



Tax-Efficient Asset Allocation and Location Decisions

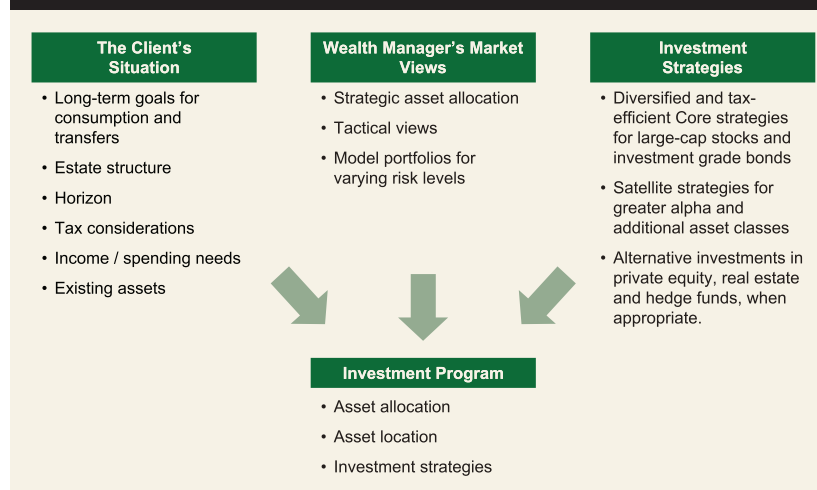
By Don Mulvihill

A wealth manager makes investment decisions based on each client's individual goals, situation, and preferences. This customization is important if the wealth manager wants to appropriately serve each investor, but the customization should not descend into chaos; it is best to maintain consistent market views across all clients' portfolios. Differences in holdings from one investor to the next should reflect differences in the investors, not inconsistent market views.

In this article, I discuss how to develop customized investment programs that integrate investors' specifics with the manager's consistent views on markets and asset allocation. This allows for a more robust value proposition, shifting investment management from the centerpiece of the relationship to a tool that helps the wealth manager to pursue after-tax income, growth, and wealth-transfer goals. I distinguish between an *investment advisor* and a *wealth manager*. The latter is an investment advisor who takes a more expansive view of the client relationship. A wealth manager views various investment strategies as part of the toolbox and understands that "the value add" is in organizing and implementing a best-fit package of investment strategies. This is particularly important for wealthier investors, especially those with estate structures that go beyond a simple will and a retirement account.

Investment advisors often use a model-based investment process. Clients are placed in models based on their risk preferences. Since no one can describe risk preference with any precision, it seems odd that such a soft variable is such an important input. The

FIGURE 1: WEALTH MANAGEMENT PROCESS



focus on risk comes from the use of an efficient-frontier approach to asset allocation. But the inputs to the efficient-frontier calculation have nothing to do with the investor; they consist only of expectations regarding the return and volatility of various asset classes, as well as the expected correlation among the returns. These yield an efficient frontier that plots the trade-off between portfolio risk and expected return. For each level of portfolio risk, some asset allocation potentially offers the highest expected return. Once an investment advisor identifies an investor's risk tolerance, it is easy to identify the ideal asset allocation.

The efficient-frontier approach is intellectually sound, but it assumes that the goal is to maximize risk-adjusted pre-tax return. This is a reasonable assumption for a tax-exempt investor but not for a taxable investor. I propose a different process that captures the insights of modern portfolio theory but accommodates investor-specific considerations. Begin with a thorough

understanding of each client's situation. Incorporate an asset allocation model that reflects both strategic and tactical views. Finally, develop a set of investment strategies that can be used to implement the asset allocation decision. This process is captured in figure 1.

Develop a Thorough Understanding of the Investor's Situation

I often ask new clients to consider the following statement and to expand upon it to describe their situation:

Subject to funding our/my consumption needs, please maximize the risk-adjusted real value of wealth that will be received, net of income and transfer taxes, by my intended heirs and charitable beneficiaries.

The ensuing discussion can help to identify many important aspects of the investor's situation and goals. Here are a number of key points to consider.

