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Location, Location, Location

Dividing Your Portfolio between Taxable and Tax-Advantaged Accounts

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Overview

Location, location, location—its importance isn't just limited to real estate. Asset allocation and investment selection may be the most important decisions you face as an investor, but tax efficiency isn't far behind. Taking control over the negative effect of income taxes can help boost your returns.[1] This message might not seem so compelling during times of double-digit market gains, but the truth is that taxes matter in all kinds of markets—even in times of lower returns, when the impact on what you actually keep can be felt to an even greater degree.

Given the potential for significant erosion of investment return due to tax inefficiency, the Schwab Center for Investment Research (SCIR) decided to see how investors might solve the problem of income tax drag on returns through the tax-efficient implementation of their investment portfolios between taxable and tax-advantaged accounts. Our research compares different location scenarios within the context of long-term return expectations that are slightly below the historical average, taking account of tax law changes resulting from the Tax Relief Act of 2003 (JGTRRA). This report explains our findings.

Key findings/Action steps

- While the primary focus should remain on a prudent overall asset allocation policy, diversification, and thoughtful security selection, our findings indicate that most investors could obtain additional benefits from holding tax-efficient investments in taxable accounts and less tax-efficient investments in tax-advantaged accounts.

- The placement decision between taxable and tax-advantaged accounts is not as simplistic as "stocks vs. bonds." Instead, investors should focus on the potential tax bite (return lost to taxes) unique to each investment type. For example, the following table illustrates where tax-smart investors might typically place their investments:

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[1] For example, from 1981-2001 high tax bracket investors lost an annual average 2.36% of their investment returns due to taxes. Source: SCIR's *Explaining the After-Tax Performance of Equity Mutual Funds,* August 2003.

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Taxable accounts	Tax-advantaged accounts such as traditional IRAs, 401(k)s, and deferred annuities
Here you'd ideally place …	Here you'd ideally place …
Individual stocks you plan to hold more than one year	Individual stocks you plan to hold one year or less
Tax-managed stock funds, index funds, low-turnover stock funds	Actively managed funds that generate significant short-term capital gains
Stocks or mutual funds that pay qualified dividends	Taxable bond funds, zero-coupons, TIPS, or high-yield bond funds
Municipal bonds	REITs

*Under current law, the qualified dividend rate of 15% or 5% is effective only through December 31, 2008 (5% rate goes to 0% for 2008 only).

First things first

Prudent investors take a top-down, one-portfolio approach in designing their asset allocations, incorporating all their accounts, both taxable and tax-advantaged, into the process. Once the overall portfolio asset allocation policy has been decided upon, the next step of implementation typically involves selecting appropriate stocks, bonds, and mutual funds that fit into the overall strategic plan. Assuming a thorough implementation process that addresses suitability, performance, costs, and other criteria important to the investor, the final decision should address the tax-efficient placement of assets between taxable and tax-advantaged accounts.

It might seem obvious, but this discussion of tax-efficient asset placement presumes a choice. Individuals with 100% of their investments in tax-advantaged accounts, such as their employer 401(k) plans, need only focus on maximizing pre-tax performance for their given level of risk tolerance. But, where discretion over asset allocation implementation between account types exists, investors have the ability to maximize after-tax performance through the efficient placement of assets between accounts. What constitutes an "efficient placement of assets"? Our research helps answer this question.

Base case

In order to test which asset types are best suited for which type of account, we begin with some basic assumptions:

- We looked at two hypothetical investors—Sam and Tishana. Each has a total portfolio of $200,000: $100,000 of which resides in a personal (taxable) brokerage account and $100,000 in a 401(k) account at work. Sam has a 30% combined (federal/state) ordinary marginal income tax bracket, and Tishana has a 40% combined ordinary marginal income tax bracket. (Note: Although ordinary federal brackets are scheduled to rise in 2011 under current law, we'll assume that both Sam and Tishana will have the same combined marginal income tax brackets at the time of account liquidation).

- Both investors seek to maintain an overall portfolio target asset allocation of 50% stocks and 50% bonds.

- For long-term projection purposes, we assume that stocks will return 8% per year (consisting of a 6% appreciation rate and a 2% dividend yield) on average and that bonds will return 5%.

