Asset Location

In investment management, conventional wisdom suggests that asset allocation is the single largest contributor to long-term returns. There is potentially another factor of equal or greater importance: asset location, or selecting which investment vehicle an investor will use for each asset in the asset allocation.

Taxes have been ignored in many analyses for a variety of reasons, but incorporating taxes should have a substantial impact on asset location, if not asset allocation.

The typical high net worth investor may have a wide variety of vehicles available for asset location, and if an investor has a larger and more diverse portfolio, then asset location becomes increasingly important. The principles of effective asset location suggest that all of one's fully taxable income oriented investments should be held in tax-deferred vehicles.
At all levels of income, long-term capital gains and qualified dividends enjoy a substantial tax advantage over passive income. Investors and their advisors should look beyond asset allocation and emphasize asset location in determining the construct of an investment portfolio.

The old adage in real estate is that the three most important considerations when determining a property's value are location, location, location. In investment management, conventional wisdom suggests that asset allocation is the single largest contributor to long-term returns. This assertion is supported by many studies and extensive experience. The one thing that has been ignored in all of these studies, however, is taxes. And when considering taxes in the equation, there is potentially another factor of equal or greater importance: asset location. We define asset location to mean selecting which investment vehicle an investor will use for each asset in the asset allocation.

Taxes have been ignored for a variety of reasons. First and foremost is uncertainty, as none of us knows today with certainty what our marginal tax rate will be next year. This uncertainty exists because of potential policy changes and potential changes in the economic environment that may impact our earnings. There is even less certainty as to what our tax rate will be at retirement. There is also no way for us to know today what interest rates will be, what the long-term performance of the stock market will be or what our earnings and savings will be over the long-term. This has resulted in analyses that have been done from a pre-tax perspective, or with the assumption that we will have substantially lower tax rates in the future. If we consider taxes as a key factor and assume that we will be successful in accumulating wealth, then we can assume that taxes will be consequential. So incorporating taxes should have a substantial impact on asset location, if not asset allocation.

The typical high net worth investor may have a wide variety of vehicles available for asset location. These can include fully taxable accounts and tax-deferred accounts, including 401(k), IRA, rollover IRA, deferred compensation, Insurance, 529 and Keogh accounts. When ignoring or avoiding the impact of taxes, asset allocation is driven by the time frame for the investment. This has traditionally suggested that tax-deferred accounts be invested largely in equities, as the money won't be accessed for a long time and should therefore be invested in the asset that is assumed to provide the highest total return over the long-term, regardless of volatility.

This advice might be quite appropriate for people who save primarily through IRAs and 401(k)s, but if an investor has a larger and more diverse portfolio, then asset location becomes increasingly important. It is also important to note that the federal government caps the amount of money that an investor can put into these vehicles. The 2015 cap for 401(k) contributions is $18,000 ($24,000 if age 50 or older). The current limit for an IRA is $5,500 ($6,500 if you're age 50 or older). These amounts are subject to earnings limits and higher income people are generally not able to make tax-deductible contributions. These limits reduce the impact that these vehicles can have on the overall portfolios of higher wage earners. Under the current tax code, the top marginal income tax rate is 39.6%. The top tax rate for capital gains and dividends is now 20%. There is also a federal tax on passive income of 3.8% for high earners (above $250,000 for married couples filing jointly), so the net top marginal federal tax rate on coupon income is 43.4% and the net top marginal federal tax rate on long-term capital gains is 23.8% (these rates exclude state and local tax rates, which also differ substantially by state and by income level and are, therefore, largely ignored). These federal rates provide a distinct tax advantage for equities if they are held for more than 12 months and they are held in a taxable account. If equities are held in a tax-deferred account, the investor will effectively achieve the conversion of tax advantaged returns into fully taxable returns at an uncertain future tax rate. An investor with means should seek to hold these tax-advantaged investments in a taxable account and hold primarily (if not exclusively) fully taxable securities in tax-deferred accounts.

