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PRICE POINT

September 2017

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THE BENEFITS OF TAX-EFFICIENT INVESTING

KEY POINTS

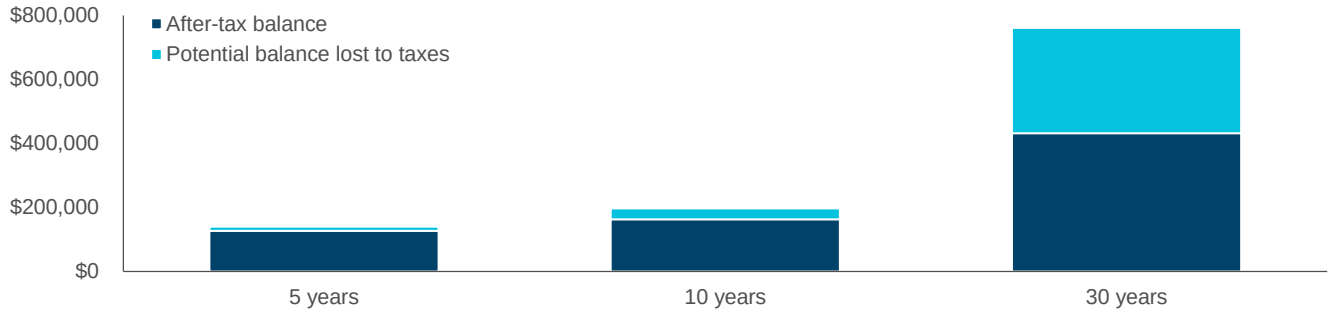
- Approximately 41% of mutual fund assets are held in taxable accounts, yet the overwhelming majority of mutual funds are managed to maximize pretax returns. Research suggests that investors lose approximately 2% each year to taxes in their taxable accounts.
- Because most portfolio managers are compensated based on their pretax performance, they are incentivized to generate the highest possible pretax return in a given year with little attention paid to after-tax returns for mutual fund shareholders.
- Mutual funds are required to distribute their income and capital gains to their shareholders each year, and investors holding mutual funds in taxable accounts are responsible for paying taxes on these distributions.
- Tax-efficient investment management techniques—asset location, long-term focus, security selection, and using losses to offset gains—can help minimize the impact of taxes on taxable assets and maximize after-tax returns for investors.

In 1993, investors Tad Jeffrey and Rob Arnott published “Is Your Alpha Big Enough to Cover Your Taxes?” In this milestone article, the authors’ research suggests that investors lose approximately 2% each year to taxes on their taxable mutual funds. While this may seem like a small price to pay over short time periods, it produces an enormous difference when compounded over longer periods of time. While other authors and pundits have expanded on this theme through the subsequent years, we have seen little substantive change in the behavior of investment professionals in the day-to-day management of the typical stock mutual fund.

Why has this issue failed to gain much traction with professional investors? The simple reality is that most mutual fund portfolio managers are evaluated and compensated based on the *pretax* performance of their portfolios. At the same time, data clearly indicate that a significant portion of mutual fund assets—41% at year-end 2016

Figure 1: The Cost of 2%

Let's consider a hypothetical taxable portfolio that starts with a balance of $100,000 and is invested for 30 years. Each year, the portfolio loses two percentage points of return to taxes. While the portfolio grows to more than $400,000, it could have grown even further—to more than $750,000—without the impact of taxes.



Source: T. Rowe Price.
Assumes a 7% average return, a 2% drag from taxes, and no new contributions.

according to the Investment Company Institute (ICI)—are held in taxable accounts. This article takes a closer look at why and how taxes can affect investor portfolios, as well as some tax-efficient strategies that can help minimize the impact of taxes and maximize after-tax returns in taxable investment portfolios.

TAX FEATURES OF MUTUAL FUNDS

The Internal Revenue Service (IRS) generally requires mutual funds to distribute all of their income and capital gains to their shareholders each year. Investors holding mutual funds in taxable accounts are then responsible for paying taxes on these distributed earnings and gains, whether they receive them in cash or reinvest them in additional fund shares. Taxable distributions from mutual funds typically come in two forms: dividends and capital gains.

- Dividend distributions arise from the interest and dividends earned by the underlying securities held in a mutual fund's portfolio. Investors must report these distributions as dividends for tax purposes, and they are generally taxed at the investor's ordinary income tax rate. Mutual funds distributed $253 billion in dividends to shareholders in 2016, according to ICI.