- In taxable accounts, stock returns are subject to current taxation at varying degrees, depending on management style. To illustrate a tax-efficient approach (buy-and-hold of individual stocks, equity index funds, etc.), we

assume the dividend yield of 2% is subject to current taxation and that long-term capital gain tax on the remaining 6% appreciation will be deferred until eventual sale. To illustrate a less tax-efficient active management approach, in addition to the 2% annual dividend yield we'll assume portfolio turnover whereby half of the 6% annual appreciation is subject to current taxation, split evenly between short-term capital gains (1.5%) and long-term capital gains (1.5%). Finally, we'll assume the annual return on bonds of 5% consists entirely of taxable interest coupon, subject to 100% current taxation at ordinary income tax rates.

- Under current tax law, we assume all dividends will be qualified and, along with long-term capital gains, are taxed at a rate of 15% through December 31, 2010. After 2010, when rules revert to pre-2003 tax law, we assume dividends will be taxed at the ordinary rate and long-term capital gains will be taxed at 18% (rate for assets held over five years).

- Future values are shown post-liquidation, net of income taxes assuming complete sale of securities in taxable accounts and complete distribution of balances in tax-advantaged accounts.

- For both investors, "Portfolio A" assumes stocks are placed in taxable accounts and bonds in tax-advantaged accounts, while "Portfolio B" assumes bonds are placed in taxable accounts and stocks in tax-advantaged accounts. Further, for each investor we examine two scenarios for "Portfolio A"—one where tax-efficient stock management is used in taxable accounts and another where less efficient, active stock management is used.

Using these assumptions, we projected the following hypothetical future portfolio values at various intervals for the two types of portfolio structures described below. For both Sam (30% combined marginal bracket) and Tishana (40% combined marginal bracket), the first set of projected values for Portfolio A assumes highly tax-efficient stock investments are used in taxable accounts. The second set of tables in each case projects the hypothetical future values where less tax-efficient, active stock management is used in taxable accounts. The last column in each table represents the advantage or disadvantage of Portfolio A compared to Portfolio B.

Portfolio A = stocks in taxable accounts, bonds in tax-advantaged accounts
Portfolio B = bonds in taxable accounts, stocks in tax-advantaged accounts

Tishana (40% combined marginal bracket)
Using highly tax-efficient stock management in taxable accounts

Years	Total Portfolio A*	Total Portfolio B*	Advantage (Disadvantage) of Portfolio A
5	216,232	204,087	12,145
15	387,030	346,127	40,903
30	975,188	846,486	128,702
40	1,841,668	1,629,675	211,993

Tishana (40% combined marginal bracket)
Using less efficient, active stock management in taxable accounts

Years	Total Portfolio A*	Total Portfolio B*	Advantage (Disadvantage) of Portfolio A
5	213,433	204,087	9,346
15	369,154	346,127	23,027
30	859,745	846,486	13,259
40	1,524,169	1,629,675	(105,506)

Sam (30% combined marginal bracket)
Using highly tax-efficient stock management in taxable accounts

Years	Total Portfolio A*	Total Portfolio B*	Advantage (Disadvantage) of Portfolio A
5	228,995	221,622	7,373
15	413,076	389,587	23,489
30	1,054,731	985,065	69,666
40	2,013,263	1,916,642	96,621

Sam (30% combined marginal bracket)
Using less efficient, active stock management in taxable accounts

Years	Total Portfolio A*	Total Portfolio B*	Advantage (Disadvantage) of Portfolio A
5	227,170	221,622	5,548
15	400,173	389,587	10,586
30	960,750	985,065	(24,315)
40	1,741,905	1,916,642	(174,737)

*All hypothetical future values are shown net of all income taxes, assuming complete sale in taxable accounts and complete distribution in tax-advantaged accounts.

Clearly, the use of tax-efficient stocks in taxable accounts and bonds in tax-advantaged accounts is a winner.…But, it’s not simply a “stock vs. bonds” decision.

Clearly, the use of tax-efficient stocks in taxable accounts and bonds in tax-advantaged accounts is a winner in all time frames, for both the mid-bracket and high-bracket investor. For practical purposes, however, the placement decision is not as simple as a choice between stocks and bonds. The decision, rather, should be based on the relative tax-efficiency of different investment types. Investments that are tax efficient by nature (e.g., investments that have a tendency to keep a higher percentage of their pre-tax return, after taxes) should generally be placed in taxable accounts, when practical. Conversely, investments that generally lose more of their return to taxes should be placed in tax-advantaged accounts. These conclusions are true for both mid- and high-bracket taxpayers, but particularly true for higher bracket investors, where the difference between the ordinary income tax rate and the long-term capital gain rate is larger. Since the amount of return lost to taxes is highest for taxable bonds and active stock management, these investments should generally be placed in tax-advantaged accounts, when possible. Since the return lost to taxes is lowest for buy-and-hold/passive stock management, these investments should generally be placed in taxable accounts. The following table illustrates where tax-smart investors might typically place different investment types:

