



TAX CONSCIOUS INVESTING:

DO TAXES REALLY MATTER?

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Taxes are one of the most overlooked costs of doing business in the investment world. Most advisors manage client portfolios with complete indifference to the tax status of the underlying investor expecting that their ability to deliver excess returns will overcome any tax liability. This position is naive and subjects a manager to warranted criticism for their disregard of client needs and objectives. With the increasing focus of more tax efficient vehicles such as indexed mutual funds and ETFs, active managers have a responsibility to develop and articulate management disciplines which maximize their after-tax capture ratio. Active managers who build taxable and tax-exempt portfolios in the same manner and expect to produce substantially similar results will be unpleasantly surprised at the outcome.

Many papers have been written comparing the after-tax results of active portfolios with passive portfolios or ETFs. The conclusion of most is that a manager has to generate annual excess returns of as much as 450 basis points to match the returns from an ETF or passive index fund.^{1 2} This paper will explore the reasons for tax conscious management as well as methods for maximizing after-tax capture ratios and outperforming passively “managed” alternatives. Successful active management has a place in most equity portfolios and with well constructed trading disciplines can generate meaningful excess, after-tax returns.

The Tax Challenge

Taxes tend to be a very awkward issue for most investment advisors for the following reasons.

Complicated Calculations

First, calculating each client’s tax liability is difficult and time consuming. Frequently an investment manager is unaware of a client’s marginal tax rate, and, in some cases, even the *client* is not up-to-date with the correct rate. Even when the rate is known, it may well change as the IRS periodically adjusts the marginal tax rates, sometimes retroactively, and even for a partial year. Another consideration is the Alternative Minimum Tax [AMT] which may impact affluent investors, especially those living off their capital. Therefore, what should be a simple arithmetic of netting out taxes becomes problematic for managers, possibly requiring the assistance of a client’s tax accountant.

Typically an investor has multiple portfolios handled by separate advisors. This makes it difficult for any single advisor to manage a client’s tax liability effectively.

¹ Jeffrey, Robert H. and Arnott, Robert D; “Is Your Alpha Big Enough To Cover Its Taxes?”, Journal of Portfolio Management, Spring 1993.

² Luck, Christopher G., “Tax-Advantaged Investing”, Journal of Private Portfolio Management, Spring 1999.

Regular communication between the advisor and client is essential to properly assess the overall tax liability and to manage it effectively across the various portfolios. The manager must be able to assess their client's tax positions on a daily basis and to manage to a tax budget which may be adjusted throughout the year. The manager must be able to maintain discrete tax lots and to manage with multiple objectives in mind; including capital growth, income and tax efficiency.

Competitive Disincentives

Second, and perhaps more importantly, very few advisors manage portfolios tax effectively because a) there is no industry wide incentive to do so, and b) no accepted standard for after-tax calculations. For example, state income taxes vary widely, so after-tax return computations can be substantially different depending upon the assumptions used. Publishing after-tax returns is a perceived disadvantage from an investment advisor's marketing perspective. In almost every situation, after-tax returns will be lower than their pre-tax counterparts. The manager who publishes after-tax returns will appear less competitive in the marketplace. The pitfalls of a tax insensitive approach are shown below.

We will use the well-known mutual fund, the Fidelity Magellan Fund, to provide an illustration of this disincentive. A \$100,000 investment in the Fidelity Magellan Fund on 12/31/05 would have totaled \$107,217 on 12/31/06. The change in value would have included the reinvestment of two distributions in May, a \$0.25 per share dividend and a \$22.11 per share long-term capital gain, and one distribution in December, a \$2.80 per share dividend. The initial investment, which did not benefit from the appreciation that generated the gain, would still be subject to the tax consequences of the distribution. Hence, the investment's after-tax gain would have amounted to \$2,881 versus the pre-tax gain of \$7,217.³

