The Effects of Taxes on Investment Portfolios

Developing an investment program is a detailed process that requires a number of steps. Part of the exercise involves identifying goals for future wealth, gauging appetite for risk (potential for short and long term loss of wealth), anticipated spending and how it will impact portfolio growth[1]. These elements are then used to develop risk/return projections[2] which provide a basis for selecting suitable asset classes and asset allocation targets that best meet an investor's goals and expectations for the future. The end product of this entire process is an Investment Policy Statement (IPS) that clearly articulates what is being done with the investment program and why. Think of an IPS as the basic framework for establishing an investment program that gets updated periodically, usually each year. This process is necessary to develop a long-term plan designed to attain desired goals, whether for taxable or tax-exempt investment programs.

However, there is an added complication for taxable investors that should be part of the planning process. The effect of taxes needs to be incorporated into any projections since it will have a bearing on portfolio construction and financial outcomes.

We all know that taxes are a significant expense when investing and the effect needs to be estimated during the planning process. In general, taxes reduce returns in rising markets and the government shares in losses when markets decline. Realistically, however, we all expect an investment portfolio to grow over time and, therefore, pay taxes. We also know that each asset class has specific tax implications which need to be addressed in the planning and implementation phase. For example, Municipal Bonds are generally exempt from Federal taxes[3] so pre- and after-tax returns are identical for the purposes of this discussion. In contrast, taxable Bonds are taxed at the taxpayer's highest rate. Stocks are taxed based on dividends and realized gains as a result of turnover and holding period (short and long term capital gains). In general, each asset class should have specific tax assumptions that adjust financial assumptions (risk/return) when developing portfolio projections on an after-tax basis.

The following example illustrates the impact of taxes on a sample portfolio using six asset classes. Each asset class was assigned a unique set of financial assumptions along with estimated tax treatment.

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[1] The effect of Spending on Portfolio growth was the subject of a previous white paper
[2] Projections are often based on Efficient Frontiers and Monte Carlo simulations using projected financial assumptions.
[3] For the purposes of this discussion, State and Local taxes will not be considered, nor will AMT

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Chart 1 - Sample Portfolio

Asset Allocation

Asset Class	Allocation
Cash	3.0%
Lg Cap Stocks	20.0%
Small Cap Stocks	13.0%
Dev'l Int'l Stocks	20.0%
Hedge Funds	10.0%
Municipal Bonds	34.0%
Total	100.0%

Financial Projections

Projections	Before Taxes	After Taxes	Percent Change
Expected Return	5.7%	4.8%	-15.8%
Annual Risk[1]	9.7%	8.9%	-8.2%

[1] Standard Deviation

Portfolio allocation is set as shown in Chart 1 with the projections based on a 10 year timeframe. Projected after-tax returns are lower by 0.9%, 15.8% less when compared to pre-tax returns. Risk also declined but by a smaller margin due in part to the dividend component in the stock return assumptions.

The example illustrates that taxes have a material impact on projections and play an important role in the planning phase for any taxable investment program. In this case, projected returns are almost 16% lower. A taxable investor would need to take more risk to realize a particular pre-tax return or settle for lower results on a net basis.

It should be noted that the results shown in this particular example are dependent on the specific set of circumstances presented (asset class mix and underlying assumptions), but will vary significantly given different situations. In practice, when projections are developed, State and Local taxes often need to be considered as well as any surcharges, such as the Investment Income tax. Each analysis should be tailored to the specific circumstances of the investor.

In summary, estimating the effect of taxes during the planning process is not an exact science. The important point here is: taxes do play a significant role in the outcome of an investment program; ~~and~~ they must be incorporated into the investment planning process; and ~~the~~ their effects need to be well understood and evaluated.

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Implementation

Moving beyond the planning process and ahead to implementation, here are a few things to consider to potentially reduce taxes both in the near term and in later years.

1. Consider investing in a tax managed index fund – this is a separate account that when properly managed will generate capital losses while closely tracking a specific benchmark return, say the S&P 500 index. The losses can be used to offset gains elsewhere in the portfolio. The caveat with these programs is that the losses produced diminish after a few years, although there are steps that can be taken to deal with this issue. Also, minimums are relatively high.
2. Utilize ETFs whenever possible rather than mutual funds especially when indexing. ETFs tend to be more tax efficient and don't distribute gains in the way mutual funds do. It's not to say that all mutual funds are tax inefficient, but ETFs are generally more attractive.
3. Use caution when investing in proprietary pooled funds managed by an advisor where unrealized gains will accumulate. Investors in pooled funds are often required to liquidate all their holdings if they choose to change advisors, realizing accumulated gains for tax purposes. Before participating in any proprietary pooled investment, understand the terms and conditions of participation and if a provision exists that provides for in-kind distributions.

In closing, consider taxes as an expense of investing but not the only consideration when developing an investment program. Understanding how taxes can effect portfolio growth will allow the investor to set reasonable expectations and manage tax liabilities through a well-reasoned approach.

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