ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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## Tax-Efficient Investing

You've likely had to account for dividends and capital gains this year or in the past as you filed your taxes, perhaps begrudging the extra work entailed and the levies due. While taxes are one of life's certainties, with some preparation and planning, there are ways you can make your portfolio more tax efficient, putting off or reducing your annual tax burden.

The concept of tax efficiency considers how various assets generate returns and the tax rates on those returns. Different investments are taxed at different rates; once you have decided on the appropriate asset allocation for your objectives and risk comfort zone, the next step is to think about fitting it into a tax-efficient framework.

At Adviser Investments, we always try to be cognizant of how taxes can impact total return. Every client's situation is different, so there are no universal rules, and in general, overall portfolio performance is more important than avoiding some taxes (especially if it means investing in lower-return funds to do it).

That said, there is some consensus thinking on the subject that any investor can consider.

### Taxable, Tax-Deferred and Tax-Exempt

Investment accounts generally fall into one of three classifications of the tax code: Tax-free accounts, tax-deferred accounts and taxable accounts. Investors with tax-free accounts, including Roth IRAs, Roth 401(k)s and 529 college savings plans, owe no tax on current income or capital gains on profits withdrawn from them, since contributions are generally made after taxes.

In tax-deferred accounts like traditional IRAs and 401(k)s, investors don't owe income tax until they begin making withdrawals, typically in retirement. The tax-deferred structure allows investments to compound untaxed, greatly enhancing long-term growth potential.

Taxable accounts encompass all other investment accounts. While it's ideal to max out annual contributions to your tax-exempt and tax-deferred accounts if possible, if you need current income from your investments or don't want them locked up until you reach retirement age, you'll need to keep some portion of your assets in a taxable account—not necessarily a bad thing. Taxable holdings offer certain advantages over tax-advantaged accounts, where all investments are eventually taxed equally as income. In taxable accounts, you can harvest losses to deduct on your annual returns, donate shares to charity and pay lower taxes on capital gains realized over periods longer than a year.

### Stocks and Stock Funds

Every time an asset is sold in a taxable account, gains must be accounted for—and losses should be logged as well for tax deduction purposes. The longer gains are held, the longer you put off paying taxes on them, so choosing long-term investments wisely can really pay off.

You also need to be aware that when mutual funds and ETFs have trades made within their portfolios, the taxes generated from the turnover are paid by clients. According to Morningstar, actively managed equity funds have a median turnover of 49% a year, creating both short- and long-term taxable gains.

Index funds are not immune from these taxes, either, especially narrowly focused indexes. For example, when a holding in a mid-cap index gets too big or small, it must be sold. While index funds tracking the S&P 500 or other broad market indexes are the most tax-efficient, they too must sell holdings to take positions in new additions to the index.

Stock funds can also be tax-inefficient if they produce a lot of capital gains, especially short-term capital gains. Funds that pay dividends can also see their returns impacted by taxes.

**Tax Efficiency of Bonds**
Bonds and bond funds are sometimes considered to be tax inefficient because much of their return is generated by monthly distributions, which is taxed as ordinary income and thus faces the maximum tax rate. This is especially true when compared to stocks, where, in general, returns primarily come from price appreciation and are only taxed when sold at a profit at the capital-gains tax rate. (See current rates in the second table below.)

Treasury bonds are exempt from state taxes, while municipal bonds are tax-free on the federal level (and sometimes state level, depending on the issuer). However, municipal bonds have a hidden cost in that they typically yield less than comparable corporate or Treasury bonds. Of course, muni bonds do have the built-in tax advantage, and during certain periods or market conditions, their yields can become more attractive compared to taxable bonds of similar duration (this is currently the case).

**Asset Placement**
A general rule when considering the tax consequences for a portfolio is that taxable accounts should house tax-efficient investments, and tax-inefficient vehicles may work better in tax-deferred accounts. The table below shows how different assets could be placed in a tax-efficient framework.

