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Investment Strategy Considerations in a Rising Tax Environment

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Synopsis

Sound investment strategy typically starts with a foundation in asset allocation. Technology has allowed novices and professionals alike to build allocations quite easily using assumptions about the future. We find that these assumptions, developed in a pre-tax world, are rarely adjusted for the real world, which is impacted by taxes. By adjusting the assumptions to consider taxes, an investor may construct superior portfolios leading to greater wealth potential.

After considering both pre-tax and after-tax portfolio construction, investors may reach a point of "tax equilibrium."[1] This is a state wherein an investor is in balance between tax considerations and other factors; where he or she neither overreacts nor underreacts to the impact of taxes in portfolio construction and maintenance.

Investors' tax equilibriums should change when the tax environment changes. In 2003, we saw ordinary rates lowered from 38.6% to 35% and capital gain rates lowered from 20% to 15%. As legislated, these rates "sunset" December 31, 2010, and move back to the prior rates.

Often forgotten in the tax discussion is the impact of estate taxes. For the average American, this is appropriate. However, for higher-net-worth families, the estate tax must be considered along with income taxes if the goal is to maximize wealth for future generations.

The purpose of this paper is to review the impact of income taxes on portfolio construction; consider how a rising income tax rate environment may affect investment strategy; and identify how portfolios should be adjusted further for the impact of estate taxes. This paper is written to high-net-worth individuals and their advisors.

Critical Observations

1. Taxes take a significant toll on a portfolio's investment returns.
2. Adjusting asset allocation modeling assumptions for taxes can result in greater wealth.
3. Investors must understand the concept of "tax equilibrium," a point at which one balances tax considerations and other economic factors relative to decisions about their portfolio.
4. Investors should reconsider the cost of taxes on their portfolio in anticipation of a rising tax environment.
5. Estate taxes can be an even more important consideration than income taxes if the goal is to maximize wealth for future generations.

Asset Allocation: Theory and Important Assumptions

Asset allocation is the way in which an investor weights diverse investments such as cash, bonds, stocks, and other investments. To determine the mix of these investments, computer-driven mean-variance optimizers are used. Optimizers need only three simple assumptions per asset class – return, risk as measured by standard deviation, and correlation. What results is an efficient mix of portfolios that theoretically achieves the highest return for a given level of risk.

In practice, optimizers can create imprudent portfolios unless constrained because the algorithm is very sensitive to the three inputs above. While the three inputs themselves are conceptually easy to understand, achieving an accurate forecast becomes a major challenge. Therefore, the application of optimizers is under constant debate.

Our paper assumes an appropriate approach has been taken in both the derivation of the assumptions and application of the resulting portfolios. The assumptions that we cite in Tables A and B are not a forecast of the future. These are assumptions we believe to be reasonable in nature based on our experience, to facilitate this example. Results and conclusions can vary depending on assumptions.

Shifting Mindsets to an After-Tax World

In 1986, a study by Gary Brinson, Randolph Hood, and Gilbert Beebower (BHB) solidified asset allocation as the building block of portfolio construction. In its most simplistic terms, asset allocation is the mix of cash, bonds, stocks and other investments. Given today's technology, it is easy for the novice to the professional to use these models to construct "optimal allocations," or those that maximize returns for a given level of risk.

It is important to note that the two main research papers that much of asset allocation theory is based upon did not consider taxes.[2] Even today, investment research and products are focused on the large institutions and pension funds that pay no tax. Therefore, it should be no surprise that the models created to construct asset allocations rarely contemplate taxes. Since high-net-worth individuals do pay tax, we believe by adjusting the assumptions in these models to consider taxes, an investor may construct superior portfolios leading to greater wealth accumulation.

To illustrate this point, let us discuss Mr. Jones, a hypothetical investor with a $50 million portfolio. Mr. Jones calls and states, "I continue to hear about how large endowment funds like Harvard's have sizeable allocations, 35% to 40%, to hedge funds. Should my hedge fund allocation be this large as well?"

A response to Mr. Jones might sound something like this: "Having some amount of hedge fund exposure could be appropriate. However, it is important to recognize that these returns are less tax-efficient to you than to Harvard."

