William Blair

Private Wealth Management

Achieving Tax Efficiency in an Investment Portfolio

After-tax returns, not gross returns, build wealth. In other words, it does not matter how much you make; it matters how much you keep.

Nevertheless, when managing an investment portfolio, consideration should be given to the investor's unique goals and specific challenges. Goals may involve achieving a certain level of return or building assets for retirement or future generations. Challenges might include an ever-changing macroeconomic environment, market fluctuation, and unforeseen life events requiring cash. Unfortunately, in focusing on these goals and challenges, the importance of tax efficiency may be overlooked.

Many people may invest as if taxes were irrelevant to net returns. Fundamental theories underpinning investment management (modern portfolio theory and the capital asset pricing model, for example), in fact, assume no taxes.

Although taxes should not drive investment decisions, they must be considered in order to maximize net return. Studies have shown that, in the long run, taxes—generated mainly by realized capital gains—have reduced fund investors' net returns by roughly two percentage points annually. Tax-aware portfolio management can close that gap, and it is particularly important in the current environment of continued tax uncertainty.

To that end, this paper discusses:

- What "tax efficiency" means
- The benefits of tax efficiency—and the consequences of tax inefficiency
- Strategies for achieving tax efficiency
- The advantages of separately managed accounts
- Tax efficiency and nonequity investments
- Special considerations in an uncertain tax environment

Defining "Tax Efficiency"

To effectively discuss the topic of achieving tax efficiency, we first must define the term. "Tax efficiency" means paying attention to the trade-off among risk, return, and taxes whenever an investment decision is made and whenever assets go through a transition.

"Tax efficiency" does not mean keeping taxes to the absolute minimum possible or letting tax considerations drive investment decisions. An investor should not let the tax-tail wag the investment dog. Portfolio management should be tax sensitive, but a tax-driven strategy can cause poor investment decision-making.

For example, consider technology stock investors in the late 1990s. Many tech stocks during this period skyrocketed in value. One fundamental tax planning tenet is that it is generally better to defer taxes as long as possible, and some investors held on tightly to their tech stock investments in order to defer the realization of gains. In addition, they may have considered the possibility that the 20% long-term capital gains tax rate might eventually be reduced.

Of course, the rate did drop a few years later—to 15% in 2003. By that time, however, the tech bubble had burst and many tech stock investors had seen their gains disappear (or even turn into losses). These investors could have come out better financially had their strategies been less tax-driven.

For example, paying a 20% tax on a $100,000 gain realized at the height of the tech boom would have left an investor with an $80,000 reward, rather than the $0 reward (or the losses) that many tech stock investors experienced. Even though more taxes would have been paid in the first scenario, it would have provided a higher after-tax return than the second scenario, which would have provided no return (or a negative return).

Tax Efficiency vs. Inefficiency

Taxes do have a significant negative impact on returns. This is due primarily to frequent trading and the resulting short-term capital gains taxes.

For example, consider the difference in after-tax returns for Investor A vs. Investor B.

This is a very simplified example that does not take into account many factors that would affect a real-life situation, but it illustrates the potential impact of frequent trades on tax efficiency: Investor A's fund manager will have to produce significantly better results to provide the same after-tax return as Investor B's fund manager.

Over time, tax consequences can become even more significant. See the chart "Effect of Compounding Can Dramatically Increase the Impact of Taxes".

EXHIBIT 1

Effect of Compounding Can Dramatically Increase the Impact of Taxes

	Investor A	Investor B
Type of Fund Management	Manager trades monthly and holds no stocks long-term.	Manager trades only twice during the year and sells only stocks that have been held long-term.
Gains Realized	$1,000 short-term gain on each month's trades; $12,000 in gains by year end.	$6,000 long-term gain on each six-month period's trades; $12,000 in gains by year end.
Tax Bracket	32%	32%
Tax Owned	$3,840 because the gains are short-term (32% x $12,000).	$1,800 because the gains are long-term (15% x $12,000).
After-Tax Return	$8,160	$10,200

Tax-Efficient Strategies

Many strategies are available that can help make a portfolio more tax-efficient. The key is to consider these strategies within the context of other factors that affect investment return as well as the investor's overall goals.

