Making the Most of Your Money

By Susan Carr-Templeton / 07/05/11 RSS feed Like

Why Taxes Matter in an Investment Portfolio

Many investors fear if they hire a manager to invest their portfolios in a tax-efficient manner they will give up more in returns than they would if the accounts were managed for a total return and they paid the corresponding taxes.

On the contrary, that is for the most part not true. Taxes matter--and matter a lot!

Investors frequently underestimate the impact of taxes on investment returns. So they ignore the effect of short-term capital gains taxes until they have to pay them.

Deferring a gain from short-term to long-term makes a big difference in taxes. Assume you have a $2,500 gain on a $10,000 investment. If this gain is short-term (less than a year) you will pay $1,000 in federal taxes (top tax bracket). But if you wait just one year and one day to sell, then you only pay $500. That is a 20 percent after-tax return versus a 15 percent after-tax return--just for waiting.

An advisor taking extra steps and effort to manage a portfolio in a tax-efficient manner often goes unrecognized. Managing a portfolio in this way does take extra work as one needs to take into account many other considerations.

Here are a few suggestions for you and your advisor to consider:

• Put your high turnover (buying and selling in less than a year) investments in your tax-exempt accounts and leave your taxable account for your long-term buy-and-hold investments.

• Investing in mutual funds, depending on the fund, may or may not be tax-efficient. Federal law requires mutual funds to distribute all of their realized short-and long-term capital gains each year and prohibits funds from distributing losses, which stay in the funds until offset by future gains. So when a fund makes a distribution, the shareholders become liable for the tax. The best way to find out about mutual funds' tax sensitivity is to read the funds annual report, which provides historical long term, short term and dividend income. A much easier way is to look at a Morningstar mutual fund report, which will even show the after-tax returns of that particular fund.Morningstar data shows that, over the past decade, U.S. investors in equity funds have seen their returns reduced by 2.5 percent annually due to taxes. On a $10,000 investment over 10 years, a portfolio would have given up $3,487 in returns due to taxes alone.

• Adjust your tax lot valuations to give you the lowest gain. If you have bought a security or a fund over time, you probably have a different cost that you paid for each purchase. When selling a portion of your holdings, you can indicate to your custodian which cost basis you want to use. The choices are LIFO (last in- first out), FIFO (first in –first out), highest cost or lowest cost. Be sure you take advantage of that flexibility.

• ETFs, or exchange-traded funds, are generally tax-efficient as their managers primarily use a buy-and-hold strategy. However, corporate actions, such as takeovers and rebalancing, will have some impact, typically small. One of the advantages of index-based ETFs is their potential for tax efficiency. An index manager does not make bets on specific stocks, so there is no driver to buy and sell stocks unless the index changes. By maintaining a lower turnover of securities in the fund portfolio, the manager keeps capital gains realizations to a minimum. As more ETFs are coming to market,many have different investment strategies, so investors need to understand the tax implications before investing.

• Typically, the fall season is a good time to take stock of your portfolio's tax situation. If you have incurred some sizeable short-term gains, you might look to sell a few of your losers to minimize the tax burden.

A little tax planning will be well worth the bonus come April 15.

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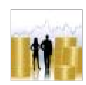

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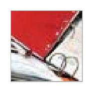

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