

# GENERATING TAX ALPHA WITH EFFECTIVE ASSET LOCATION

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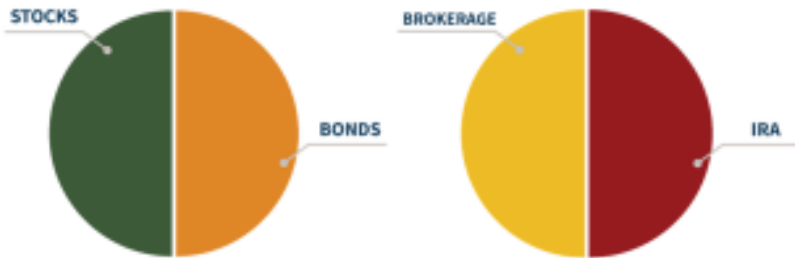
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## THE ASSET LOCATION CHALLENGE

- 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
				<b>Total</b>	<b>\$8,581,994</b>

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

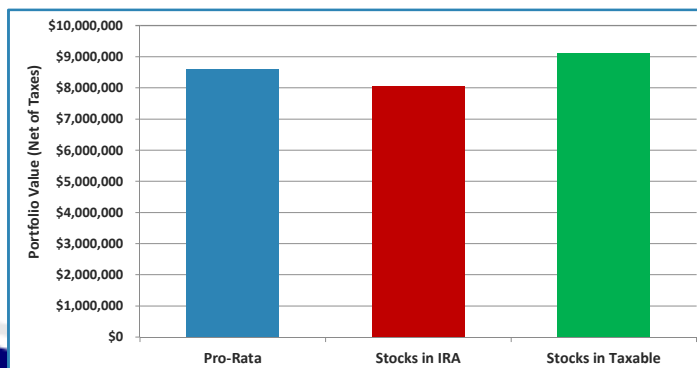
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## ADDING TAX ALPHA WITH ASSET LOCATION

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



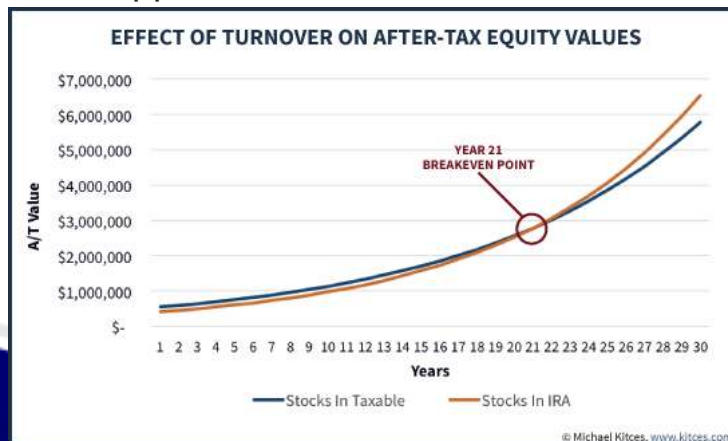
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## ADDING TAX ALPHA WITH ASSET LOCATION

- The impact of tax efficiency –  
What happens when there is turnover?



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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
<b>Starting Value</b>	\$500,000	\$500,000	\$500,000
<b>Gross Final Value</b>	\$8,724,704	\$7,875,138	\$8,724,701
<b>After-Tax Final</b>	\$6,543,526	\$7,013,109	\$7,490,996
<i>Total Including Bonds</i>	\$8,052,262	\$8,633,837	\$9,111,724

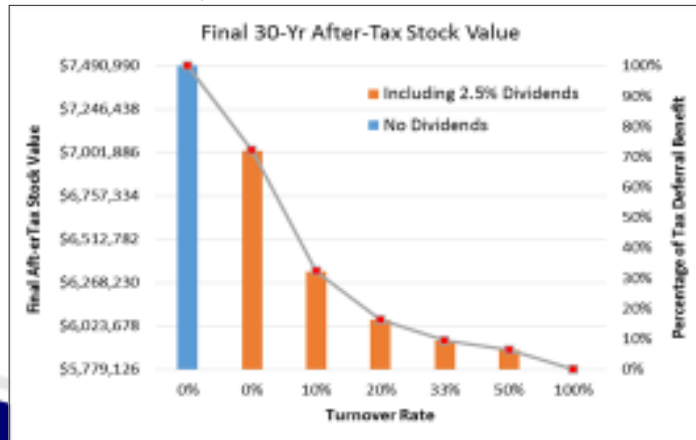
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## ADDING TAX ALPHA WITH ASSET LOCATION