As can be seen in Exhibit 1, there is a substantial advantage for long-term capital gains and dividends versus income. The advantage increases from a 10% difference at lower levels of income and reaches a peak of 20% at higher levels of income. If an investor is seeking to maximize his or her wealth over time, then taxes must be considered, making asset location a key factor in achieving long-term wealth creation.

As income increases, vehicles such as 401(k)s and IRAs should be largely populated with assets that generate income, short-term capital gains and/or non-qualified dividends.

Let's assume that an investor implemented a successful investment program in her twenties and has done sufficiently well that she will remain in one of the higher tax brackets at retirement. A focus on asset location would have resulted in investing tax-deferred monies in income-generating assets, notably bonds, and investing taxable monies in equities and other tax advantaged investments including municipal bonds. The taxation of equities is complex relative to income, but generally lower. Capital gains are only taxable when a stock is sold and then they are taxed preferentially if held for the long term (greater than 12 months). If this investor had acquired a portfolio of high quality stocks, it is conceivable that sales would have been minimal over the years and capital gains taxes could have been deferred or even avoided entirely, if held until death. Dividends would have been taxed at a preferred rate that is generally lower than the rate for passive income (this preferred tax rate for dividends has come and gone over the years, but is currently in place). If this same investor had focused on asset location and used tax deferred accounts to buy bonds (and other fully taxable investments) across the risk spectrum over the entirety of her working life, she could have better optimized her investment program to minimize taxation and enhance wealth.

The principles of effective asset location suggest that all of one's fully taxable income oriented investments should be held in tax-deferred vehicles. For most people, the most accessible, tax-deferred investment they have is a 401(k) plan.

The Default Option

Target date funds are increasingly becoming the default investment vehicle for 401(k) plans. These products tend to be heavily weighted toward equities in the early years and increasingly balanced as the target date approaches. This reflects the equity bias inherent in these tax-deferred accounts. When these accounts are liquidated, the cumulative contributions, income, gains and dividends are all taxed at the investor's top marginal tax rate at the time of distribution. It is impossible to know in advance what rate this will be. What we do know is that it will be taxed as income and the investor will have effectively eliminated the beneficial tax rates associated with long-term capital gains and dividends.

Typical Target Date Fund Asset Allocation			
Age Range	23-27	43-47	58-62
Years to Retirement	40	20	5
Stocks	90.00%	90.00%	65.00%
Bonds	10.00%	10.00%	35.00%
Based on an average of the top three target date fund managers by asset size as of 30 Nov 15.			

If clients have the ability to save outside of these vehicles, then financial professionals might propose a dramatically different construct for a tax-deferred portfolio. These allocations should seek to minimize equities as a holding and maximize assets that seek to generate income and short-term capital gains. These vehicles might be largely populated with diversified portfolios of investment-grade fixed-income securities, high income securities, equity securities that pay non-qualified dividends and alpha strategies that rely on active trading and high turnover generating a substantial portion of the return through short-term capital gains. None of these strategies are typically found in a corporation's 401(k) plan offerings and few advisors recommend these strategies in other tax-deferred accounts.

Likewise, these strategies should be available through variable annuity contracts as they can protect the investor from adverse tax consequences, reduce the risk (and cost) to the underwriting institution (assuming it provides a minimum guaranteed rate of return and the alternative investment would have been equities) and provide a reliable source of accretive income.

Conclusion

At all levels of income, long-term capital gains and qualified dividends enjoy a substantial tax advantage over passive income. As we would rarely recommend that municipal bonds be used in a tax-deferred account, we should emphasize that fully taxable assets be located in tax-deferred vehicles. Other assets that enjoy some degree of preferential tax treatment should be located in taxable accounts to derive the greatest benefit. Investors and their advisors should look beyond asset allocation and emphasize asset location in determining the construct of an investment portfolio. Tax-deferred vehicles are a great tool for savings. Optimizing asset location can greatly enhance tax efficiency and enhance long-term wealth accumulation.