Where is the money going? Is it likely to be consumed in retirement or pass to heirs and charities?



When is the money moving?

How many years until retirement? Will transfers take place at death? If so, what is the investor's life expectancy? Will some transfers take place sooner?

Through what will the money pass? What is the estate structure? Most investors have at least a personal account and a retirement account. Others may have more complex estate structures, such as deferred compensation arrangements and children's trusts.

What is the income tax situation? What are the marginal tax rates, including state and local taxes? Are they subject to the alternative minimum tax (AMT), and is their AMT status likely to change?

What is the transfer tax situation? If the investor group includes various entities or generations, what are the income and transfer tax considerations of each, and how do they interact? A thorough understanding of income and transfer tax considerations is essential to the development of an effective asset location strategy.

What are the current assets? What is the total, and how much of it is liquid? Are there concentrated positions, such as single stock holdings, and are they highly appreciated? Are there factors that prevent diversification, and will such restrictions change over time? Is there an operating family business, one likely to be sold at some point? Are there expected future inheritances? Is there life, health, and disability insurance?

What is the cash flow situation? Is there income from salary or a business? How stable is this cash flow, and is it expected to increase or decrease over time? In the case of salary, when is retirement likely? What is the investor's current spending, and how is that likely to change? Are there future large expenses such as college tuition to be planned for? Are there significant estate tax bills that may have to be paid?

Is the investor operating in a liquidation or bequest situation?

Liquidation investors are likely to sell the bulk of their financial holdings in the future to meet their needs. Bequest investors have sufficient wealth to meet current and future needs. This distinction affects how you approach capital gains taxes. A bequest investor can defer gains to allow pre-tax compounding of appreciation. If the holding is disposed of through death or charitable giving, the appreciation may not be subject to capital gains tax. This is an obvious and easy way to enhance future transfers.

A thorough discussion of these and related issues should yield a deeper understanding of the investor's situation. In my experience, such discussions often help the investor as well as the wealth manager. Working closely with a client's accountants and lawyers also can be helpful and can facilitate future collaboration.

Asset Allocation and Asset Location

Asset allocation decisions focus on constructing an optimal portfolio, that is, one with the highest expected return for a given level of estimated risk. This discussion focuses on how to adjust the typical asset allocation to integrate tax and other investor-specific factors.

I suggest a practical two-step process to develop reasonable asset location strategies.

1. Develop a target asset allocation based on estimated after-tax returns. Calculate the after-tax returns based on where most of the investor's money is held. For example, if the bulk of the assets are in personal accounts, adjust expected returns based on the appropriate marginal tax rate for each asset class. If most of the money is held in a retirement account, apply an effective tax rate to each asset class based on the expected pre-tax return, the

marginal ordinary tax rate, and the expected time of deferral.

2. Make asset location decisions. This means decide where to place various components of the asset allocation among individuals and entities that make up the investor or family. In the simplest case, making asset location decisions could mean positioning assets between a personal account and a retirement account. A more complex example might include multiple-generation family personal accounts, retirement accounts, and various trusts.

Asset location can powerfully enhance after-tax growth and transfer of wealth. The goal is to match the return and tax character of each asset class with the income and transfer tax characteristics of each individual and entity.

Table 1 provides a template for working through asset location decisions. Table 1 assumes that the advisor has determined the target asset allocation and is ready to determine the location. This example assumes an investor with an estate that consists of personal accounts, a retirement account, and a children's trust, and that the aggregate is to be invested to meet the target asset allocation.

Personal Accounts

Personal accounts are subject to immediate taxation, but they also benefit from preferential tax rates applied to dividends and long-term capital gains and the tax exemption of municipal bonds. Personal accounts can benefit from the step-up in basis. Charitable gifts of appreciated assets from a personal account can be used to reduce unrealized gains. Personal accounts may be a good location for equity strategies, especially those managed tax-efficiently. Assuming no short-term capital gains, the maximum federal tax rate for personal accounts



TABLE 1: ASSET LOCATION GRID

Asset Class	Personal Account(s)	Retirement Account(s)	Children's Trust(s)	Total	Target Allocation
Cash					10%
Taxable					
Tax-Exempt					
Bonds					20%
Taxable					
Tax-Exempt					
High Yield					5%
Stocks					70%
Domestic					40%
Int'l Developed					20%
Emerging Mkts.					5%
REITs					5%
Total	\$	\$	\$		100%

is only 15 percent. The effective tax rate can be even lower by deferring capital gains using indexing or tax management. Thus, the after-tax return of equities is likely to be higher in a personal account than in a retirement account.

