PR Wealth Management Group, Inc.
A Registered Investment Adviser

The Value of Advice

Asset Location

The goal of most investors is to maximize returns on an after-tax basis for a targeted level of risk. Many financial articles and research deal with maximizing gross investment performance. In this article, we want to talk about tax efficiency, which plays an equally important role in maximizing after-tax returns.

The first step in tax efficiency is using low turnover funds that minimize trading. Such funds typically generate long-term capital gains and qualified dividends, rather than short-term capital gains and dividends taxable as ordinary income. Another step is using municipal bonds in taxable accounts for a portion of the bond allocation, if you are subject to high marginal tax rates. A third way to increase tax efficiency is what we call asset location.

To illustrate asset location, visualize it as putting your slice of key lime pie in the refrigerator while leaving your slice of pecan pie on the counter. We cannot put both in the refrigerator because there is only so much room. The same concept applies with asset location. Rather than replicate your target asset allocation in each account, we choose to divvy up the different pieces of pie into different types of accounts (taxable, tax-deferred, or Roth). Across all your accounts these slices add up to your target allocation, but we choose which account to put them in based on each slice's expected return and the tax treatment of its investment gains.

Walking Through an Example

Mr. X has a $3 million salary which he places into 3 accounts (we ignore contribution limits to simplify this example). Mr. X chooses to put $1 million in a tax-deferred 401k, $1 million in a Roth IRA (taxes are paid, leaving $604,000) and the last $1 million in a regular taxable account (again taxes are paid, leaving $604,000). Mr. X would like to invest in a 50% equity and 50% bond allocation overall. As the following table illustrates, if Mr. X optimizes his asset location rather than splitting each account equally into equity and bonds, he will have $400,000 more on an after-tax basis after 20 years.

Equities into the tax-deferred retirement account first, then Roth and taxable accounts	50% equity and bonds in every account	Equities into the Roth account first, then taxable and tax-deferred accounts
$4,500,101	$4,797,126	$5,199,838

For the purposes of this example, we do not use any particular investment but assume that the return of equities is 8% (75% of which is taxed as long-term capital gains) and the return of bonds is 3% (0% of which is taxed as long-term capital gains). We also assume that Mr. X has an average sensitivity to taxes and his effective tax rate is 39.6% for income and 23.8% for capital gains. Investors should consult with their financial adviser and tax professional, as all assumptions herein will not apply to every case. In addition, future changes in tax laws and the actual returns of asset classes over an investor's investment period may change the optimal asset location.

Asset Location Priorities

Choosing the right location for an asset can improve long-term after-tax returns. Academic evidence shows that investors can increase after-tax returns by holding broad-market funds and other low-turnover equity funds in taxable accounts, while holding REITs and less tax efficient assets in tax-deferred accounts.[1]

Asset Class	Least tax efficient		Place in your
Real Estate			
High-Yield Bonds		These investments typically pay relatively large dividends taxed at higher income tax rates.	Tax-deferred and Roth accounts
Inflation Protected Securities			
Emerging Stocks			
International Developed Stocks			
Value Stocks			
Small Capitalization Stocks			
Large Capitalization Stocks			
Growth Stocks			
Broad Market Stocks		These investments have low turnover, lower expected returns or pay tax-free income.	Taxable accounts
US Treasury Bonds			
Municipal Bonds			
	Most tax efficient		

**For taxpayers in the highest income tax brackets. Consult your financial adviser before making investment decisions.*

Each investor's time horizon and risk tolerance should be considered in conjunction with asset location to determine the appropriate mix of assets across all accounts. Keep in mind that money placed into tax advantaged accounts typically must remain there until age 59½ or be subject to penalties by the IRS, with a few exceptions.

[1]Dammon, Spatt, and Zhang 2004