

Article of the Month (7/01)

Should Investments Be Tax-Driven?

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Recently a client raised this question in her appointment, and it is a provocative issue. Generally speaking, the Cambridge Approach does focus on tax efficiency and controlling investment costs as the cornerstone of long term investing. We cannot control the other aspects of investments, i.e. the market, so we should make sure we do a good job at controlling what we can control - taxes and investment costs. Tax and investment cost management are critical strategic considerations in making investment decisions to maximize returns, but this does not mean that tax savings is necessarily the primary consideration in making investment decisions.

Controlling Investment Costs

Investment costs that we can control fall into two main categories: fund expenses and acquisition/disposition costs, which include both commissions (loads) and transaction fees. When calculating the true performance of an investment, these items must be taken into consideration.

The expense ratio of a fund is the percentage of the fund's net assets used to pay annual fund expenses, including marketing, distribution, manager salaries and other administrative expenses. The long-term effect of expenses on the growth of a portfolio is well documented and several websites feature calculators that illustrate this (see www.forbes.com and www.sec.gov).

The use of no-load funds is obviously the primary way to control acquisition/disposition costs. Transaction fees can be minimized by managing trades. Most brokerage houses, in addition to offering no-load funds, also offer no-transaction-fee funds. If selecting a fund that does carry a transaction fee, this fee can still be minimized through larger, less-frequent trades. Transaction fees are also being commoditized by the marketplace, in large part because of the explosion of internet trading of securities. For example, five years ago Merrill Lynch and other brokers routinely charged \$400 to sell 500 shares of stock. Today we can enjoy \$12.95 stock trades and enjoy a much higher rate of return on our portfolios because of it.

There is a hidden opportunity cost when investment costs are not taken into account in building a portfolio in that it becomes very difficult to adjust the portfolio to adapt to changing market conditions or an individual's personal situation. For example, our client Mary S. bought \$50,000 of a very highly rated mutual fund that carried with it a 5.5% front-end load. This means that she paid over \$2,500 in commissions to the person who purchased it for her. Shortly after the purchase, the fund manager left and the fund performance nose-dived. At the same time, due to personal health reasons, she needed to move her investments to a lower risk profile. But because of the high costs that she incurred by going into this fund - which seemed the right thing to do at the time - it made it very difficult for her to make the necessary changes. In contrast, had she purchased a good no-load fund, she could have made this adjustment with virtually no costs or less than \$100.

Tax Management

Tax management of investments is a very broad topic. It covers everything from integrated strategies that identify the best investments for specific investment vehicles (what are the best

investments to hold in a Roth IRA vs. a 401(k) vs. your standard brokerage account) to "no-brainers" like taking paper losses at the end of the year to offset capital gains (the securities sold can be replaced in 30 days, or immediately with similar-but-not-identical investments, thereby guaranteeing the tax benefit with no impact on the portfolio's asset allocation). Let's look at just a couple of examples.

A mutual fund whose performance keeps up with the S & P may actually be substantially under performing the S & P when you factor in the tax consequences. In addition to investment costs of 85 - 125 basis points (.85 - 1.25%), an actively managed large cap mutual fund (as opposed to an index fund) may have a turnover rate of 100 - 150%, meaning that over the course of a year, all stocks in the fund are sold and new ones are purchased and then many of those new stocks are also sold and new ones purchased. The capital gains generated from this trading are netted against the capital losses and any resulting capital gain is passed along to the shareholders, who then must pay the capital gains taxes. This can be a substantial amount. An index fund, on the other hand, will have little or no turnover. So a \$50,000 position in an index fund might generate a \$300 - \$500 tax bill whereas for the inefficient managed fund the tax bill could be \$5,000 - \$6,000. Of course, this is not an issue if the fund is held in a qualified (tax-deferred or non-taxable) account, but tax efficiency is critical for non-qualified (taxable) funds.

Obviously, there are tax consequences with assets other than securities. Harry and Jane P. had a vacation home in northern Michigan that had appreciated substantially. Their children are now grown and have dispersed to other areas of the country and Harry and Jane want to move to Florida. The vacation home would be sitting idle all but maybe two weeks per year. Harry and Jane were not interested in the hassles of renting, but were facing paying taxes on a substantial gain as the vacation home was not their primary residence and would not be eligible for any tax exclusion. In their situation, the right decision was to sell and pay the taxes. They could then take the proceeds from the sale and put that money to work for them instead of it sitting idle in an asset from which they were no longer receiving any benefit. Now, had they been willing to go the rental route, a tax strategy could have been developed whereby they rented the house out for a couple of years to establish it as a rental and then arranged a 10

So, good planning can help to maximize tax benefits and minimize tax consequences, but when the right time comes to sell an appreciated asset, it should be sold irrespective of tax consequences. Tax savings is not a principal objective of an investment policy; the purpose of investing is NOT to save taxes.

Moreover, taxes take a 'back seat' when it comes to assuring proper diversification, rebalancing a portfolio, or assuring capital preservation, or providing liquidity. Often these objectives can be accomplished through the strategic use of new investment funds, but when that is not the answer, accepting the tax consequences is a small price to pay.

In my experience over the past 30 years, I have come to the staunch conclusion that there is NO excuse for lack of or failure to diversify. Whether sentimental attachment, concern about tax consequences, belief that the asset will appreciate or feeling like you'd be selling it for less than you "should" - none of these reasons justify the failure to diversify. Over and over again, I have seen that the lack of diversification has proven to be the kiss of death for individuals who literally "had it made" - had achieved their financial goals - and then watched it all collapse within a short period of time.

Should investments be tax-driven? No! *Investment Portfolios* should be driven by a client's life goals, to provide the financial foundation of your dreams and aspirations. The *Investment Strategies* necessary to accomplish this primarily require a focus on diversification, which demands a combination of liquidity, growth, capital preservation, and asset utilization strategies. *Investment Tactics* properly deployed enable the investor to implement the desired strategies

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most efficiently. These include individual cost control, tax management as well as investment selection.