Retirement Accounts

Retirement accounts benefit from deferral of all income tax but eventually all returns are subject to ordinary tax rates. There is no opportunity for the step-up in basis. This is a good location for asset classes that generate a lot of ordinary income or short-term gains. Examples include taxable bonds, real estate investment trusts, and high-yield bonds. The after-tax return on these assets should be higher in a retirement account than in a personal account because—in either case—they are subject to ordinary tax rates. Deferral of this tax allows for pre-tax compounding, reducing the effective tax rate.

Therefore it generally is better to own stocks in a personal account and taxable bonds in a retirement account, rather than to hold municipal bonds in a personal account and stocks in a retirement account. Retirement accounts may be useful for tactical trades. For instance, if an investor wanted to temporarily increase the allocation to emerging markets and

reduce the allocation to bonds—expecting that this would be reversed in the future—this can be implemented within the retirement account without triggering any immediate taxes when the trade is either initiated or unwound.

While retirement accounts have some negative tax aspects, investors still should fund these accounts. The ability to defer income tax on salary and invest the pre-tax dollars is a powerful combination. Most individuals with salary income should contribute the maximum to such plans. The point here is that if an investor has assets in personal and retirement accounts, the overall after-tax return is likely to increase if asset allocation places the income-oriented asset classes in the retirement account.

Children's Trusts

Children's trusts often are structured so that the parents can pay the income taxes on the trust, without the tax payment being subject to gift tax. This feature can significantly increase the expected net transfer to children if enough time is allowed for the power of compounding to do its work.

Investment Strategies and Portfolio Construction

The final step is to select and combine investment strategies to implement the

asset allocation and location targets.

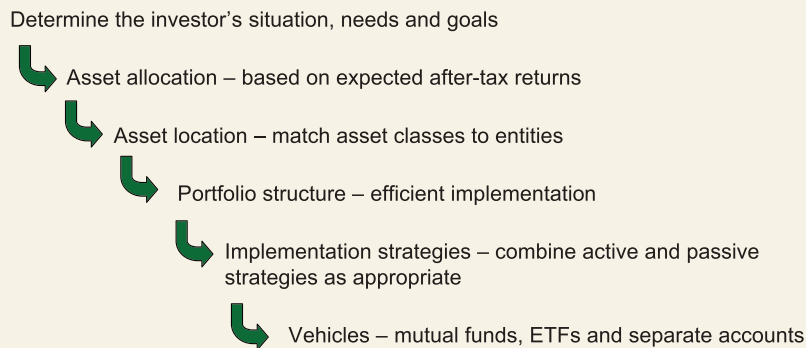
These strategies can be accessed through mutual funds or separately managed portfolios. The two key choices are between active versus passive strategies and between mutual funds versus separate accounts.

The active versus passive choice can take on the tone of a religious debate. Index adherents disdain active management as expensive folly. Active advocates equate indexing with not even trying, with settling for average. The intensity can obscure the fact that this is not an either/or issue. An investor can rationally combine both passive and active strategies in a portfolio. Passive strategies belong in asset class/location combinations where passive is likely to generate the highest net after-tax return and active management belongs where it is likely to do better.

Allocation to active management does not have to follow the asset allocation. A core-and-satellite portfolio structure can allow for a more thoughtful allocation to active management, as shown in figure 2.

The traditional approach is one related to the style-box approach to portfolio construction. The equity market is broken into many submarkets based on region and capitalization. Each submarket then is separately managed by a port-



FIGURE 2: PORTFOLIO STRUCTURES

folio manager, who supposedly possesses special skills and niche capabilities. The drawback is that if active managers are used for all strategies, then most active management is taking place in U.S. and international large-cap stocks, market areas considered to be fairly efficient.