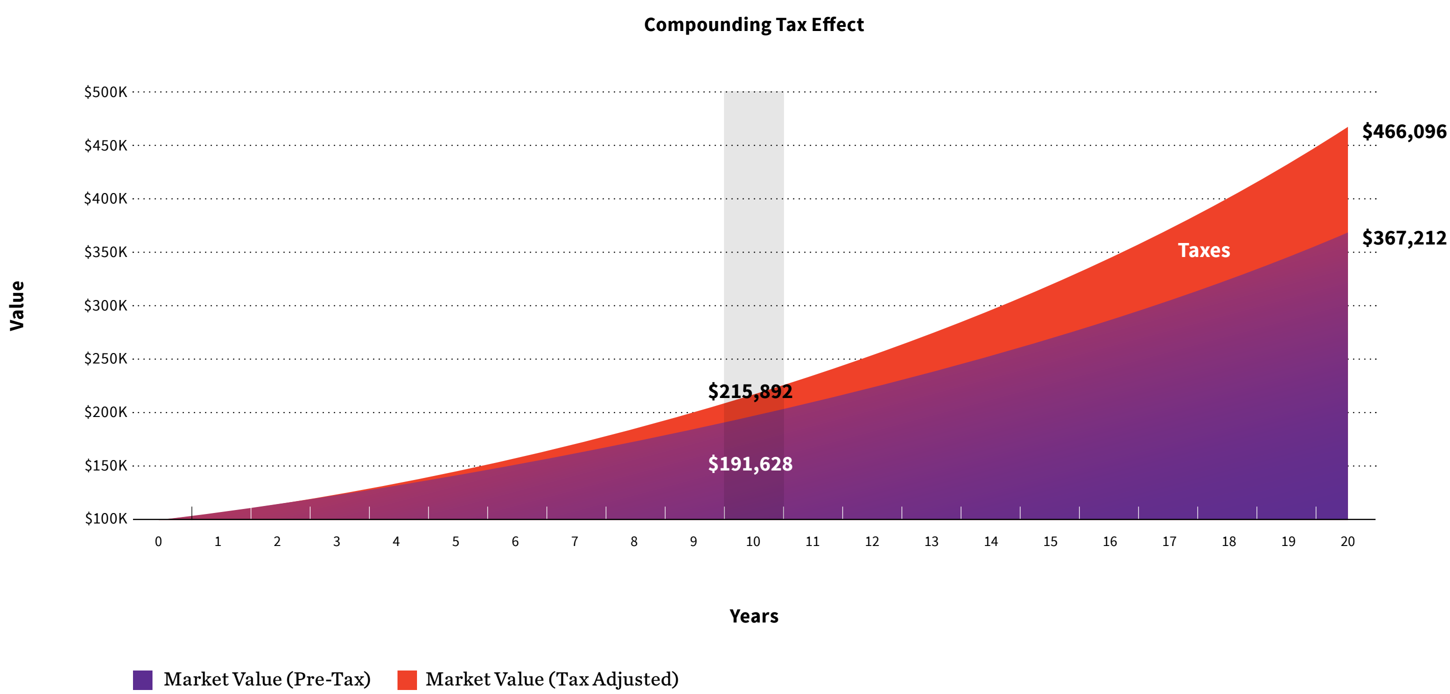
Defer the realization of gains.
As mentioned earlier, a fundamental tax planning tenet is that it is generally better to defer taxes as long as possible, and one way to do this is by deferring the realization of gains. In many circumstances, this strategy can make a portfolio more tax-efficient. For example, by investing in a high-quality growth company at the early part of its growth phase, with the intention of owning the stock for years, not months, turnover is kept low, reducing the frequency of events that trigger capital gains.

One situation in which deferring the realization of gains can be especially beneficial is when it allows the gains to receive long-term gains tax treatment. The current 20% long-term capital gains rate for individuals in the top tax bracket is 17 percentage points lower than the highest

EXHIBIT 2

Effect of Compounding Can Dramatically Increase the Impact of Taxes

An investment of $100,000 at an annualized return of 8% nets $215,892 at the end of 10 years. If the tax efficiency is 84%, the after-tax return is $191,628. The effect is even greater after 20 years: $466,096 vs. $367,212.



ordinary-income rate of 37%. The long-term rate generally applies to investments held for more than 12 months. Holding on to an investment more than one year may help substantially cut taxes on any gain. Even if tax rates rise, future long-term rates will likely be lower than the current year's short-term rate.

