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The Sound Investor Series #22

Save Money by Carefully Allocating Investments in Your Accounts

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Readers of this column know that I am always looking for ways to save investors money. Today's idea deals with how to split investments into various accounts to maximize your after-tax returns.

The concept is simple and rests on two points: First, investment income is taxed differently depending on its type. Generally speaking "interest income" and "non-qualified dividends" are taxed as ordinary income while "capital gains" and "qualified dividends" get preferential treatment.

Second, most investors have both "taxable" and "tax-qualified" accounts. Taxable accounts are your regular brokerage accounts while tax-qualified refers to 401(k)s and IRAs which have preferential tax rules.

Considering these two points, investors should match up their investments which do not have preferential tax treatment with accounts having preferential treatment, and vice versa. Holding non-preferential investments in non-preferential accounts will probably lower your after-tax returns.

This does not mean you should change your investment plan to fit what happens with taxes, that's not a smart idea. But after creating your portfolio, you should hold investments in the most tax-efficient account.

This strategy's potential savings are modest, but important. You might improve your annual returns from 0.30% to 0.50% (30-50 basis points) by changing from a poor tax allocation configuration to a better one.

Investors need to secure every possible basis point and this idea is well worth a few minutes of your time. When these basic ideas become part of your decision making process, they won't require any extra time.

Getting started, take your investments and calculate their potential tax liabilities as if they were all held in your taxable account, not your 401(k) or IRA.

Let's look at bonds first since they are easiest to understand. Bonds pay holders interest which is taxed as ordinary income. If a bond's interest rate is 4%; and your marginal tax rate is 25%, the potential tax liability is 1% (1/4 of 4%) of your investment.

Other investments likely to have potentially large tax liabilities are TIPS bonds, short-term trading strategies and REITs. With TIPS, interest income is taxed each year and if the principal is adjusted upward for inflation, this adjustment is also taxed.

Short-term trading strategies are a concern because short-term gains are also taxed as ordinary income. If a trading strategy earns 10%, but gets taxed at 25%, your tax liability is 2.5%. REITs are also a problem since their large dividends are non-qualified and taxed as ordinary income.

At the other end of the tax spectrum are ETFs based upon broad stock indexes such as the S&P 500. For the most part these instruments only distribute “qualified” dividends. If your tax rate is 25%, qualified dividends are taxed at 15%. Therefore, with the S&P 500 currently yielding about 2%, the potential tax liability is 0.30%. But to be perfectly clear, if the ETF is up when you sell, you ultimately will have to pay capital gains taxes.

Calculating the potential tax liability of actively managed mutual funds is bit more complicated as they generate dividends as well as short and long-term capital gains. The capital gains are difficult to predict and you will need to make a best guess based upon previous periods and information from the fund.

Now rank your investments from highest to lowest based on their potential tax liability. This list is now your guide on where to hold investments. The investments at the top should be held in your tax-qualified accounts, if possible. Work down the list until the tax-qualified accounts are full and then put the remaining investments in your taxable account.

For more information and detail please go to Farmcreeksecurities.com.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal.

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