

Chapter 15

Tax Efficient Investing

For all long-term investors, there is only one objective – maximum total real return after taxes.

John Templeton¹

Uncle Sam wants you...to pay income taxes. But you don't have to pay him right away. In fact, you can legally delay most income taxes on investment gains indefinitely, even after death. The longer you delay paying income tax, the more money you have working for you and the more you will accumulate. A good investment plan always puts heavy emphasis on tax-efficient investing.

How Taxes Affect Market Returns

If you ask someone how much money they made last year, they will likely quote a figure based on their annual salary. This figure may be a fair indication of gross income, but it is not how much they kept. Our silent partners take a large cut. They are the Federal government, most State Governments, and some local governments. Net income is what we keep after paying income tax.

Like your pay, most investment gains are also eventually subject to income tax. Tax is due each year if the income or gain is realized in a personal account, and it is due when funds are withdrawn from tax-sheltered retirement accounts. Uncle Sam will a cut of everything you make one way or another.

In a personal account, the rate you pay on investment gains depends on the nature of the income. Interest, dividends, and short-term capital gains are subject to ordinary income tax at your tax rate. If you have a realized gain on assets held for more than one year, a lower capital gains tax is applied. On a year over year basis, the payment of taxes on investment returns can significantly lower your investment performance.

¹ Excerpts from *The Templeton Touch* by William Proctor, quoted in *Classics*, ed. Charles D. Ellis (Homewood, Ill.: Dow Jones-Erwin, 1989), p. 738

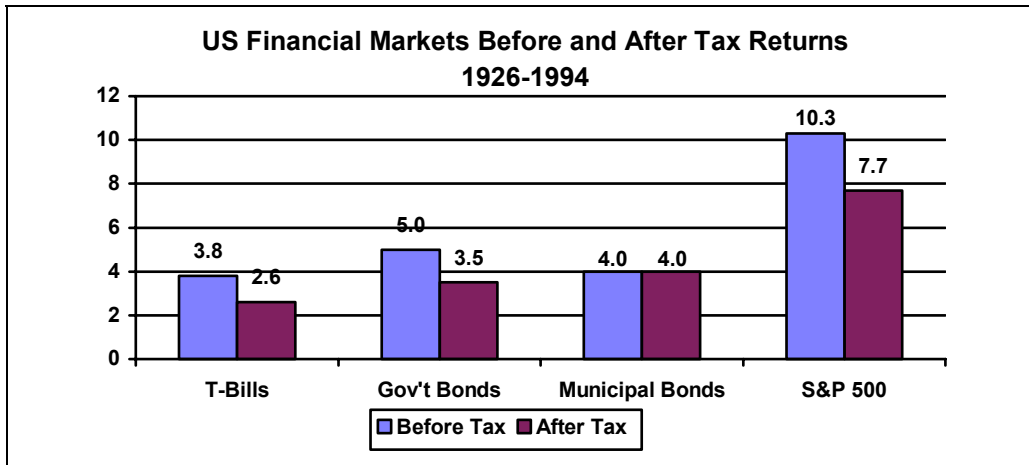


Chart 1, Source: Siegal & Montgomery, *Journal of Portfolio Management*, Winter 1995

There are a few taxes not reflected in the chart above, one of them is the inflation tax. Poor government monetary and fiscal policy creates inflation, which erodes the purchasing power of our dollars earned and cripples the real value of our retirement savings. Although government policy created inflation, Congress does not allow us to recognize it when figuring our taxable income. As a result, we pay tax on investment gain as though no inflation exists. Since 1926, the inflation rate has averaged about 3% and the after tax return on Treasury bills was about 2.6%. But after adjusting for inflation, all the gains from t-bills was lost and then some.

Taxes and Mutual Fund Returns

There are those who make money in the market, and those who keep it.

