

GENERATING TAX ALPHA WITH EFFECTIVE ASSET LOCATION

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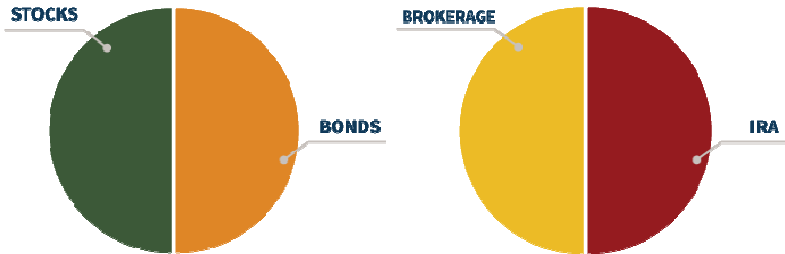
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THE ASSET LOCATION CHALLENGE

- Diversified portfolios hold a wide range of investments
 - Different asset classes/holdings have different return and tax efficiency characteristics
- Households have a number of different types of accounts
 - Taxable/brokerage accounts
 - Tax-deferred IRAs
 - Tax-free (Roth)
- In which accounts should each investment be allocated?

THE ASSET LOCATION CHALLENGE

- In which accounts should each investment be allocated?



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ADDING TAX ALPHA WITH ASSET LOCATION

- Ways to “asset locate”
 - Make each account a pro-rata share of each

	Taxable		Notes	IRA	
	Stocks	Bonds		Stocks	Bonds
Starting Value	\$250,000	\$250,000		\$250,000	\$250,000
Gross Final Value	\$4,362,351	\$754,368	30 Years @ 5% Bond, 10% Stock	\$4,362,351	\$1,080,486
After-Tax Final	\$3,745,498	\$754,368	25% Ordinary, 15% L/T Cap Gains	\$3,271,763	\$810,365
				Total	\$8,581,994

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ADDING TAX ALPHA WITH ASSET LOCATION

- Ways to “asset locate”
 - Asset locate across the account types

	Stocks in IRA		Notes	Stocks in Taxable	
	Taxable Bonds	IRA Stocks		Taxable Stocks	IRA Bonds
Starting Value	\$500,000	\$500,000		\$500,000	\$500,000
Gross Final Value	\$1,508,736	\$8,724,704	30 Years @ 5% Bond, 10% Stock	\$8,724,701	\$2,160,971
After-Tax Final	\$1,508,736	\$6,543,526	25% Ordinary, 15% L/T Cap Gains	\$7,490,996	\$1,620,728
	Total	\$8,052,262		Total	\$9,111,724

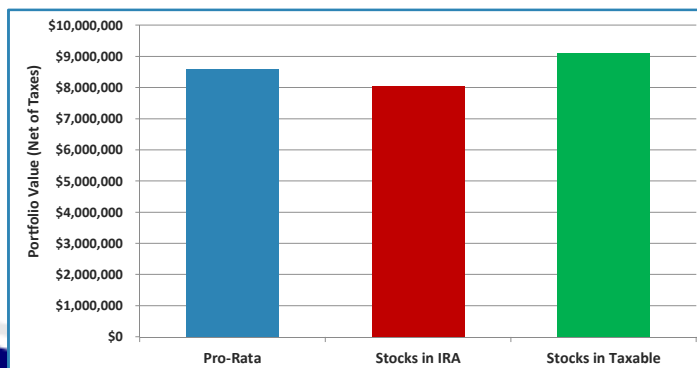
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ADDING TAX ALPHA WITH ASSET LOCATION

- Ways to “asset locate”
 - Net Portfolio Values:



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ADDING TAX ALPHA WITH ASSET LOCATION

- The impact of tax efficiency –
What if equity returns are 2.5% (qualified) dividends and 7.5% appreciation?

	Stocks in IRA	Stocks in Taxable (With Dividends)	Stocks in Taxable
Starting Value	\$500,000	\$500,000	\$500,000
Gross Final Value	\$8,724,704	\$7,875,138	\$8,724,701
After-Tax Final	\$6,543,526	\$7,013,109	\$7,490,996
Total Including Bonds	\$8,052,262	\$8,633,837	\$9,111,724