Taxable accounts	Tax-advantaged accounts such as traditional IRAs, 401(k)s, and deferred annuities
Here you'd ideally place …	Here you'd ideally place …
Individual stocks you plan to hold more than one year	Individual stocks you plan to hold one year or less
Tax-managed stock funds, index funds, low-turnover stock funds	Actively managed funds that generate significant short-term capital gains
Stocks or mutual funds that pay qualified dividends	Taxable bond funds, zero-coupons, TIPS, or high-yield bond funds
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*Under current law, the qualified dividend rate of 15% or 5% is effective only through December 31, 2008 (5% rate goes to 0% for 2008 only).

Note: We specifically did not rebalance the portfolio allocations in our hypothetical examples above, in order to isolate and better illustrate the general long-term impact of efficient asset location. We did run a scenario where the portfolio was rebalanced periodically (at points when stocks reached approximately 55% of the overall allocation). This has the effect of lowering the hypothetical ending values in all cases (along with expected risk) and would also reduce the relative advantage of holding tax-efficient stock investments in taxable accounts. However, such rebalancing simulations did not materially alter the general conclusions. In practice, to the extent such rebalancing could be done within tax-advantaged accounts and/or in conjunction with periodic cash inflows or outflows, the tax impact would be lessened.

Other considerations

In most situations, individuals will likely not have equal amounts in taxable and tax-advantaged accounts and the overall asset allocation will not be so evenly split. Also, in our hypothetical examples we assumed complete liquidation at a single point in time, which is not likely to be the case in practice. Nevertheless, following the general rule of using tax-efficient investments in taxable accounts and less efficient investment types in tax-advantaged accounts, when possible, should add value over time.

There are a number of other factors to consider as well, some qualitative in nature:

- **Active trading** (by individuals or by mutual funds), when successful, tends to be less tax efficient and might seem better suited for tax-advantaged accounts. At the same time, when active trading by individuals generates realized losses they cannot be used to offset realized gains if held in tax-advantaged accounts.

- **Investor behavior** (e.g., lack of long-term discipline) can derail the good intention of holding for the long term. For example, studies of investor behavior have shown the typical investor tends to hold his or her mutual funds for less than what most would consider as long term.[2]

- **A preference for liquidity** might prompt some investors to hold bonds in taxable accounts, even if it makes more sense from a quantitative perspective to hold them in tax-advantaged accounts. In some other situations, it may be impractical to implement all of the portfolio's fixed-income allocation using taxable bonds in tax-advantaged accounts. If so, the after-tax return on taxable bonds should be compared to the tax-exempt return on municipal bonds to see which might make the most sense on an after-tax basis.

[2] One study by Dalbar Inc. found that, as of the year 2000, investors held on to their mutual funds for only 2.6 years on average.

- **Estate planning issues** and philanthropic intent might play a role. Stocks held in taxable accounts receive a step-up in basis at death. Not so for stocks held in tax-advantaged accounts. Additionally, highly appreciated stocks held long-term in taxable accounts might be well suited for charitable giving purposes since a full fair market value deduction could be available with no current taxation.

- **Other preferences or temporary outside restrictions** (e.g., company-specific policies, regulatory and statutory restrictions, etc., which could prevent the sale of certain equity positions) may prevent investors from taking an otherwise more tax-efficient approach for a period of time. In these cases, investors should do their best to work around such constraints until a time when a more optimal strategy could be implemented.

- **The Roth IRA** might be an exception to the general rules of thumb discussed above. Since qualified distributions are tax-free, assets you believe will have the greatest potential for higher return are best placed inside a Roth IRA when possible.

Investors wishing to maximize their potential for long-term wealth accumulation would do well to consider the impact of taxes on their investment performance and act accordingly to structure the most efficient portfolio possible.

Conclusion

In constructing an efficient portfolio, the main focus should be on establishing a prudent overall asset allocation and intelligent security selection designed to meet specific circumstances, needs, and goals. Beyond that, however, a thoughtful tax-efficient implementation between taxable and tax-advantaged accounts could significantly enhance after-tax returns. Investors wishing to maximize their potential for long-term wealth accumulation would do well to consider the impact of taxes on their investment performance and act accordingly to structure the most efficient portfolio possible.

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