Simply deferring gain realization to the next tax year—perhaps a deferral of only weeks or even days—also can be tax-efficient. Consider a situation where an investor has already recognized a net capital gain for the year. One long-term appreciated stock in the investor's portfolio is Company X, and in the fourth quarter it is announced that the company will be acquired by Company Y, a high-quality growth company. Under the merger's terms, Company X's shareholders are given two options: 1) surrender their shares for cash, or 2) swap their shares for Company Y shares.

While taking the cash would be the simpler option, it would add to net capital gain for the year, therefore potentially creating a tax liability. Presuming that the investment manager is comfortable owning the stock of the new company, taking the stock may be the more tax-efficient option. The investor potentially can reap the benefits of owning stock in a high-quality growth company while having the opportunity to sell the stock if desired after Dec. 31, when net capital gains are presumably back to $0. This also may be beneficial if the presumed tax liability is less in the next year than in the current year. Once again, this decision would make sense only if owning the new company is a good investment decision.

A caveat: Although the conventional wisdom is defer, defer, defer, if capital gains tax rates rise in future years, then it may be sensible to take some gains now. This allows the opportunity to pay the tax at the potentially lower rate.

Harvest losses.

Investments that are worth less than cost basis create a loss for tax purposes when sold. Unrealized losses in a portfolio can be "harvested" by selling such investments. Then the losses are used to offset realized gains. The tax benefit of recognizing a loss will depend in part on the netting rules that relate to short-term versus long-term gains and losses. While many investors may harvest losses only in December, this activity can be more valuable if it is done throughout the year through carefully timed selling strategies. Because tax planning often is put off until year end, increased trading often occurs that makes the market more volatile late in the year. At the same time, volume may be lower because of the holidays. Both of these situations can result in pricing dislocation of stocks. By executing loss-harvesting trades throughout the year, these price dislocations can be better avoided.

To help achieve a tax loss with minimal change in the portfolio's asset allocation, the wash sale rule should be kept in mind. It prohibits the recognition of a loss on a security if a substantially identical security is bought within 30 days before or after the security that created the loss is sold. The loss can be recognized only when the replacement security is sold.

There are ways to avoid the wash sale rule while both achieving a tax loss and minimally changing the portfolio's asset allocation. For example, an investor may immediately buy stock of a different company in the same industry or shares in a mutual fund that holds stock much like the stock sold. Or, the investor can wait 31 days to repurchase the same stock. Alternatively, before selling the stock, the investor can purchase an equal number of additional shares of that stock and then wait 31 days to sell the original portion at a loss.

Maintain sensitivity to low-cost-basis holdings.

Highly appreciated investments can generate significant capital gains tax liability when sold. Alternative strategies may be more tax-efficient. For example, donating appreciated publicly traded stock that you've held long-term may result in a charitable income tax deduction equal to the stock's fair market value and avoidance of the capital gains tax that otherwise would have been owed if the stock had been sold.

A donor can take this strategy a step further by using the stock to fund a charitable remainder trust (CRT). For a given term, the CRT pays an amount to the donor annually (some of which may be taxable). At the term's end, the CRT's remaining assets pass to one or more charities. The donor can realize a charitable income tax deduction equal to the present value of the remainder interest that will benefit charity. Because the CRT is a tax-exempt entity, it can sell the stock tax-free and reinvest the proceeds, perhaps in a variety of investments to help diversify the donor's portfolio.

Another option is for the investor to hold on to highly appreciated investments until death. Heirs generally will receive a step-up in basis to the fair market value on the date of the investor's death. (The step-up in basis does not apply when lifetime gifts are made.)

Pay attention to tax lots. When considering the sale of part of a holding in a particular investment, and if shares were bought at different times, it also is important to pay attention to tax lots. Some may have been held long-term and others short-term. Selling lots that have been held long-term can reduce the capital gains tax.