- Tax efficiency & Turnover



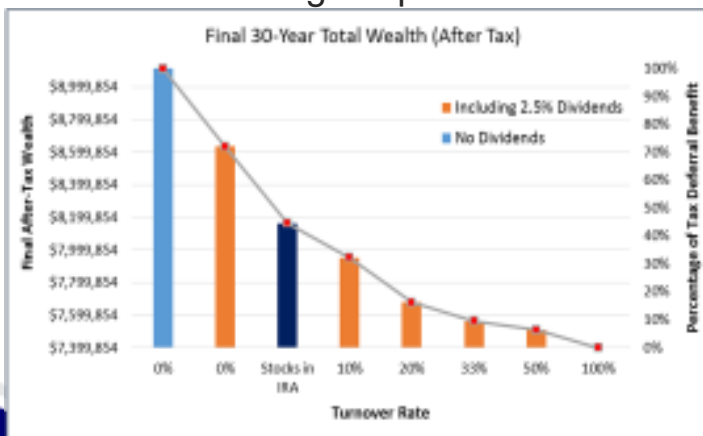
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## ADDING TAX ALPHA WITH ASSET LOCATION

- 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!

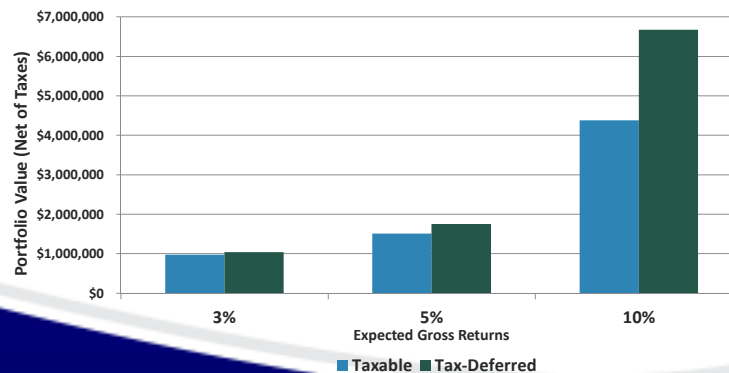
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## ADDING TAX ALPHA WITH ASSET LOCATION

- 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



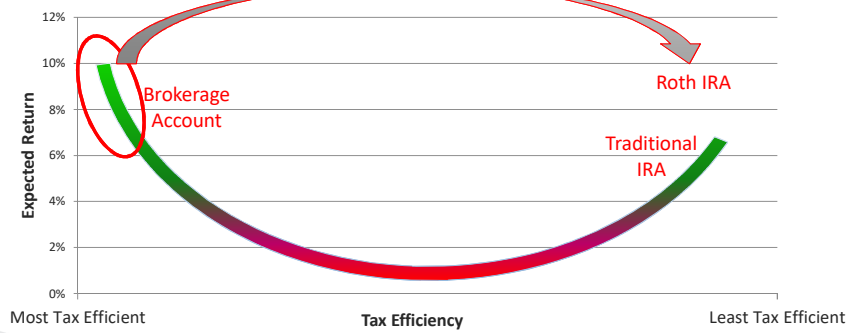
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- The intersection of tax efficiency & expected return



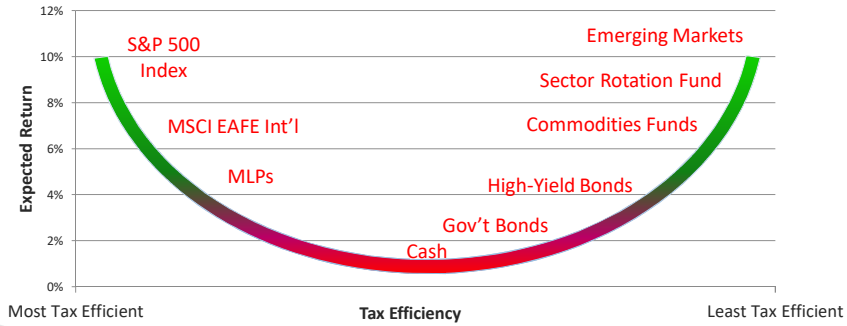
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## ADDING TAX ALPHA WITH ASSET LOCATION

- Building The Asset Location Priority List



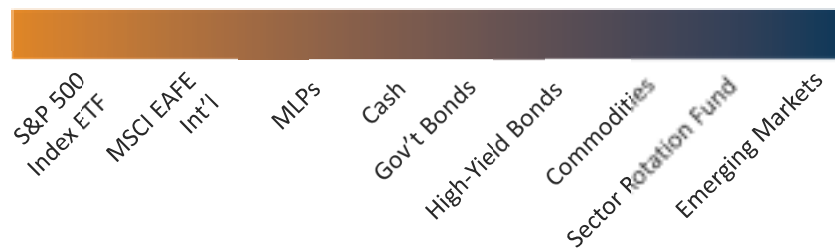
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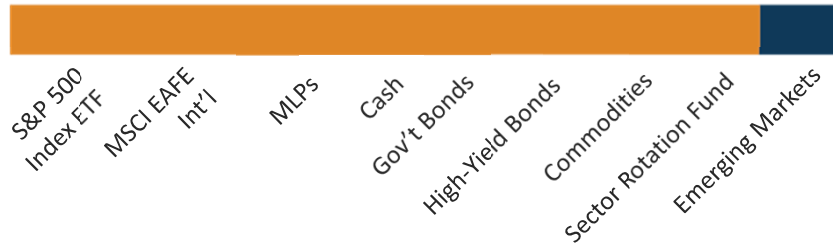
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## ADDING TAX ALPHA WITH ASSET LOCATION