The core-and-satellite strategy begins with a core portfolio designed for long-term diversified participation in investment grade bonds, U.S. large-cap stocks, and international large-cap stocks. These core portfolios should have modest fees and be managed in a tax-efficient manner. The tax issue is most relevant to equity strategies. Active managers tend to turn over their portfolios and realize capital gains that could have been deferred with a passive strategy.

The tax consequences of using active management are most onerous for bequest investors, who ultimately can avoid capital gains taxes by the way they dispose of assets. The tax consequences are less onerous to liquidation investors, who are expecting to sell and pay capital gains taxes. There are no adverse tax consequences to active management if the strategy is held within a retirement account.

The core strategies could be indexed or enhanced index. Enhanced index strategies are not purely passive and seek modest enhancement of total return through many small deviations from the benchmark. These may include weighting stocks based on fun-

damental characteristics such as valuation, earnings quality, and profitability. This core then can be complemented with satellite strategies that provide exposure to other asset classes or perhaps participate in large-cap markets in a more concentrated manner.

The core-and-satellite structure has two advantages for a wealth manager. The first has to do with asset location. Core and satellite breaks the portfolio into a tax-efficient core and (perhaps) less tax-efficient satellites. Relative to the traditional portfolio structure, core-and-satellite allows for more-efficient asset location strategies. This is most evident when the investor's personal account is large relative to the retirement account. In this situation, the retirement account can be thought of as a scarce resource; only a limited portion of the total portfolio can reside within the retirement account. The personal account can hold the tax-efficient core and the retirement account can hold the tax-inefficient satellites.

The second advantage comes from the ability to use the core portfolio to solve specific investor needs. Core equity portfolios can be managed for purposes such as minimizing realized gain, maximizing dividend yields, or moderating the potential for large losses with hedging. Note that none of these strategies would fit within the conventional style-box approach to equity portfolio construction, but each might

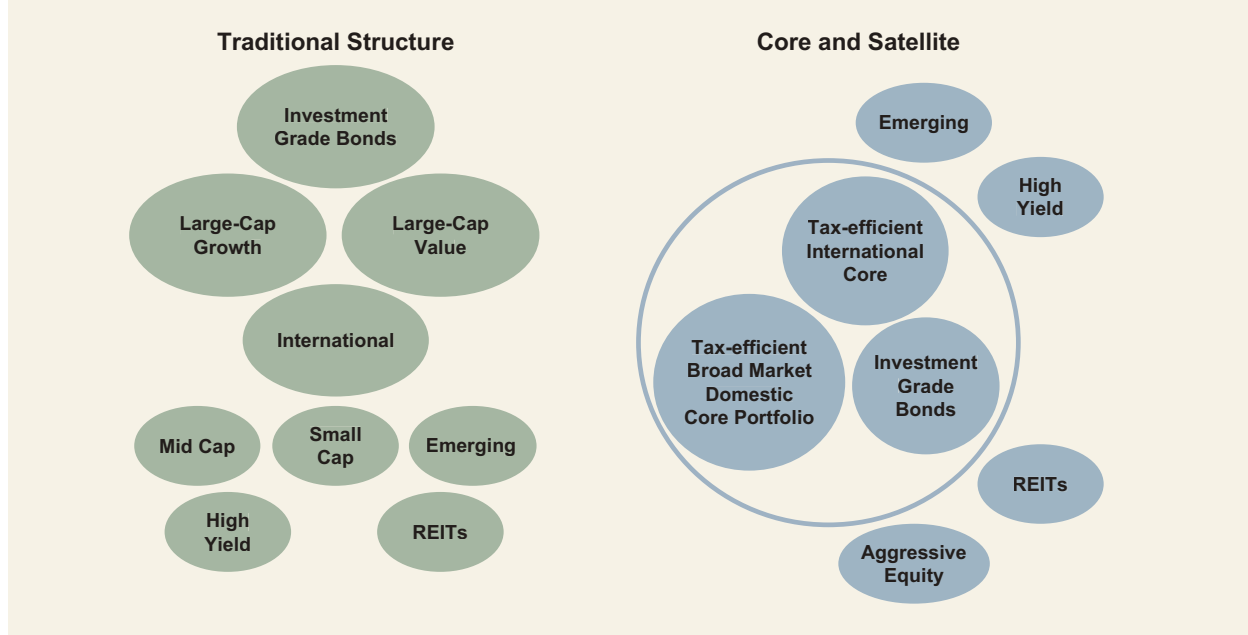
be appropriate in certain situations.