Additionally, the price paid and thus the cost basis may vary from lot to lot. If the sale will generate a gain, selling low-tax-basis shares will generate a larger gain for tax purposes and thus may create more tax liability than selling high-basis shares (depending on the holding period). If the sale will generate a loss, it also may be more tax-efficient to sell high-basis shares, because they will create a larger loss for tax purposes that can be used to offset other gains in the portfolio.

Consider which investments should go in which accounts.

Every investment should be clearly designated as appropriate, or not, for taxable accounts and then managed accordingly. For example, investments to be held long-term, as well as index funds, tax-managed funds and other low-turnover funds, should generally go in taxable accounts.

Investments that likely will create short-term gains—stock likely to be held no more than a year and actively managed funds—should generally be held in tax-deferred accounts, such as 401(k)s or IRAs. Because qualified distributions from Roth accounts are tax free, these accounts may be the most tax-efficient place to put investments expected to produce the highest returns.

EXHIBIT 3

Effect of Compounding Can Dramatically Increase the Impact of Taxes

Long-Term Gain	**Long-Term Gain**	**Long-Term Loss**	**Long-Term Loss**
Netted with short-term gain	Netted with short-term loss	Netted with short-term gain	Netted with short-term loss
The long term gain gets preferential rates of 15% or 20%. The short-term gain is taxed with your other income at your marginal rate.	Two scenarios to consider: **1.** If the gain is bigger than the loss, you have to net the long-term gain and can take advantage of the preferential rates for the net gain. **2.** If the loss is bigger than the gain, it is a net short-term loss, and you can use up to $3,000 of the loss against other types of income and carry forward any amount above the $3,000.	Two scenarios to consider: **1.** If the gain is bigger than the loss, you have a net short-term gain, which is taxed at your marginal rate. **2.** If the loss is bigger than the gain, you have a net long-term loss, and you can use up to $3,000 of the loss against other types of income and carry forward any amount above the $3,000.	If the combined loss is less than $3,000, you can use the entire amount to offset ordinary income. If there is more than $3,000 in losses, you will use the short-term loss first and then carry forward the remainder, maintaining the character of each loss.

Advantages of a Separately Managed Account

When it comes to tax efficiency, a separately managed account can provide significant advantages over a mutual fund or other vehicle (such as a hedge fund):

- The ability to monitor tax lots down to the level of the specific stock or other investment—this provides a greater ability to manage the account tax efficiently.
- Transparency—specific holdings show up on tax reporting forms as opposed to mutual funds, which get listed as a single line item.

A study sponsored by the International Center for Pension Management in Toronto finds that, even among pension funds with access to the world's best money managers, the smallest accounts earn the biggest returns.

Tax Efficiency and Nonequity Investments

While public company stock and stock funds make up a large portion of many investors' portfolios, tax efficiency should be considered with all investments, such as bonds, real estate interests in closely held businesses and even art and collectibles. In many cases, the same tax-efficient strategies that apply to equity investments also apply to these other investments. There are also unique tax-related opportunities and challenges to consider.

For example, municipal bonds are tax-free for federal purposes. Although they usually pay a lower interest rate than other types of bonds, their rate of return may be higher than the after-tax rate of return for a taxable investment, depending on the investor's tax bracket. To compare apples to apples, the tax-equivalent yield, which incorporates tax savings into the municipal bond's yield, must be calculated.

There are other tax differences to consider as well. For instance, long-term gain attributable to certain recapture of prior depreciation on real property is subject to a higher rate of 25%. Long-term gain on art and collectibles is subject to an even higher rate of 28%. Gain on qualified small business stock held more than five years, however, is eligible for capital gain exclusion, ranging from 50% to 100% depending on the acquisition date.

These are just a few examples of tax considerations affecting nonequity investments.

Tax Law Uncertainty Makes Tax Efficiency Even More Important

Whether the current preferred rates on long-term capital gains and qualified dividends are allowed to continue or not, taxes eventually are going higher. A long-term view and a sharp focus on the frictions of investing are critical to the success of an investment program.

EXHIBIT 4

Type of Investment Income

Short-Term Capital Gains	37%
Long-Term Capital Gains	20.0%
Nonqualified Dividends	37%
Qualified Dividends	20.0%

Since 2013, the following tax also applies: Medicare tax of 3.8% on certain types of investment income for those with modified adjusted gross income exceeding $200,000 (single)/$250,000 (married filing jointly).