- Using The Asset Location Priority List

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



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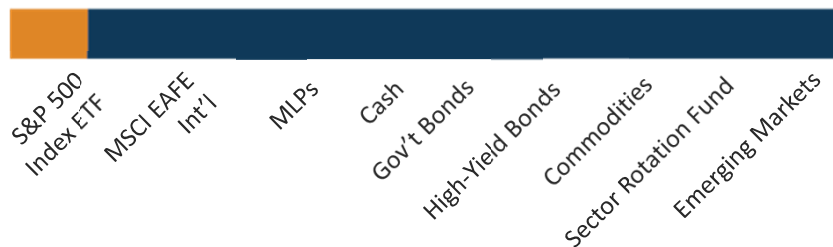
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## ADDING TAX ALPHA WITH ASSET LOCATION

- Using The Asset Location Priority List

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



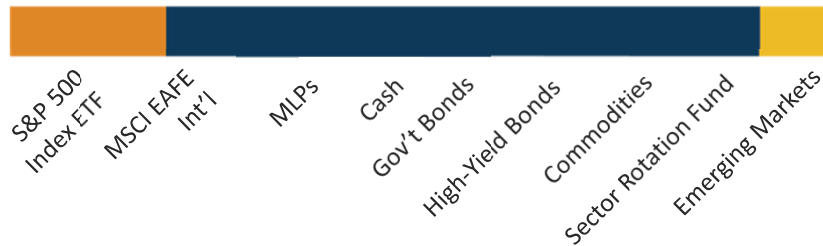
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## ADDING TAX ALPHA WITH ASSET LOCATION

- Using The Asset Location Priority List
  - \$200,000 taxable, \$700,000 IRA, \$100,000 Roth IRA



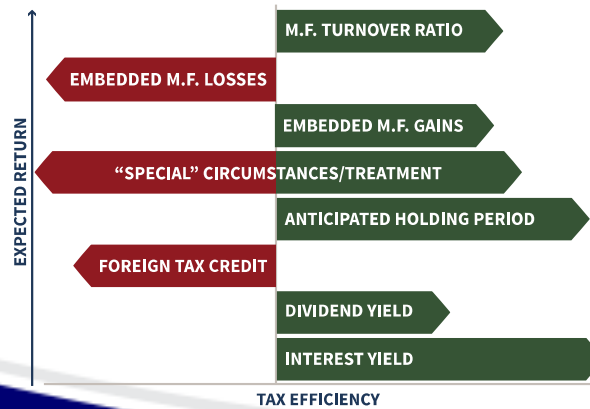
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## ADDING TAX ALPHA WITH ASSET LOCATION

- 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?)

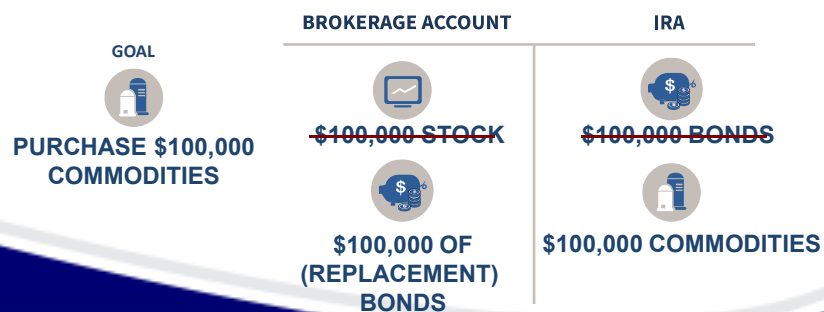
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## ADDING TAX ALPHA WITH ASSET LOCATION

- 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

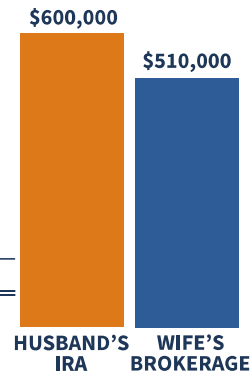
- Asset Location & Client Psychology

- Asset location may not align to

client mental accounting



	Stocks	Bonds
Beginning	\$500,000	\$500,000
% Increase	20%	2%
\$ Increase	\$100,000	\$10,000
<b>Ending</b>	<b>\$600,000</b>	<b>\$510,000</b>



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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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