To understand this, we need to make some assumptions. All hedge funds are not created equal. Therefore, let's assume the modeled pre-tax returns of aggressive and conservative hedge funds approximate the returns of a portfolio split 50% to equities and 50% to fixed income. This portfolio, referred to as "50/50," is illustrated in Table A and compared to a 100% hedge fund portfolio.

TABLE A:

Asset Allocation Model: Pre-Tax Assumptions

	50/50	Hedge Fund	Difference
Large Cap Core	25	0	
Small Cap Core	10	0	
International Equity	15	0	
Taxable Bonds	50	0	
Hedge Funds	0	100	
Modeled Return	7.17%	7.50%	-0.33%

Note that the hedge fund portfolio has a slight return edge, pre-tax, of 33 bps. Unlike Harvard, however, Mr. Jones pays income taxes. It is important, therefore, that we adjust the model's *assumptions* for each of these asset classes to account for that. As background, we think of asset classes being either tax-efficient or tax-inefficient. Some examples of tax-efficient asset classes would be stocks and private equity. Why are these efficient? Their returns come in the form of capital appreciation or dividend income, which is taxed at 15%. To the extent the capital appreciation is not realized, this gain is deferred into the future, creating further benefit. Municipal bond returns are also efficient as they may escape federal tax altogether. Contrast this with an inefficient return such as that of the hedge fund. The vast majority of the return of a hedge fund is ordinary income or short-term gain in nature and, therefore, taxed at 35%.

When you adjust allocation models for income taxes, they yield different results as shown in Table B. Our model's change is now 111 bps in favor of the 50/50 portfolio. Assuming Mr. Jones decreases his hedge fund allocation by 20% because he is now "tax aware," we have helped him improve his after-tax return by 22 bps (20% x 111 bps).

TABLE B:

Asset Allocation Model: Post-Tax Assumptions

	50/50	Hedge Fund	Difference
Large Cap Core	25	0	
Small Cap Core	10	0	
International Equity	15	0	
Taxable Bonds	50	0	
Hedge Funds	0	100	
Modeled Return	5.99%	4.88%	1.11%

Assuming Mr. Jones has a $50 million portfolio, that improvement creates $110,000 annually. By adjusting the assumptions to consider taxes, Mr. Jones has constructed a superior portfolio leading to greater wealth.

Of course, Mr. Jones must also consider the resulting risk of the portfolio. Depending on risk assumptions, the higher return may or may not come at a price. Risk in allocation models is traditionally measured by standard deviation, or variability in return. Since risk is defined as a function of return, it is worth noting that the less efficient a return, the lower its after-tax risk. In other words, while the government may get a larger percentage of the profits on inefficient returns, they also share a greater percentage of the loss with the investor.

While hedge funds were the focus of Mr. Jones, inefficient investments include anything where the primary return component is taxed as ordinary income. Other examples include REITs (as their dividends are not considered "qualified" dividends) and high-yield bonds. The bottom line: when using allocation models, shifting one's mindset from gross returns to after-tax returns should yield superior portfolios and more wealth.

Shifting Locations to Achieve Higher Returns

Generally, one way to have your tax-inefficient "cake and eat it too" would be to find structures in which investors can place ordinary income producing assets to have that income shielded. These structures may include IRAs or 401(k) plans. As an example, Mr. Jones may have a $5 million IRA in his $50 million portfolio. He may want to consider purchasing some of his hedge funds or high-yield taxable bonds inside his IRA, which would defer current taxation until distributions are taken. Since distributions would be ordinary in nature anyway, Mr. Jones is no worse off from a tax standpoint and has achieved a higher return by allowing a higher-returning asset to compound in the IRA. Note that when hedge funds are purchased inside an IRA, a special tax issue called "unrelated business taxable income" (UBTI) must be considered.

Another example of shifting location to achieve a higher return can arise when an intentionally defective grantor trust (IDGT) is involved and the children are the beneficiaries. An IDGT is a grantor trust with a purposeful flaw that causes the grantor to continue to pay the income taxes even though these trusts can be structured so that the assets are not in the grantor's estate.

