

The Importance of Tax-Efficient Investing

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It's not what you make, but what you keep after taxes that counts. And these days, tax-efficient investing is more important than ever.

Return lost to taxes

The Schwab Center for Financial Research has done a lot of work in the past examining the impact of expenses and taxes on investment returns over time. Our broad conclusion? While asset allocation and investment selection are still some of the most important decisions you face as an investor, keeping costs and taxes low isn't very far behind.

For example, assume an investor in the top tax bracket earned an average return of 15% on actively managed mutual funds in taxable accounts from 1981 to 2001. After taxes, average return dwindled to roughly 12%—which means our investor lost an average of 2.4% in return to taxes (the numbers reflect a compound rate of return).

Investment return lost to taxes doesn't just affect mutual fund investors—depending on what you hold in your taxable accounts and how you manage your investments, individual stock and bond investors are vulnerable, as well.

As big of a drag as return lost to taxes might be, the good news is you can exercise a good deal of control here. Think about this: Diversification and asset allocation are great tools for helping to reduce portfolio volatility, but we're still going to be subjected to the short-term whims of the market, no matter how diligent we might be in setting up our portfolios and selecting our individual investments. Where we have the greatest degree of control is the area of expenses and tax-efficient implementation. Doesn't it make sense that where we can exercise the most control, we would do so?

A Good Tax Strategy Is Better Than Ever

The Tax Relief Act of 2003 brought more than a tax break on

Why is tax-efficient investing more important than ever?

First, let's assume that over the next 20 years, annual compound returns for the broad stock

qualified dividends. Lower tax rates on long-term capital gains enhance what was already a tax-smart move. Holding long-term assets in taxable accounts instead of tax-deferred accounts, when possible, still makes as much sense for top-bracket investors—and makes even more sense for middle-bracket investors. See "What's Up With Dividends?" for more on the 2003 Tax Act.

market average between 8% and 10%, and bonds average about half that. If such long-term expectations pan out for the major asset classes, average portfolio returns would be less than what we enjoyed over the last 20 years.

That means *any* return lost to taxes will be a much bigger deal. In other words, losing 2.4% per year to taxes may not have seemed like much if you were making 15% or 20%. But if you only expect to make 9% on your investments, keeping as much of that return as

possible can be vital to achieving your long-term goals.

Second, tax efficiency is more important than ever because of the changes to the tax rules in 2003—most notable, the new 15% rate on qualified dividend income.

Previously it might have made sense to hold dividend-paying stocks in a tax-deferred account such as an IRA instead of a taxable account. Either way, dividends were taxed at your ordinary income tax rate—between 28% and 39.6% prior to 2001—and at least an IRA offered tax-deferred potential growth.

But currently, qualified dividends in a taxable account are taxed at a maximum rate of 15%. Those same dividends would be taxed at the ordinary rate—currently as high as 35%—when withdrawn from your tax-deferred accounts. As a result, the value of putting dividend-paying stocks in taxable accounts has grown tremendously.

Where should you consider placing investments to try to maximize tax efficiency?

Broadly speaking, investments that tend to lose less of their return to income taxes are good candidates go in taxable accounts. Likewise, investments that lose more of their return to taxes could go in tax-deferred accounts. Here's where tax-smart investors might want to place their investments:

Where Tax-Smart Investors Typically Place Their Investments

Taxable accounts	Tax-deferred accounts such as traditional IRAs, 401(k)s and deferred annuities
<i>Here, you'd ideally place...</i>	<i>Here, you'd ideally place...</i>
Individual stocks you plan to hold more than one year	Individual stocks you plan to hold one year or less
Tax-managed stock funds, index funds, low-turnover stock funds	Actively managed funds that generate significant short-term capital gains
Stocks or mutual funds that pay qualified dividends	Taxable bond funds, zero-coupon bonds, inflation-protected bonds or high-yield bond funds
Municipal bonds, I Bonds (savings bonds)	REITs

Of course, this presumes that you hold investments in both types of accounts. If all your investment money is in your 401(k) or IRA, then as they say in New York City, fuggedaboutit—just focus on asset allocation and investment selection.

Other considerations

In general, holding tax-efficient investments in taxable accounts and less tax-efficient investments in tax-advantaged accounts should add value over time.

However, there are other factors to consider, including:

- **Periodically rebalancing your portfolio** to maintain your strategic asset allocation will cause additional tax drag on returns, to the extent you rebalance in taxable accounts. You may want to focus your rebalancing efforts on your tax-advantaged accounts, including your taxable accounts only when necessary. Keep in mind, adding new money to underweighted asset classes is also a tax-efficient way to help keep your portfolio allocation in balance.
- **Active trading** by individuals or by mutual funds, when successful, tends to be less tax-efficient and better suited for tax-advantaged accounts. A caveat: Realized losses in your tax-advantaged accounts can't be used to offset realized gains on your tax return.
- **A preference for liquidity** might prompt you to hold bonds in taxable accounts, even if it makes more sense from a tax perspective to hold them in tax-advantaged accounts. In other situations, it may be impractical to implement all of your portfolio's fixed income allocation using taxable bonds in tax-advantaged accounts. If so, compare the after-tax return on taxable bonds to the tax-exempt return on municipal bonds to see which makes the most sense on an after-tax basis.
- **Estate planning issues** and philanthropic intent might play a role. Stocks held in taxable accounts receive a step-up in cost basis at death (something your heirs would appreciate)—not so for stocks in tax-advantaged accounts. Additionally, highly appreciated stocks held in taxable accounts for more than a year might be well-suited for [charitable giving](#).
- **The Roth IRA** might be an exception to the general rules of thumb discussed above. Since qualified distributions are tax free, assets you believe will have the greatest potential for higher return are best placed inside a Roth IRA, when possible.

The bottom line

You have a lot of control when it comes to maximizing your after-tax wealth. First, decide on a suitable asset allocation. Next, select low-cost investments that make sense for you. Then, be tax-smart about where you hold your investments.

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