**Assets and Accounts: A Rough Guide**

| **Taxable Accounts** | **Tax-Deferred Accounts** |
|---|---|
| Broad Stock Index Funds | Taxable Bonds and Bond Funds |
| Low-Turnover Stock Funds | High-Turnover Stock Funds |
| Tax-Managed Funds | CDs |
| Individual Stocks | REITs |

Why hold stocks in taxable accounts? For one, capital gains can be deferred indefinitely—so long as you don't sell any shares—and qualified dividends are taxed at 15% (20% for the highest income-tax bracket), much lower than ordinary income regardless of your tax bracket. (To a certain extent this is also true of stock funds, but as mentioned above, the tax efficiency can be impacted by portfolio turnover and short-term capital gains. However, we think most investors are still better served by mutual funds' diversification than they are by a single-company stock's potential tax efficiency.) Stocks and stock funds in tax-deferred accounts see long-term gains turned into income, meaning gains are taxed at a higher rate.

**Federal Income Tax Rates for 2013 and 2014**

| | **Taxable Income** | | | **Tax Rate** | |
|---|---|---|---|---|---|
| | Single | Married/Joint | Head of Household | Ordinary Income & Short-Term Capital Gains | Long-Term Capital Gains and Qualified Dividends |
| **2013** | $36,251 to $87,850 | $72,501 to $146,400 | $48,601 to $125,450 | 25% | 15% |
| | $87,851 to $183,250 | $146,401 to $223,050 | $125,451 to $203,150 | 28% | 15% |
| | $183,251 to $398,350 | $223,051 to $398,350 | $203,151 to $398,350 | 33% | 15% |
| | $398,351 to $400,000 | $398,351 to $450,000 | $398,351 to $425,000 | 35% | 15% |
| | >$400,000 | >$450,000 | >$425,000 | 39.6% | 20% |
| | | | | | |
| **2014** | $36,901 to $89,350 | $73,801 to $148,850 | $49,401 to $127,550 | 25% | 15% |
| | $89,351 to $186,350 | $148,851 to $226,850 | $127,551 to $206,600 | 28% | 15% |
| | $186,351 to $405,100 | $226,851 to $405,100 | $206,601 to $405,100 | 33% | 15% |
| | $405,101 to $406,750 | $405,101 to $457,600 | $405,101 to $432,200 | 35% | 15% |
| | >$406,750 | >$457,600 | >$432,200 | 39.6% | 20% |

Note: Table does not include additional 3.8% Medicare tax rate on investment income in excess of adjusted gross income of $200,000 ($250,000 for married filing jointly) and 0.9% on salary and self-employment income exceeding this amount. Also excludes 10% and 15% tax brackets, which are not subject to long-term capital gains taxes.

**The Big Picture**
While we've shared some common rules investors can use to gauge the tax consequences of their investments, as we wrote

above, every investor is different, and what makes sense for your neighbor might not make sense for you. If you have any questions or concerns about the tax efficiency of your portfolio, we recommend that you confer with a trusted tax or investment professional before making any moves. The discussion should be able to help you confirm that you're making the right choices or reveal other means of achieving the same goal.

One thing we tell our clients when they begin to focus more on avoiding taxes than the health of their overall portfolio is, "Don't let the tax tail wag the portfolio dog." In other words, tax efficiency is not nearly as important as achieving solid after-tax returns.

**Next Time**

In our next *Adviser Fund Update*, we'll look at the tax efficiency and tax-adjusted returns of Fidelity and Vanguard funds, which will help us show you how the tax efficiency of a fund is not always the best way to gauge the quality of the investment.

**About Adviser Investments**

Adviser Investments and its subsidiaries operate as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. With 2,400 clients and more than $2.5 billion under management, Adviser Investments is one of the nation's largest mutual fund research and money management firms. Our investment professionals focus on helping individual investors, trusts, foundations and institutions meet their investment goals. Our minimum account size is $350,000. Adviser Investments was recently named to *Barron's* list of the top 100 independent financial advisers nationwide and its list of the top advisory firms in Massachusetts.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.