Let us assume Mr. Jones set up an IDGT years ago for the benefit of his children and it is now valued at $10 million. (In this example, we are ignoring the gift tax issues that would have been considered when these trusts were formed.) In addition, his three children have portfolios of $5 million each. Mr. Jones is working with an investment advisor to manage the IDGT and his children's portfolio. They appropriately decide to view the total $25 million pool as a whole with a single asset allocation. To the extent that there will be inefficient asset classes included in the allocation (hedge funds, REITs, high-yield, etc.), they fill up the IDGT with these investments first. Why? If the children invest in them, they pay the tax with dollars out of their estate. However, if the IDGT holds the assets, Mr. Jones pays the tax.

Given that he has an estate tax problem and his children will most likely inherit only roughly half of his net estate (to simplify we assume a 50% estate tax rate), his dollars should be viewed like half dollars. Therefore, if the trust yields a 10% return ($1 million) that was subject to the 35% rate, Mr. Jones pays $350,000. To the family, however, the ultimate economic impact is approximately half that. Standing back for a second, we observe Mr. Jones has improved his portfolio by both focusing on after-tax returns and paying attention to asset location. With these two mind shifts, Mr. Jones may now have achieved his tax equilibrium.

Finding Tax Equilibrium

As advisors, we should never lose sight that it is the overall net investment return that ultimately matters and focusing solely on tax reduction could cause investors to miss potential investment opportunities. Taxes are just one key factor, but they should not drive investment decisions without at least equal attention given to investment returns and other broad considerations, such as investment objectives, risk tolerance, and income needs. At some point, an investor reaches his or her tax equilibrium, which is a state where there is balance between tax considerations and other factors. In other words, the investor is neither overreacting to the cost of

The Importance of a Family Mission on Asset Allocation Choices

Before doing anything, including a preliminary asset allocation, an advisor for an affluent family should take a step back and examine the family's mission for their assets. What are they trying to accomplish in or through their investments? Is their primary goal to maximize cash flow? Is it ultimately to spend down all money or to leave a large legacy to their children, to charitable groups, or to both? These are highly personal decisions but they may be influenced by such factors as the size or scope of their assets, and/or the ages of their children. These decisions may also ultimately affect one's tax equilibrium.

TABLE C:[3]

Historical Maximum Tax Rate on Ordinary Income

Tax year	Top marginal tax rate (percentage)
1954-63	91.00
1964-67	70.00-77.00
1968	75.25
1969	77.00
1970	71.75
1971-81	70.00
1982-86	50.00
1987	38.50
1988-90	28.00
1991-92	31.00
1993-2000	39.60
2001	39.10
2002	38.60
2003-10	35.00

TABLE D:[4]

Historical Maximum Tax Rate on Long-Term Capital Gains Income

Tax year	Top marginal tax rate (percentage)
1954-67	25.00
1968	26.90
1969	27.50
1970	30.20
1971	32.50
1972-77	35.00
1978	33.80
1979-80	28.00
1981-86	20.00
1987-96	28.00
1997-2002	20.00
2003-10	15.00

taxes nor ignoring them. Since everyone's situation is different and their concerns vary around a range of factors including risk, taxes, expenses, and overall investment goals, each investor's point of tax equilibrium is uniquely their own and depends heavily on their family's mission for their assets.

Investors' tax equilibriums can and do change, though, when the tax or business environment changes. We believe the winds of change are blowing. As you can see from Tables C and D, ordinary rates are currently 35% and capital gain rates are 15%. As legislated, these rates "sunset" December 31, 2010, and return to the 2002 levels.

It is helpful to understand that by any measure, relative to historical tax rates, today's marginal rates are low. Why is this important? Given that a natural tax increase is already legislated *and factored into the budget*, it underscores the probability that taxes will rise in the coming years.

