March 14th , 2014
Volume 13, Issue 2

Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

Between 2009 and 2013, the average bid-ask spread on small lots of municipal bonds was 1.73%. Over the same period, comparable trades in corporate bonds had a 0.87% spread

The S&P 500 Exchanged Traded Fund, SPY, has not paid out a capital gain distribution in the last two years.

Tax Efficient Investing Revisited

Price levels in equity markets have increased substantially of late. 2013 was a banner year for the US stock market. Significant economic gains accrued to investors and, with that, the potential for tax liability. Eleven years ago, this newsletter reviewed some of the principals of tax efficiency, many of which were associated with passive investing. These principals have been put to the test in the recent bull market. This month's edition of *Intelligent Money* will consider the recent taxable gains of some passively managed portfolios to determine if these strategies are robust in the current financial climate.

Background on Asset Class Returns

The accommodative policies of the world's central banks in conjunction with a moderate economic recovery have produced fine returns in most risk-oriented markets. The table below describes the annual returns of three popular asset class aggregates: The S&P 500(US Stocks), The EAFE (Foreign stocks) and the Aggregate Bond Index (US Bonds)

The last two years should be a useful testing ground for portfolio tax efficiency. For portfolios that are primarily invested in equities, there have been a lot of economic gains to deal with.

Year	S&P 500	EAFE	Aggregate Bond Index
2012	16.00%	17.90%	4.22%
2013	32.39%	23.29%	-2.02%

The Tax Regime

Stock funds generate tax liability in a number of ways. The dividend payout is a pass through of underlying dividends paid by constituent stock holdings. These dividends may or may not qualify for favorable tax treatment depending on how long the stocks paying them have been held. Additionally, funds may pay out capital gains distributions if and when stocks are sold in the portfolio. Again, the tax treatment is a function of the holding period of the stock that is sold.

Bond funds deliver returns in the form of interest payments that are taxable as ordinary income. They are typically reported to the IRS as "non-qualified dividends". Because returns are taxable to the investor at the higher ordinary income tax rate, bonds are generally considered a less tax efficient vehicle than stocks.

The table describes the marginal tax rate of the foregoing income streams to a family with $300,000 in taxable income. For the purposes of simplicity, we ignored the Obamacare surtax and used the tax brackets that prevailed in 2013

	Tax Rates in 2013
Ordinary Income	33%
Long Term Capital Gains	15%
Short Term Capital Gains	33%
Qualfied Dividend	15%
Non-Qualified Dividend	33%

Portfolio Construction

The portfolios managed at Haven Financial Advisors have some common characteristics that are relevant to the issue of taxation. While tax efficiency is not the primary objective of portfolio construction, it is a welcome byproduct.

Exchange traded funds (ETFs) are typically used as core holdings in client portfolios. ETFs track stock indices like the S&P 500 or the Russell 2000 with very low management fees. Because they don't try to outsmart the market, there is little trading in the underlying stocks. Conventional mutual funds must also sell stock to raise cash for investor redemptions. Not so with ETFs – they can deliver the underlying stocks to investors to satisfy redemptions. Again, this keeps trading to a minimum. Thus, capital gains distributions from ETFs are pretty rare.

As an example, the S&P 500 index ETF (SPY) is one of the most tax efficient investments out there. Someone who held that fund exclusively over the last two years would have paid an effective tax rate of only 1.6% on its considerable gains.

Let's put things in perspective. Both mutual fund and ETFs have indexed products that successfully minimize taxes. Morningstar studied the capital gains histories of US large cap mutual funds and ETFs from 2007 through 2011. The following table describes the results. The technical structure of ETFs does provide some additional tax relief but the bigger benefit is delivered by the move to a passive strategy.

5 year average	Yearly Capital Gains Distributions
Active Mutual Funds	1.92%
Passive Mutual Funds	0.16%
ETFs	0.00%

"Unlike mutual funds, ETF managers need not sell securities to satisfy redemption requests. Instead, the fund manager is allowed to deliver low cost basis stock to the redeeming party instead of cash."

The balance of client equity holdings are held in the form of "smart index" funds. Many of these are managed by Dimensional Fund Advisors (DFA). While DFA does not manage their portfolios to maximize tax efficiency, the trading volume is typically low. These funds also should remain relatively immune from tax liability.

If the components of client portfolios behave as anticipated, their tax liability should change little as we move from 2012 to 2013. The greater economic returns in 2013 should not trigger additional capital gains or dividends. Moreover, the overall tax burden should remain low in both years. Let's look at real data to verify our conjecture.

Client Portfolio Selection

To test the hypothesis, the best place to start is with actual assets. We sampled client portfolios randomly with the only precondition that there be no major individual fund sales in 2012 and 2013. Sales of funds themselves will generate taxable events. Five accounts were selected with a total value of $9.3 million at the midpoint of the two years in question.

"A reasonably well managed stock portfolio should remain insulated from tax liability, regardless of the tax regime. The corollary is that bonds need the structural shelters afforded by IRAs and 401ks""

The assets of the accounts consisted primarily of stock funds with some taxable and tax-exempt bonds. The former will generate ordinary income tax events while the latter will not. Taxable bonds comprise about 18% of the client portfolios and this reduces tax efficiency somewhat.

The first step was to confirm that the actual client portfolios generated more economic gains in 2013 than 2012. In fact, the portfolios gained almost $1.5 million in 2013 after a reasonable increase of about $900,000 in 2012. Then we looked at the tax liability generated assuming that the investor was a married couple with a taxable income of $300,000. The actual clients, of course, varied somewhat from this model.

The results were clear. The consolidated portfolio generated ***less*** tax in the banner year of 2013 than 2012. Thus, the effective tax rate imposed on the larger portfolio returns was substantially lower. Here is a summary of the results.

Aggregated Portfolio	2012	2013
Economic Gain	917000	1483000
Capital gains	75000	85000
Qualified Dividend	99000	97000
Non-qualified Dividend	77000	59000
Tax-Exempt Interest	16000	18000
Estimated Tax	51510	46770
Effective Tax Rate	5.6%	3.2%

The hypothesis was confirmed. The broader portfolio performance behaved as advertised. Even though the clients earned almost $600,000 more money in 2013, the total tax bill went down. The majority of the economic gain remained unrealized as the indexed funds did little trading. Good news! A bull market does not bring the tax man calling.

The effective tax rate on the portfolio gains was substantially lower than the marginal tax rates applicable to the underlying investor. These rates were 5.6% and 3.2% for the years 2012 and 2013, respectively. On average, the client paid less than one third the tax due under the lower capital gains rate of 15%.

There's a broader message embedded in the results. A reasonably well managed stock portfolio will remain insulated from tax liability, regardless of the tax regime. The corollary is that bonds need the structural shelters afforded by IRAs and 401ks. Bond interest cannot be deferred in a taxable account.

What does the future hold? With looming deficits in America's entitlement programs, we can reasonably infer that tax rates will increase while tax deductions are eliminated.

Our first example is the Obamacare surtax that became effective in 2013. It's a 3.8% tax on married investors with income of $250,000 or more. For the sake of simplicity, it was ignored in the analysis. However, this new tax shifts many investors into a higher tax bracket. That makes the management of investment income even more critical.