



Asset Location, as Well as Allocation, Matters for Retirees

By Mark McLaughlin

The financial services industry devotes tremendous energy to identifying and promoting investments that can offer retirement account holders the best combination of risk, return, and diversification. Often lost in this asset allocation push, however, is the drag taxes can take on wealth creation.

“In a world where alpha is so hard to generate and advisors spend hours looking for ways to save a few basis points, it is surprising how little attention is paid to the issue of how various components of investment income are taxed,” says Alexey Bulankov, a certified financial planner with McCarthy Asset Management in Redwood Shores, Calif. “No investment plan is complete without a tax angle.”

To increase the likelihood of their clients reaching retirement with ample savings, Bulankov and other advisors advocate asset location—the process of assigning investments to taxable or tax-deferred accounts, such as 401(k)s and IRAs, based on the types of taxable distributions they generate.

“Strategic asset location is a source of tax alpha for investors, because it’s designed to minimize taxes and maximize after-tax wealth,” says Glenn Freed, CEO of Los Angeles-based Vericimetry Advisors.

WHERE TO LOCATE ASSETS	
Taxable Accounts	Tax-Deferred Accounts
Municipal Bonds	Commodities
U.S. Dividend Stocks	REITs
	Foreign Stocks

Source: Metis Group

A series of studies conducted in 2005 by financial planners Gobind Daryanani and Chris Cordaro found that implementing asset location in a portfolio, versus equally dividing assets across taxable and IRA accounts, added 20 basis points of performance annually. While 0.2 percent doesn’t seem like much, compounded over a 30-year to 40-year savings period, the benefits can be substantial.

On the surface, the asset-location decision looks easy and obvious: Place bonds and other income-producing investments in tax-deferred accounts, and capital-gains producing stocks and other securities in taxable accounts. But an investment’s tax efficiency is just the starting point in the asset-location process.

An asset location study by T. Rowe Price using stock and bond mutual funds determined that an investor’s expected tax bracket and retirement time horizon also figure prominently in the asset-location decision.

STOCKS VS. BONDS

T. Rowe Price found that, in general, the higher your tax bracket in retirement—when distributions are taxed at ordinary income rates—and the shorter your investment accumulation period, the more beneficial it is to place stock funds in taxable accounts and bond funds in tax-deferred accounts.

On the other hand, investors in lower tax brackets with longer holding periods (10 years or more) would do better keeping stock funds in the tax-deferred bucket and bond funds in the taxable bucket.

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T. Rowe Price also concluded that even though stock funds’ earnings are taxed at higher ordinary income tax rates at retirement, that drag is offset by the advantage of deferring taxes for many years on their higher compounded growth.

Stocks generally are tax efficient as two of the three types of income they generate—long-term capital gains and qualified dividend income—are taxed at a low 15 percent. Short-term capital gains, which apply to holding periods of less than a year, are taxed at ordinary income tax rates that can be as high as 35 percent.

But stocks of different market caps and investment styles can vary greatly in their tax efficiency. Large-capitalization [cnbc explains] growth stocks are the most tax-efficient equity asset class, due to their low turnover and lack of dividends, according to Rockford, Ill.-based Savant Capital Management. Small-cap value stocks are least efficient due to their high turnover as they grow in size and migrate into growth stocks and because they tend to pay higher dividends.

Stocks are easier to trade than individual bonds when it comes to harvesting capital losses that can be offset against capital gains in any given years, says Vericimetry’s Freed, and so it makes sense to keep at least a portion of an equity position in a taxable account. Capital gains on stocks can also be deferred, providing additional flexibility in managing taxes.

TAX FACTOR: MOVING TARGET

Another factor that plays into where you keep your assets is future tax rates, which are very much a moving target.

HIGHER TAXES AHEAD?		
Tax Category	Current	2013*
Marginal Income	25%	28%
	28%	31%
	33%	36%
	35%	39.60%
Long-Term Capital Gains	15%	20%

Source: Metis Group

* Projected rates

Should Congress fail to take action, personal-income tax and long-term capital gains rates will increase across the board on Jan. 1, 2013. The 15-percent rate for qualified dividend income will disappear, says Larry Karmel, a partner at New York-based accounting firm Metis Group. As part of ObamaCare, investment income will also get hit with a 2.9 percent surcharge starting in 2013.

For investors who expect to see their marginal rates rise and have cash to pay the upfront tax bill, advisors suggest transferring tax-deferred retirement account assets into a Roth IRA before rates rise. Roth account holders pay taxes today on their contributions, but owe no future taxes on earnings or qualified distributions.

“As for future, probable tax structure, it’s really just a guessing game,” says Rick Ashburn, who runs Lafayette, Calif., advisory firm Creekside Partners. “On balance, I would advise higher-income clients to plan for higher marginal rates.”