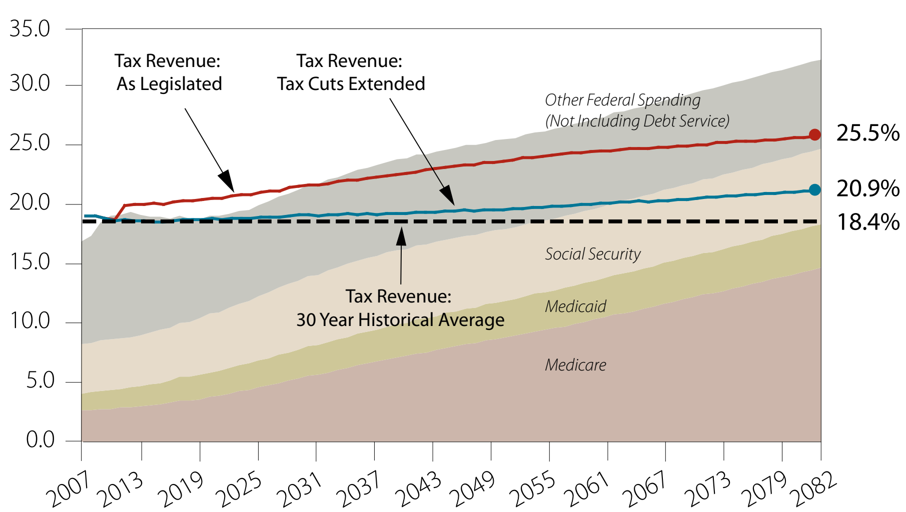
After all, Congress would have to take proactive steps to change the law to prevent this. We feel this is unlikely. For starters, the hundreds of billions of dollars committed to economic rescue and stimulus programs will make this challenging. In addition, the unfunded liabilities of Medicare, Medicaid, and Social Security may make the rescue package look like an after-thought. Using the Congressional Budget Office's own figures (shown in Graph A), these three programs may absorb 100% of tax revenues before the end of this century if left unchanged. Given these and other factors, we believe taxes will rise.

Investment Strategy Considerations in a Rising Tax Environment

Returning to our example, it is natural to expect Mr. Jones to ask how the probable increase in tax rates might impact his portfolio. When we modeled a "sunset" 2011 tax environment, we observed some interesting results.

GRAPH A:

Tax Increases Needed to Absorb Planned Programs



Data source: Congressional Budget Office Long-Term Forecast, December 2007 and The Heritage Foundation

Six Tax-Smart Strategies You Should Consider

1. **Buy and hold.** This avoids the tax drag and transaction costs when you sell an asset. If you can hold onto your stock until you die, you will also have succeeded in completely avoiding most income taxes on investments. For the best tax results, use non-dividend-producing stock so that you do not have to pay toll charges along the way. But this does not apply if you die in 2010 as the step-up basis rule is revoked for that one year. Normally, the tax-basis of stock is stepped up to its value when the owner dies. If the stock is then sold, there would be no capital gain tax.
2. **Tax-loss harvesting.** Any time that you have a taxable gain, consider harvesting a tax loss to offset taxes on the gain. This does not mean you should automatically do it, rather consider it. If you sell stock for this reason, with the intention of maintaining exposure, be aware of the "wash sale" rule, which stipulates that you cannot buy back the same stock within 30 days. One way to avoid that is to use the sale's proceeds to buy stock in a similar company and then buy back the original stock after a month passes – that is, if you still desire it as an investment. You should also consider using indexes to maintain your market exposure for 30 days.
3. **Tax-lot selling.** Deciding which lot of stocks to sell first can make a substantial impact on taxes. Sell high-basis stock shares first to minimize the realization of capital gains.

(continued)

The after-tax impact of moving from a 35% tax to a 38.6% tax reduces the return of the 50/50 portfolio by 6.4%. The hedge fund portfolio is less affected, and is reduced by only 5.5% What is happening? Observe that a change from 35% to 38.6% is only about a 10% change. However, when you observe a change in the long-term rate of 15% to 20%, this is a 33% change. The dividend rate is even worse as a change from 15% to 38.6% represents a 157% increase. Although the dividend return is just a small component of the total stock return, you can see how efficient assets like equities (and the 50/50 portfolio) will be impacted at a greater level.