- Long-term capital gain distributions result from a mutual fund's net gains, if any, from the sale of securities held in its portfolio for more than one year. (Short-term capital gains—profits on a security held for less than one year—are usually taxed as dividends.) When the gains exceed losses, they are distributed to the fund's shareholders and are taxed at a maximum rate of 20%. ICI data shows that mutual funds distributed $220 billion in capital gains to shareholders in 2016.

There are a number of other tax implications for mutual funds and their shareholders. For example, some high-income investors may be subject to an additional 3.8% tax on net investment income on interest, dividends, and capital gains. Investors may also be liable for taxes on any capital gains resulting from the sale of their mutual fund shares, just as they would if they sold an individual stock or bond.

THE IMPACT OF TAX-BLIND INVESTING

A primary reason for the large gap between pretax and after-tax returns is the level of trading activity in a mutual fund. Because portfolio managers typically are compensated based on their pretax performance, they are incentivized to generate the highest possible return in a given year. As a result, they frequently engage in high-turnover trading activity intended to maximize pretax performance with little attention paid to the tax implications for mutual fund shareholders.

However, a simple reference to "turnover" is inadequate for most taxable investors. Instead, turnover should be broken down into recognition of gains and of losses. Recognizing that individual circumstance will vary, loss realization is, on the whole, good for taxable investors. Gain realization typically is a taxable event, and, therefore,

bad for taxable investors. This is because the IRS allows mutual funds to “harvest losses” by using stocks that have lost value to offset the tax liabilities produced by gains realized in other stocks. Because the IRS allows mutual fund managers to carry these losses forward to future years, this advantage holds even in a down market where there may be few, if any, gains to offset.

While taxes should never be the primary focus of your investment decisions or strategy, a tax-efficient investment strategy—considered carefully and implemented thoughtfully—represents an opportunity to maximize after-tax returns.

A TAX-EFFICIENT INVESTMENT APPROACH

Because different investments and accounts receive different tax treatment from the IRS, asset location becomes a critical first step for tax-efficient investors. Investments with high interest income, high dividends, or high turnover, such as real estate investment trusts, taxable bond funds, and high-dividend stocks, are most appropriate for tax-deferred investment accounts, such as those in 401(k) and other defined contribution plans. The reason for this is the tax consequences arising from interest and dividend payments, as well as the frequent trading activity that takes place in most stock mutual funds. A taxable account may be best for individual securities held for a longer time period, tax-advantaged securities, or mutual funds that take a low-turnover, growth-oriented investment approach—an approach typical of tax-efficient strategies.

A tax-efficient investment approach also calls for dramatically lower gain recognition. Our research suggests that gain-producing turnover should be held to 10% or less each year—a level not often found outside of tax-efficient investment strategies. While most pretax-focused investors have a time horizon of 12 months or less, tax-efficient investors must invest for the long term in order to minimize the temptation to shift in and out of individual securities to chase performance or avoid losses.

The focus on long-term investments highlights the importance of security selection in a tax-efficient investment strategy. A company’s ability to grow earnings over time is a particular point of emphasis. While stock dividends can result in tax liabilities for investors, the unrealized growth from price appreciation has no immediate tax consequences for a buy-and-hold investor. Tax-efficient investors frequently seek companies that are early in their life cycle as these companies tend to reinvest profits into additional growth rather than pay dividends. Corporate management teams should also be grounded in proven business concepts typical of more mature companies that would allow them to successfully evolve and compete over a full business cycle.

Tax-efficient security selection also includes tax-loss harvesting. As mentioned above, IRS regulations allow investors to credit any losses realized in a mutual fund portfolio against any realized short-term gains, thus harvesting losses to mitigate the tax implications of portfolio gains. Many investors implement a form of this strategy at the end of a tax year in one major portfolio rearrangement. However, we recommend an approach that spreads tax-loss selling over the course of a full year. This offers a portfolio manager the ability to monitor the market and reverse a decision and still be in compliance with IRS regulations that prohibit realizing a loss on a stock and purchasing a similar stock within a 30-day period.

AN INVESTMENT CHALLENGE—AND AN OPPORTUNITY

It’s been nearly 25 years since Jeffrey and Arnott asked, “Is your alpha big enough to cover your taxes?” The answer, in many cases, is still no. All too often, investors continue to overlook the impact that taxes can have on their taxable investment portfolios. And when taxes are considered, they frequently complicate an already complex task for professional and nonprofessional investors alike. While taxes should never be the primary focus of your investment decisions or strategy, a tax-efficient investment strategy—considered carefully and implemented thoughtfully—represents an opportunity to maximize after-tax returns.

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