Date	Unit Price	Shares Purchased	Shares Accumulated	\$ Value	Gain	Taxable Rate	Tax Due
12/31/05	106.44	939.50		100,000			
5/5/06	94.69		2.48	235	0.35	82	
5/5/06	94.69		219.37	20,772	0.15	3,116	
12/1/06	89.49		36.34	3,252	0.35	1,138	
12/31/06	89.52	1,197.68		107,217	7,217	4,336	
					2,881		

May 5 Long Term Capital Gain Distributed \$22.11 per share
 May 5 Dividend Distributed \$0.25 per share
 December 1 Dividend Distributed \$2.80 per share

Original \$100,000 Investment

Gain After Taxes Paid

³ Data provided by Morningstar.

Shining a Light

The SEC has pressed mutual funds to provide after-tax return information to shareholders, but the chances of the industry ever advertising these broadly is unlikely. The CFA Institute, a self-regulatory association supporting ethical and educational standards in the investment management industry, encourages investment advisors to provide after-tax calculations as supplemental performance information. Unfortunately for clients and shareholders, there is *no* incentive to be the first to step up to the plate.

Morningstar, a popular mutual fund rating service, does provide an estimate of mutual fund after-tax returns, as well as a “potential capital gains exposure”.

Fidelity Magellan Fund Average Annual Total Returns as of 12/31/06			
	Before Taxes	After Taxes	Capture Ratio
1 Year	7.22	3.67	51%
3 Year	7.04	5.59	79%
5 Year	3.17	2.24	71%

Source: Morningstar

Morningstar estimates for the Magellan Fund's after-tax capture ratios range from 51% to 79% for the 1, 3 and 5 year periods. Furthermore, even after the \$22 distribution in May, the PCGE remains at 24% of assets.

Unfortunately, similar after-tax estimates such as Morningstar's do not exist for the investment advisory world. The lion's share of current tools and techniques for sophisticated investment management were developed for the tax-free pension world. The science of the “efficient frontier”⁴ is based on raw returns, not after-tax returns. In the 1996 Yearbook, Ibbotson Associates calculated the after-tax return for large-company stocks to be 7.8%, significantly lower than the 10.9% raw return. Likewise the return for long-term government bonds falls from 6.0% to 3.6% after taxes. The long-term return for municipal bonds is 4.1%, both before and after taxes. Obviously, using pre-tax returns to derive a taxable investor's appropriate asset allocation could produce a sub-optimal result.

	Large Company Stocks	Long-Term Gov't Bonds	Municipal Bonds
Pre-Tax	10.9%	6.0%	4.1%
After-Tax	7.8%	3.6%	4.1%

Source: 1996 Ibbotson Associates Yearbook

⁴ The efficient frontier was first defined by Harry Markowitz in his groundbreaking paper “Portfolio Selection” which appeared in the 1952 Journal of Finance.

Passive vs. Active

Although there is considerable debate on the merits of passive versus active management, there is evidence that professional money managers can add value through rigorous investment processes and insight. Winners do beget winners, not always with the consistency that everyone would like, but an active manager's overall batting average can be quite high. A sizable percentage of managers have outperformed the S&P over the past 5 and 10 years even adjusting for survivor bias. Most of this return advantage can be preserved through careful, tax conscious management, but it has to be tailored to the taxable investor through separately managed portfolios.

	5 Years	10 Years
S&P 500 Return	6.19%	8.42%
Outperforming Managers*	62%	72%
Median Excess Return	98 bps	140 bps

*Large Cap Equity, as of 12/31/06 Source: eVestment Alliance

Supporters of passive investing focus on an after-tax basis that assumes the portfolio appreciates at a given return rate of 6-10% with a dividend yield of 2%. The passive investor realizes no gains and the active manager (with 100% turnover!) pays short-term capital gains tax each year. Based upon these assumptions, the alpha hurdle for active management can exceed 4% to produce the same after-tax return. There are several major flaws in this argument.