Based on these and other observations, Mr. Jones will see that in a rising tax environment:

1. His inefficient asset classes (hedge funds, REITs, high-yield, etc.) will be more attractive on a relative basis compared to efficient assets.
2. His efficient asset classes (stocks, private equity) will become less attractive on a relative basis compared to inefficient assets.
3. High dividend paying stocks (value and preferred stocks) will become less attractive on a relative basis compared to lower or non-dividend paying growth stocks. For example, Stock A is a value stock assumed to return 10% (3% through dividend and 7% through capital appreciation). Stock B is a growth stock assumed to return 10% all through capital appreciation. Under current law, the after-tax return of both stocks would be approximately the same assuming a holding period of one year and a day. However, under 2011 law, the after-tax return would be 7.4% for Stock A versus 8% Stock B.

Given the first two observations, Mr. Jones may actually decrease his allocation to efficient asset classes as the after-tax benefits of them are lessened. Given the third observation, Mr. Jones should revisit the balance of value and growth stocks in his portfolio. In 2003, some investors deliberately sought out value stocks due to the tax benefit. If this law reverses, those same investors may reverse their strategy, putting downward pricing pressure on value securities. Lastly, the after-tax returns of his bond portfolio need to be reconsidered depending how market yields adjust.

If Mr. Jones owns assets with large capital gains and he does not plan to die with them (receiving the step-up in basis), he should consider the pros and cons of selling them now. For example, let us assume Mrs. James (his sister) owns a highly concentrated $50 million position in zero-basis stock. She wants to diversify this holding in the next few years to reduce her risk, but has been reluctant to do so because of the high dividend of 3.5%. This dividend yielded approximately $1,500,000 annually after federal tax. Looking forward to a 2011 rate environment where the dividend tax rate is now 38.6%, her dividend will pay her around $1,075,000 after federal tax. With nothing but the dividend tax rate changing, Mrs. James suddenly would be earning about two-thirds of her previous after-tax yield.

(Tax-Smart Strategies continued from previous page)

4. **Rebalance with new money.** Rebalancing your portfolio is an important part of maintaining your desired asset allocation. Unfortunately, this can create a taxable event. If possible, use new cash to add to underweight targets.
5. **Keep the AMT and its implications in mind.** The alternative minimum tax acts like an entirely separate tax code. It disallows a number of fairly common deductions, including personal exemptions for dependent children, real estate taxes, and state and local income taxes. Long before filing your annual income taxes, it can be helpful to conduct a rough run-through, first without the AMT, and then using the AMT. Consider the options and which, if any, financial transactions would help you arrive at the most favorable tax scenario. Interestingly, those in the highest tax bracket may benefit from paying the AMT because it involves a lower maximum tax rate (28%) than the highest federal income tax rate (currently 35%).
6. **Use appreciated stock to make charitable gifts.** Rather than making cash gifts, you should consider making gifts to charity using appreciated stock from your portfolio. This will reduce the unrealized gains in your portfolio and reduce future tax liability. The cash that was to be used for making the gift can be used to "reimburse" your portfolio, which will also allow you the opportunity to rebalance.

Mrs. James could consider selling the stock now even though she will pay a significant tax on the sale. By selling the stock now, she would save $2.5 million versus a sale at the 20% tax rate in the future. Assume that Mrs. James' goal after the sale is simply to generate an attractive after-tax yield and to protect the principal. One alternative for her would be to invest the net $42,500,000 proceeds in a diversified municipal bond portfolio generating 3.5% in tax-free income which would provide annual cash flow of approximately $1,500,000. For a tax cost of $7.5 million, Mrs. James retained her after-tax annual income and has less portfolio risk.[5]

Tax Environment Under President Obama

While we modeled an "as legislated" environment above, it is important to think about how President Obama's policies will impact our conclusions and how he might change one's tax equilibrium.

Overreacting or underreacting to possible changes to the tax laws will cause an investor to lose his or her tax equilibrium. Investors must have a view of the future that carefully balances multiple factors so as to not destroy their tax equilibrium. We offer our view of the future with the knowledge that the global recession and response by governments across the globe change everything.

We believe that there will be major tax legislation early in Obama's presidency. Just a few months ago it seemed all but certain that the 15% capital gains rate would be history in 2009. It now appears that Obama and the Democratic Congress may leave all of the tax rates for individuals unchanged until their natural demise at the end of 2010. It also appears that there could be tax cuts for small businesses and possibly for wealthy investors.