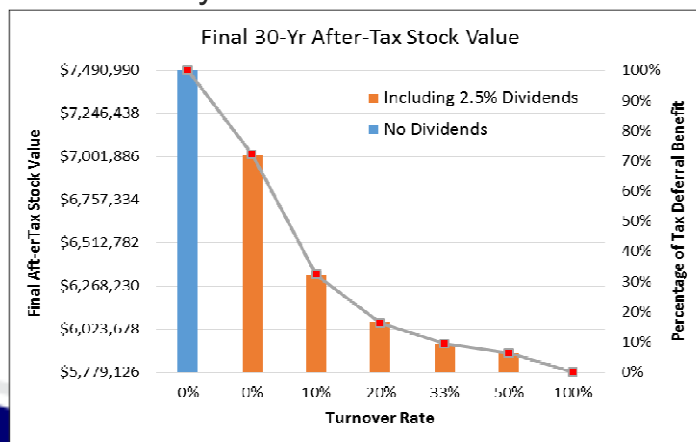
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ADDING TAX ALPHA WITH ASSET LOCATION

- Tax efficiency & Turnover



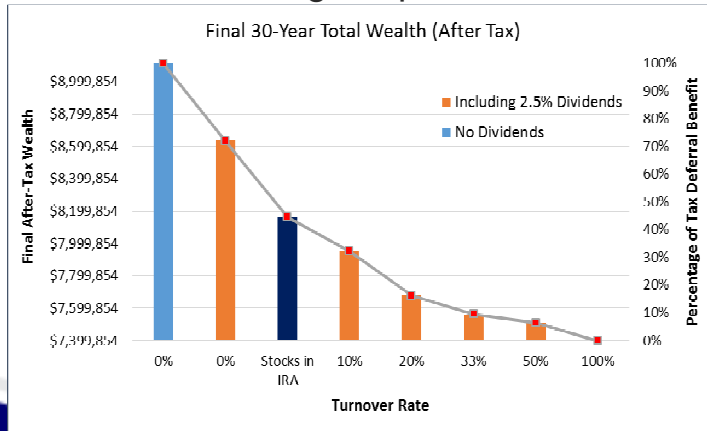
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ADDING TAX ALPHA WITH ASSET LOCATION

- How turnover changes optimal location outcome



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ADDING TAX ALPHA WITH ASSET LOCATION

- Evaluating Tax Efficiency
 - Numerous factors can impact (equity) tax efficiency:
 - Portion of (equity) return that is dividends
 - Portion of dividends that are non-qualified
 - Potential holding period/turnover of investment
 - Especially with active management!
 - Need for rebalancing to keep equities in line?
 - The higher the client tax brackets, the more this matters!

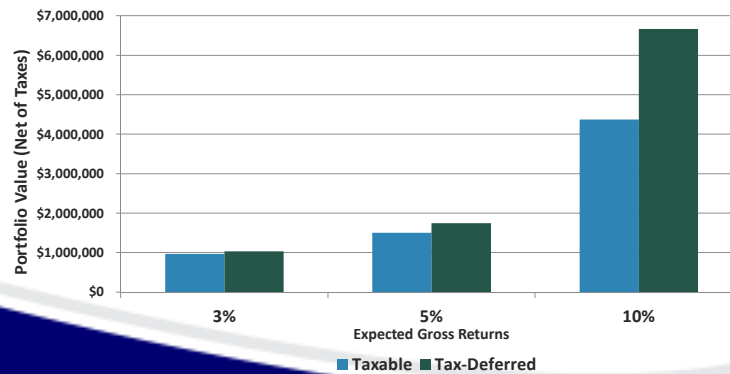
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ADDING TAX ALPHA WITH ASSET LOCATION

- The Impact Of Expected Return
 - Tax-deferred compounding growth matters more when there is more growth rate to compound tax deferred!



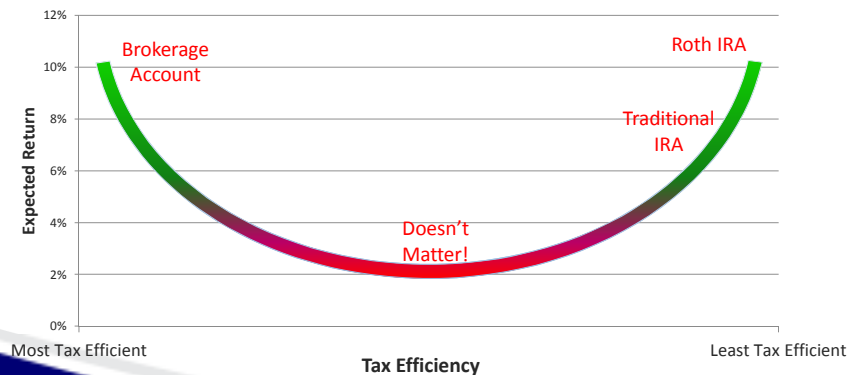
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ADDING TAX ALPHA WITH ASSET LOCATION