First, even passive portfolios will have turnover. Every index needs to reconstitute itself due to takeovers, mergers, corporate actions (share issuance/buybacks), stock dividends, etc. This turnover can average as high as 20% for some of the small cap benchmarks. To suggest that there will be no ongoing tax liability in a managed index fund is incorrect.

Secondly, price appreciation in a portfolio in any year is far from uniform. While the expected return from an equity portfolio may average 8-10%, the return pattern is widely distributed and uneven.⁵ This pattern applies to both the markets and to individual securities in a portfolio. Unless a manager is incredibly lucky, there will be winners and losers in any portfolio no matter how ebullient the markets or successful the manager.

For the astute investor, this winner/loser scenario presents an opportunity to manage holdings in a tax favored fashion to defer or minimize taxes, to increase tax basis or to offset gains. There are several tax management techniques that can help meet these goals. For instance, an active manager could use pair trades (with observation of appropriate wash sale rules) to harvest tax losses. A manager could also use sector ETFs to accomplish the same goal in situations where a viable stock substitute is unavailable. A manager's willingness to book losses on mistakes and to trade poorly-timed, but solid long-term holdings, can also augment portfolio after-tax returns.

⁵ According to Ibbotson Associates in Chicago the long-term compound rate of return for large cap common stocks was 10.2 percent from 1926 through 2002.

Studies have shown that this practice alone can add 80 basis points annually to a taxable investor's overall returns.⁶

Another challenge in the passive vs. active tax advantaged management argument is that a portfolio of significant size rarely starts with just cash. More often a portfolio has a number of low basis holdings that would adversely impact the investor's tax liability if sold. The active manager has a number of options to deal with a low cost position; including cashless collars (partial or entire position), covered call writing, swaps and other forms of hedging. A manager can also build a portfolio around the concentrated positions which may hedge some of the securities' implicit risk. There are also circumstances when a partial or total liquidation of a security may be warranted. In these situations an active manager has a distinct advantage over passive management in developing the best options for the client. Active management techniques help to minimize tax consequences by evaluating each holding and its outlook versus available alternatives. On the other hand, passive management, i.e. selling and moving into an ETF or index fund, incurs immediate, adverse tax impact that may affect the portfolio's performance for years to come.

Active, separate account management can provide a very competitive alternative for investment of taxable funds. An advisor with the investment skill, a compatible process and the necessary operational capabilities is likely to achieve a better after-tax return than an index fund. It is clear that most managers are not focused on maximizing after-tax returns, to do so requires flexibility and careful interchange with the client. Tools for managing concentrated positions are an important consideration in the success that a manager can enjoy.

The following are questions that provide insight into a manager's tax conscious investing capabilities.

1. What is the advisor's holding period length?
2. What is the advisor's turnover in the last twelve months? 3, 5, 10 years?
3. Does the advisor harvest tax losses? Ask for an example and the frequency of the decision making process.
4. In cases with multiple accounts, how does the advisor manage accounts with different tax environments?
5. Does the advisor communicate regularly and openly about taxes?

⁶ Horovitz, Jeffrey E. and Wilcox, Jarrod; "Know When To Hold'Em and When To Fold'Em: The Value of Effective Taxable Investment Management", Journal of Wealth Management, Fall 2003.

6. Does the advisor understand the portfolio's current taxable position? Are they aware of the investor's entire tax picture?
7. Does the advisor discuss possible strategic moves with the client? What is the frequency of these discussions? Tax conscious management is not just a year-end consideration, but a continually practiced responsibility.
8. Does the advisor's investment process include tax consciousness? Or is the decision an afterthought?
9. What are the advisor's pre-tax and after-tax discretionary returns?
10. What is the advisor's after-tax capture ratio? Does it cover the advisor's fees and still leave the client with excess returns?

In summary, after-tax returns are too often ignored in comparing investment alternatives for taxable portfolios. While it is impossible to avoid taxes completely, skilled professional management can minimize the impact on portfolio returns and produce superior long-term after-tax results even against a "passive" alternative. The work required to maximize after-tax performance can make a big difference in a client's ultimate wealth accumulation.

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