A wealth manager seeks to solve an investor's problems and uses investment strategies as tools to design solutions.

A final consideration is whether to use mutual funds or separate accounts. Technological advances have made it feasible to open a separate account for as little as \$50,000. The investment management industry's advertising suggests that separate accounts have more cachet. Certainly a separate account is a more appropriate vehicle in some situations, but mutual funds have their advantages. An investor can use a combination of funds and separate accounts, using each when it is most attractive.

Mutual funds may provide more diversification because there is no practical limit on the number of positions they might hold. A diversified core equity portfolio might require several hundred different positions to achieve returns that consistently track a benchmark. Separate accounts rarely hold so many positions and, even if they did, the investor might regret owning them when it comes time to prepare tax returns. The case for funds is even stronger with taxable bonds; diversification of credit risk is an important consideration and unlikely to be fully achieved in a separate account. A fixed-income mutual fund can purchase a large number of different securities and it is able to purchase them at market prices. In the case of a separate bond account, it may not be feasible to purchase a large number of diversified securities. The prices paid for small denominations of bonds sometimes reflect significant mark ups, which reduce the investor's return.

Mutual funds may have lower fees, and their fees are implicitly tax deductible. The fees on small separate accounts can be much higher than the fees on a mutual fund. The investor who owns a separate account owes income tax on *gross* income and seeks a deduction for management fees. If the investor is subject to the AMT, the fees may


FIGURE 3: A SUGGESTED WEALTH-MANAGEMENT PROCESS


not be deducted. Even if the investor is not subject to the AMT, the deduction may be denied or diminished due to thresholds and phase-outs.

In the case of a mutual fund, the investor owes tax on the *net* distribution, and so the fees and expenses always are deductible. This is not an insignificant point. For example, an AMT investor comparing a managed equity portfolio to a mutual fund might be choosing between paying a 1.50-percent annual fee for the separate account, with no deduction, versus a 1.25-percent annual fee embedded within a mutual fund, with the effect of the fee being diminished by taxes.

Separate accounts have their advantages. One important advantage is the ability to contribute appreciated stock to the account. Investors generally can contribute only cash toward a mutual fund, and thus would have to sell any assets before investing. Appreciated positions can be placed in a separate account without any tax consequences. Of course, this feature is useful only if the portfolio manager is able to provide true separate-account management by holding onto the highly appreciated positions. If,


instead, the separate accounts all are run according to a model with little customization, the appreciated positions might soon be sold.

Separate-account strategies also can be useful for tax-loss harvesting strategies. A mutual fund cannot pass net losses through to investors; it can only carry them forward against future gains. A separate account is directly owned by the investor, so any net realized losses can be used by the investor to offset gains from other investments. This feature has no value if the asset is held within a retirement account.

Summary

One key insight of modern portfolio theory is that all investment decisions should be evaluated only in terms of their impact on the total portfolio's expected return and risk. We suggest applying similar logic to the wealth-management process. Each decision should be made on the basis of its contribution to the investor's overall goals, as shown in figure 3.

The wealth manager must resist the industry-wide bias toward focusing efforts primarily on portfolio manage-

ment with an emphasis on pre-tax investment results. Portfolio management is only one aspect of the process and it is one of several tools a wealth manager can utilize in developing a customized plan to help each investor pursue particular goals. The great advantage of the wealth-management approach is that it provides many more ways to add value. 

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