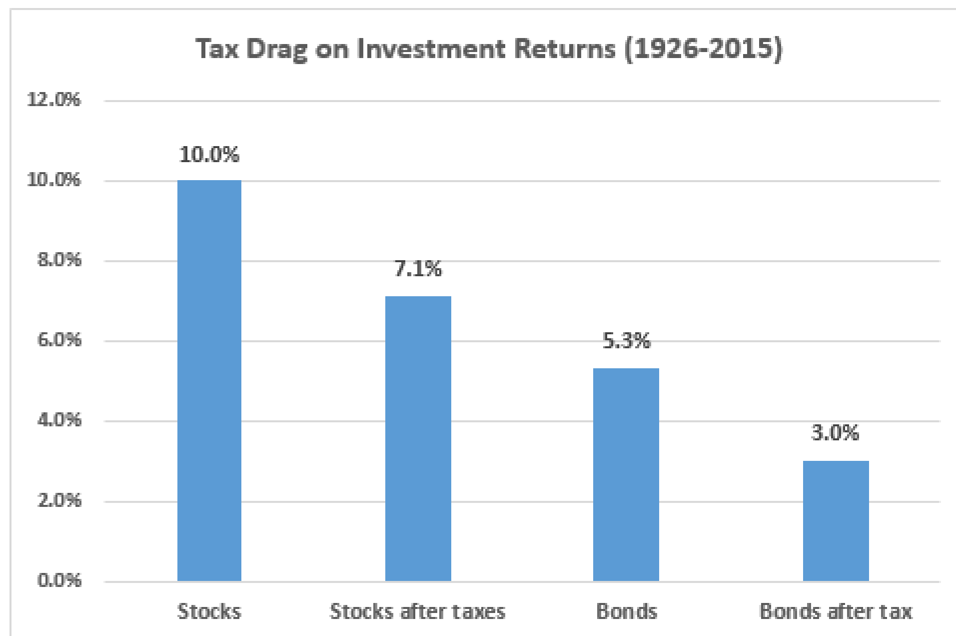
Tax Efficient Investing

The long-term goal of investing is to multiply the eggs in our basket. Most people are very focused on producing more eggs (getting high returns) but pay little attention to the fox that perpetually robs the hen house. If you ignore the fox, soon there will be nothing left to produce more eggs. That fox is taxation.

– Warren Buffett

Over the long term, thoughtful tax management has the power to meaningfully improve investors' after-tax investment returns. For this reason, Harbour Capital Advisors uses various tools to help construct the most tax-efficient portfolios possible. Proper asset location, the use of tax-advantaged investment vehicles, and tax loss harvesting are three of the tax management techniques we employ to enhance our clients' after-tax returns in hopes of reducing the drag that taxes may place on their portfolios.

Here is what's at stake: A recent Merrill Lynch study quantified the tax drag on investment returns, as detailed in the chart below. Using investment return data since 1926, a $10,000 taxable portfolio invested in 50% stocks / 50% bonds would grow to approximately $29,780 over a 20-year time horizon. If allowed to grow tax-free, however, this same portfolio would have grown to ~$51,360 over the equivalent time period – a delta of more than 70%.



Note: 75% of the stock's return is assumed to be taxed at the long term capital gains rate of 23.8% and 25% at the short-term rate of 43.4%. Bonds are assumed to be taxed at the short term rate. These tax rates include the 3.8% health care surtax. Stocks are represented by the S&P 500, bonds by the 10-year U.S. Treasury.

Source: Merrill Lynch, Bloomberg, Robert Shiller and GWIM Chief Investment Office. Annual data as of December 31, 201.

Past performance is no guarantee of future results.

Asset Location

“Asset location” centers around placing income-generating assets (e.g., fixed income or high dividend-paying stocks) in tax-deferred or tax-free accounts, while focusing higher growth, appreciation assets in taxable accounts. This strategy ensures that, to the extent possible or desired, a greater portion of a client’s investment income (taxed at the ordinary income rate) may be deferred until a later date at which time the client may be in a lower tax bracket. Conversely, gains realized from stock sales within a client’s taxable account are taxed at the capital gains rate which is likely to be lower than the ordinary income rate the client pays.

While a number of different factors (e.g. age, risk tolerance, tax bracket) contribute to each investor’s portfolio decisions, studies have shown that asset location can generate 0.7% to 1.0% of a portfolio’s value annually.

Tax Advantaged Assets

Another important strategy utilized to further limit income generated in a taxable account is the use of tax-advantaged assets that reduce the level of taxable income paid to the investor. Municipal bonds, for example, are exempt from Federal tax, and most state and local taxes for in-state investors. While these securities may, from time to time, have lower nominal yields than comparable taxable bonds (e.g. corporate bonds), on an after-tax basis (what an investor ultimately cares about) they often provide superior returns at a given level of risk.

Conversely, pass-through entities such as REITs (Real Estate Investment Trusts) and MLPs (Master Limited Partnerships) are structured in such a way that the income they produce is not taxed at the corporate level, thereby resulting in a higher taxable income stream to the investor. As a tax-advantaged instrument that pumps up the level of income received by the investor, these securities are more appropriate investments for tax-deferred accounts.

Tax Loss Harvesting

Tax loss harvesting is another valuable practice employed in optimizing portfolios for tax efficiency. While many investors place heightened focus on tax loss harvesting toward the end of the year, it is important to have an eye on this strategy whenever market volatility temporarily drives stock prices lower. Specifically, the method of tax loss harvesting allows investors to deliberately realize losses in one security to offset capital gains elsewhere in the portfolio. While the ability to take advantage of the portfolio’s net losses is capped at $3,000 in tax losses per year (any excess losses are carried over to future years), it does enable us to smooth our clients’ tax bill from year to year.

Further, while a client may lock in a loss on a given security, by swiftly replacing it with a substitute security of similar characteristics, the investor may still participate in any future appreciation when the stock recovers.