Benjamin Graham

Taxes can have a devastating effect on mutual fund returns. In Part I of this book, we measured the performance gap of mutual fund investors on a pre-tax basis. If we were to measure the gap on an after-tax basis, it would be much larger. Over a 20-year period, less than 10% of surviving large-cap mutual funds had performed better than the S&P 500 on a pre-tax basis. On an after tax basis, the number drops much lower. Perhaps only one or two funds beat the market. John Bogle, Chairman of the *Vanguard Group*, in a speech during the summer of 1997 stated the problem clearly:

Portfolio managers, fund sponsors, and distributors know that fund [*managers*] don't pay much, if any, attention to tax concerns. This important fact should be stated in the prospectus: "This fund is managed without regard to tax considerations, and, given its expected rate of portfolio turnover, is likely to realize and distribute a high portion of its capital return in the form of capital gains which are

taxable annually, a substantial portion of which is likely to be realized in the form of short-term gains subject to full income tax rates”.

In a 1998 presentation for the Association for Investment Management and Research (AIMR), Bogle compared the returns of actively managed stock funds to index funds on a pre-tax and after tax basis. Bogle used an average turnover rate of 80% for active funds in his example. This was the average turnover for all US equity funds in 1997 as reported by Morningstar. His example assumes a market return of 10%:

Index Funds After-tax Verse Active Funds After-tax

	Gross Return	Expenses	Pre-tax	Taxes	After Fees & Tax
Average Actively Mgd Fund	10%	2.0%	8.0%	1.5%	6.5%
Buy and Hold Index Fund	10%	0.2%	9.8%	0.8%	9.0%

Bogle’s example clearly shows a hidden advantage of index funds. Fees and taxes reduced the return of the average actively managed fund by 3.5%. That is a full 35% of the total gain lost to fees and expenses. On the other hand, index fund returned 9.0% after fees and taxes. Only 10% of the total gain was lost.

The problem of mutual fund taxation can be very shocking to investors. In 1997, some people got caught in the volatile overseas markets. Mutual funds with a high concentration of stocks in Asian economies lost significant value. But that wasn’t the end of the story. Many investors who lost money were also hit with significant capital gains distributions at the end of the year. This means they had to pay taxes even though they lost money on their investment. For example, Investco Asian Growth Fund distributed 21% of its net asset value during December 1997, after losing 38.5% during that year. If an investor put \$10,000 in the fund at the beginning of the year they would have lost \$3,850 by December 31 and they still had to pay tax on a \$1,300 capital gain distribution! Talk about adding insult to injury.

Tax Strategies You can Use

There are a number of strategies you can use to limit the income on investment gains. Here is a partial list:

1. Use tax-sheltered retirement accounts such as an IRA and 401(k)
2. Use tax friendly investments in personal accounts
3. Dollar cost average index funds in personal accounts to establish different tax-lots
4. Stay away from high cost tax shelters such as variable annuities and other packaged products
5. Spend taxable money first in retirement

Tax Sheltered Accounts

The Government wants the public to save for retirement, so Congress has established a number of qualified accounts doing so. If you put money into these accounts each year, you can deduct the amount from taxable income. Investors should participate to the fullest extent in all the tax-sheltered accounts set up by Congress. These include IRA, 401(k), Roth IRA, and similar qualified savings vehicles. They do not include high cost variable annuities and other insurance products. If you own a business or are self-employed, consider opening prototype pension offered through a low cost provider such as Vanguard, Schwab, or other no-load mutual fund company.

Use Tax-friendly Investments in Personal Accounts

The chapter on fixed income investing discussed the advantages of tax-free municipal bonds in a personal account. For most people, municipals make the most money on an after-tax basis.

For the stock portion of your taxable portfolio, the low turnover of a stock index fund is a huge benefit. The dividend and capital gain distribution of the average index fund is about one-fifth the average actively managed stock fund. This means less tax to pay each year. Over the last five years, Vanguard has introduced a number of tax managed index funds. These popular portfolios are even more tax-efficient than a standard S&P 500 index fund. They use a variety of tax-efficient management techniques to ensure distributions are held to a minimum.

