate increase tacked on an additional 0.33% of additional return each year needed for the liquidated portfolio to achieve the same value as the transitioned portfolio.

In conclusion:

As taxable investors reallocate their portfolios, understanding the underlying tax benefits and consequences of different investment vehicles is important to the bottom line. Separating total investment returns from the tax bill resulting from those investments can leave investors dazed and confused come April 15th. Index funds and ETFs can be very efficient to the buy and hold investor; however, the ETF trading numbers show investors are trading these instruments at a rate that often

wipes away some of the perceived benefits. Investors needing systematic withdrawals should be aware that the only way to accomplish this with an ETF is to sell shares at current market values creating a taxable event. There are additional tax considerations that commodity and currency ETF investors should be aware of. Separate accounts offer the most flexibility to taxable investors, but only if their managers are taking full advantage of all tax management tools available within a separately managed account. Regardless of investment vehicle, reducing the tax bill from investment decisions can add significant value as the tax savings remain invested and compound over time.

ⁱ Andrew Tanzer, "Pay Less Tax on Your Funds"; *Kiplinger's Personal Finance*, November 2008
http://www.kiplinger.com/magazine/archives/2008/11/tax_efficient_funds2.html?kipad_id=x

ⁱⁱ Investment Company Institute, *Research Fundamentals*- December 2009 vol 18, No. 8
<http://www.ici.org/pdf/fm-v18n8.pdf>

ⁱⁱⁱ Andrew Tanzer, "Pay Less Tax on Your Funds"; *Kiplinger's Personal Finance*, November 2008
http://www.kiplinger.com/magazine/archives/2008/11/tax_efficient_funds2.html?kipad_id=x

^{iv} Lipper: *Taxes in the Mutual Fund Industry--2009: Assessing the Impact of Taxes on Shareholders' Returns* April 15, 2009- Abstract <http://www.lipperweb.com/Research/ResearchStudies.aspx>

^v Investment Company Institute, *Research Fundamentals*- December 2009 vol 18, No. 8
<http://www.ici.org/pdf/fm-v18n8.pdf>

^{vi} Samuelson, W. & R. J. Zeckhauser. (1988). *Status quo bias in decision making*. *Journal of Risk and Uncertainty*, 1, pp. 7-59.

^{vii} "Mental Accounting Matters" Richard H. Thaler; *Journal of Behavioral Decision Making*, 1999, 12(3), p 183-206

^{viii} "Ten ETF Stats That Will Shock You" Michael Johnston; January 6, 2010
<http://etfdb.com/2010/ten-etf-stats-that-will-shock-you>

^{ix} "ETFs were wider off the mark in 2009" Ian Salisbury; *The Wall Street Journal*, page C9: February 19, 2010
<http://online.wsj.com/article/SB10001424052748704269004575073850786749116.html>

^x "Ten ETF Stats That Will Shock You" Michael Johnston; January 6, 2010
<http://etfdb.com/2010/ten-etf-stats-that-will-shock-you>

^{xi} "Watch Out for Hidden Tax Traps Inside ETFs" Jason Zweig; *The Wall Street Journal*, page B7: April 17, 2010
<http://online.wsj.com/article/SB10001424052702304628704575186433316749798.html>

^{xii} 2007 Report on Socially Responsible investing trends in the United States, *Social Investment forum*
http://www.socialinvest.org/pdf/SRI_Trends_ExecSummary_2007.pdf

^{xiii} Avi Feller and Chuck Marr, "Tax Rate for Richest 400 Taxpayers Plummeted in Recent Decades, Even as Their Pre-Tax Incomes Skyrocketed," *Center on Budget and Policy Priorities*, February 23, 2010
<http://www.cbpp.org/cms/index.cfm?fa=view&cid=3090>

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