- The intersection of tax efficiency & expected return



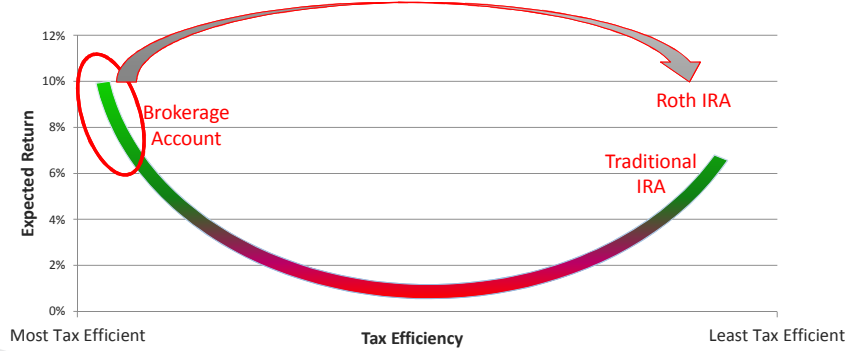
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ADDING TAX ALPHA WITH ASSET LOCATION

- The intersection of tax efficiency & expected return



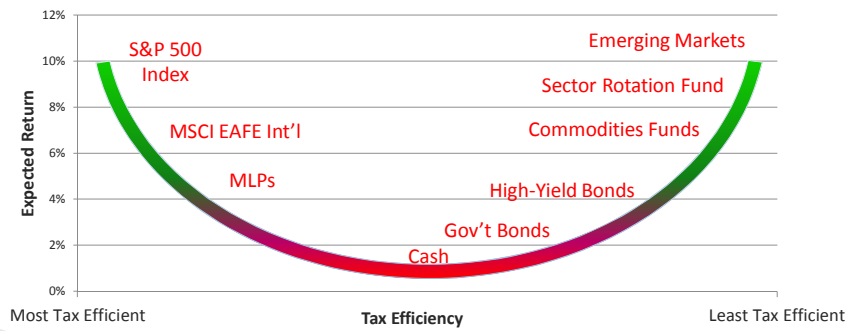
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ADDING TAX ALPHA WITH ASSET LOCATION

- Building The Asset Location Priority List



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- Building The Asset Location Priority List



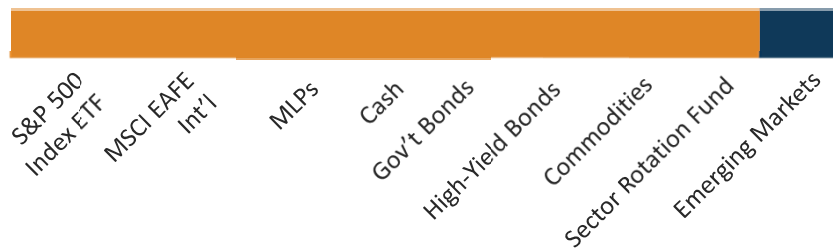
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ADDING TAX ALPHA WITH ASSET LOCATION

- Using The Asset Location Priority List
 - \$900,000 taxable, \$100,000 IRA



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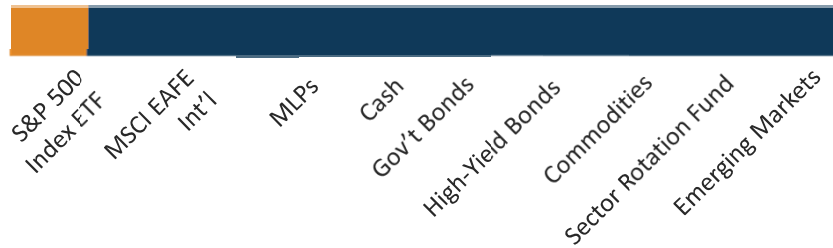
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ADDING TAX ALPHA WITH ASSET LOCATION

- Using The Asset Location Priority List

- \$100,000 taxable, \$900,000 IRA



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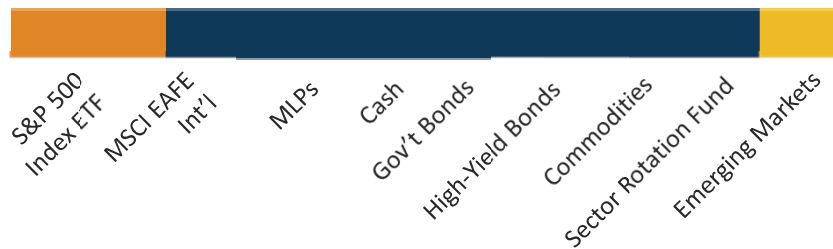
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ADDING TAX ALPHA WITH ASSET LOCATION