Dollar Cost Average into Index Funds and Use Tax-swaps

In a personal account, I recommend buying stock index funds over a period of time, rather than jumping in the market all at once. This concept has nothing to do with the direction of the market, or a market timing strategy. It has to do with establishing different tax-lots for your mutual fund shares. It is very likely that sometime during the year the stock market will trade at a lower value than the price of some of your tax-lots. You could use the opportunity to tax-swap from one index fund to another and establish a permanent tax loss without ever leaving the market.

The IRS does not allow you to do a tax-wash with individual stocks. You cannot sell a stock at a loss, take the tax deduction, and immediately buy the same stock back. You must wait 30 days to buy it back. However, in an index fund tax-swaps are different. Since there are so many index funds offered by different companies, you can swap out of one company's index fund and into another and it is not a tax-wash. For example, assume you sell a tax-lot in the Vanguard Total Stock Market Index Fund and immediately buy the TIAA-CREF Equity Index Fund. Both funds are offered by different mutual fund companies and follow a slightly different index. Therefore, they are not considered "virtually identical" securities and a tax-swap is perfectly legal. Using this strategy, you can take a tax loss while remaining fully invested in the US stock market.

Tax-swaps on municipal bonds are similar to index fund swaps. You can sell one bond at a loss and buy another with the same yield to maturity. Be careful with all tax swaps because the rules are somewhat complex. I recommend consulting your tax accountant before proceeding.

Stay Away from High Cost Tax Shelters such as Limited Partnerships, Variable Annuities, and other Packaged Products

If you like permanent frustration and want to go years without seeing your money, if ever, buy a tax shelter limited partnership. Many high commissioned, low potential tax shelters should only be bought by the very knowledgeable, but are frequently sold to the very naive. I have only heard of a few tax-shelter partnerships that actually worked the way it was supposed to. Congress loves to close loopholes on tax shelters just about the time the public embraces the idea. I highly recommend staying away from limited partnerships with your retirement money.

Do not buy a variable annuity unless it is unavoidable. The insurance aspect of the variable annuity is certainly not worth the price you pay. In fact, it is the most expensive life insurance you will ever own. There are hundreds of thousands of stockbrokers, insurance salespeople, and independent advisors on the prowl selling these high cost products. They are doing it strictly for commission. There are better ways to invest. A stock index fund generates greater wealth in the long-term, and the income tax and estate tax are much lower.

If you already own a variable annuity, do a 1035 transfer to the Vanguard Variable Annuity Plan. They offer a product that has index funds within an annuity, so the fees are much lower than the typical broker sold product. In addition, there is no commission built into the price of the insurance, so the fees are only a fraction of the broker sold products.

Stay away from “investing” in other insurance products as well. This includes Variable Life, Whole Life, and other high cost insurance that disguises itself as an investment. If you need insurance, “buy term and invest the rest” in tax-efficient index funds and municipal bonds.

Spend Taxable Money First in Retirement

When you finally retire, your savings will likely be in two forms, tax-sheltered accounts and personal accounts. The government requires minimum distributions from tax-sheltered accounts once you turn age 70 ½. The minimum distribution is based on your life expectancy. Ordinary income tax is due when the money is distributed.

If you retire prior to age 70 ½, spend your personal savings first. You have already paid tax on this money and will not be taxed again. To the extent you need to liquidate stocks or index funds to meet

current obligations, the tax rate on long-term capital gains is lower than ordinary income tax charged to retirement plan distributions. As a result, in most cases it makes sense to draw down personal savings first before taking a taxable distribution from a retirement account.

The Laws are Always Changing

The tax code is always changing. Congress tinkers with the tax rates and methods of collecting tax almost every year. The investment strategies discussed in this book are flexible and can be easily adapted when changes do occur. It is always wise to stay abreast of tax law changes and to seek the help of a qualified tax accountant.