Regardless of the long-term capital gains rate, many of our clients have already realized enough long-term capital losses in the year 2008 that could be carried over into 2009 (for some even 2010) to offset potential future capital gains. These taxpayers must adjust their thinking through a rebalance of their tax equilibrium, as capital gains up to their capital loss carryovers are effectively tax-free. For taxpayers who did not harvest excess capital losses last year, there is still time to harvest their unrealized losses this year before their positions, one hopes, rebound.

How to Give the Government Back Your Income Tax Savings

If the goal is to leave wealth to children or other heirs, then consideration of the estate tax is a fundamental component of one's tax thinking and achievement of tax equilibrium. It should also impact after-tax asset allocation considerations. If one plans to spend all of one's money in his or her lifetime or plans to leave it to charity, then this section may not be relevant.

Today the estate tax exemption is $2,000,000 and it will rise to $3,500,000 this year, with a tax rate of 45% on assets above the exemption. In 2010, there will be no estate tax and in 2011 the law reverts to the period prior to the Economic Growth and Tax Relief Reconciliation Act of 2001 that provided an estate tax exemption of $1,000,000 and a maximum estate tax rate of 55%. Worth noting, www.barackobama.com outlines a $3,500,000 exemption and a 45% rate.

We do not think that the law will revert back to the old rate and exemption, as both political parties seem to want to end this debate. Thus, we believe that the estate tax law will be rewritten. The exemption will likely range between $3,500,000 and $5,000,000, and possibly be indexed to inflation. The top estate tax rates could range between 15% and 45%. On the issue of returning to a unified gift and estate exemptions our crystal ball is hopeful, but cloudy. In any event, we are advising clients to simply assume that there will be an estate tax in 2010 and beyond.

If Mr. Jones wants to leave his money to his children, estate taxes should impact his tax equilibrium and resulting asset allocation. Why? For Mr. Jones, his $50 million estate could be worth only $23 million to his children based on actual 2011 estate tax rates. To incorporate estate taxes into his tax equilibrium, we first have to understand his wealth goals, which we simplified as follows: a) spend all his money, b) leave it to charity, or c) leave the money for future generations.

Let us assume the answer is a combination of "b" and "c," but Mr. Jones is still a big spender. Furthermore, before Mr. Jones realized there was an estate tax he had planned to leave $10 million to each of his three children, with the remaining $20 million going to charity. Recall that his three children already have $5 million portfolios each, and there is an IDGT for their benefit with $10 million. Previously we suggested viewing the total $25 million pool (the children plus the IDGT) as a whole with a single asset allocation placing the inefficient assets in the IDGT.

In this situation, Mr. Jones may wish to broaden his view of his asset allocation and investment selection to look at the entire family (and $75 million) as one global unit. Mr. Jones' allocation could be very conservative with a municipal bond portfolio providing more than adequate current income, while preserving the bulk of his estate to meet his charitable and family gifting goals. Meanwhile, the children and the IDGT could invest for growth as their assets are outside the estate. The IDGT would still contain the least efficient asset classes so that Mr. Jones bears the brunt of the taxes. Approaching allocation in this way could drive millions of dollars in additional value to his heirs. In other words, Mr. Jones should integrate his investment, tax, wealth transfer, charity, and lifestyle plans into one family strategy.

The Conclusion

Investors should be thinking about the cost of taxes on their portfolios and considering the impact of a rising tax environment. Investors should strive to achieve tax equilibrium, which strikes a balance between tax considerations and other economic factors. The most successful investors will coordinate their investment, tax, wealth transfer, charity, and lifestyle plans into one integrated family strategy.

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[1] The term "tax equilibrium" is a proprietary concept developed by Mark J. Blumenthal, CPA to educate and inform clients as well as tax and investment consultants.

[2] BHB's research from 1986 and Markowitz's 1952 modern portfolio theory.

[3] Congressional Research Service Report for Congress, April 4, 2003.

[4] Congressional Research Service Report for Congress, April 4, 2003, updated by Blackman Kallick, May 2006.

[5] The economic risk from lack of diversification of a single stock position that represents the majority of an investor's wealth is a serious risk. There are many investment models that would incorporate the low 15% capital gain tax rate from a sale today and could model the risk and probable returns of future diversified asset class portfolios.

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