- Using The Asset Location Priority List

- \$200,000 taxable, \$700,000 IRA, \$100,000 Roth IRA



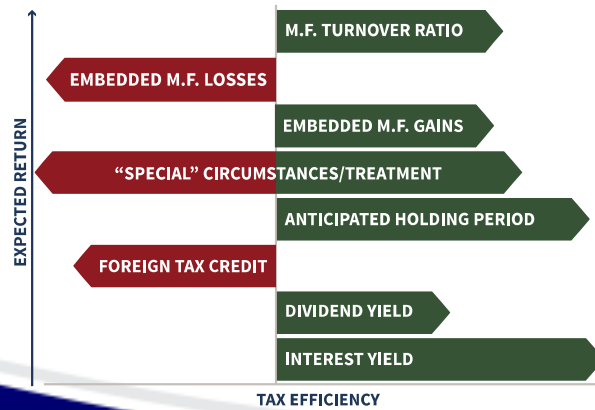
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ADDING TAX ALPHA WITH ASSET LOCATION

- Factors in building an Asset Location Priority List



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ADDING TAX ALPHA WITH ASSET LOCATION

- Expanding types of accounts for asset location
 - Employer retirement plans
 - Difficult to manage on a household basis?
 - Non-qualified annuities
 - Creating a tax-deferred bucket for those who don't have one?
 - Weighing the balance between annuity costs & value of tax-deferral?
 - 529 plans
 - Segment separately (asset location goal by goal?)

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ADDING TAX ALPHA WITH ASSET LOCATION

- Implementing Asset Location
 - Highly conducive to “rebalancing” software tools!
 - Allows for systematic implementation of asset location
 - Difficult to implement if portfolios are not model-based?
 - Difficult to implement across “held-away” assets?
 - Requires managing portfolios on a “household” basis
 - But that can actually *be* a differentiator?
 - Wealth management vs “investment only”?

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ADDING TAX ALPHA WITH ASSET LOCATION

- Implementing Asset Location
 - Asset location priority list must be built
 - Specific to the investments being held for clients!
 - ...And/or used in advisor’s models?
 - Priority list should be updated at least annually
 - New return assumptions
 - Changing market conditions?
 - Dynamic tax characteristics (mutual funds w/ embedded?)

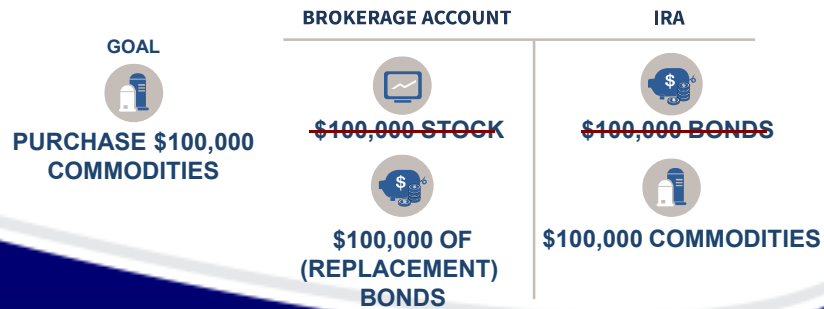
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ADDING TAX ALPHA WITH ASSET LOCATION

- Implementing Asset Location
 - Priority list or allocation changes can trigger asset swaps
 - But not necessarily a tax problem!?
 - Swap stocks in brokerage for commodities in IRA...



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ADDING TAX ALPHA WITH ASSET LOCATION

- Asset Location & Client Psychology
 - Asset location may not align to client mental accounting



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ADDING TAX ALPHA WITH ASSET LOCATION

- Asset Location Caveats & Concerns
 - May be different for lower income clients
 - Stocks in brokerage accounts for 0% capital gains rates?!
 - Difficult to implement without software
 - Even software is limited if investment process isn't systematized?
 - Software varies in its capabilities to help?
 - Be cautious if performance reporting is not done on a household basis, too?

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ADDING TAX ALPHA WITH ASSET LOCATION

- What Is Asset Location Worth?
 - 0bps – 25bps (Daryanani & Cordaro)
 - 23bps (Blanchett & Kaplan)
 - Value will vary by:
 - Return & tax efficiency assumptions
 - Relative amounts available for different types of accounts
 - Time horizon?
 - A form of advisor “gamma” or “tax alpha”
 - A “free lunch” for those who can implement effectively?

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ADDING TAX ALPHA WITH ASSET LOCATION

- Summary
 - Asset location depends on both tax-efficiency *and* expected return
 - Should not be based on tax treatment alone!
 - Systematize by creating an asset location priority list
 - Utilize software to manage on an ongoing basis
 - Potential value of approximately 25bps?
 - An opportunity for tax alpha (or advisor “gamma”!)

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