



Tax Efficient Portfolio Management *Keeping more of what you make*

Good fortune has its price. It's called tax day – April 15th. In exchange for a civil, safe and advantaged society, we all agree to pay our taxes. The question is how much will ultimately go to Uncle Sam?

It's a key question, and one that much of the financial services industry conveniently ignores. *Pre-tax* returns are the standard point of comparison in marketing materials, but for individuals, pre-tax return is a work-in-progress number. Before taxes, return is a half-told story, a cake still in the oven. These figures are not meaningless, but they're sorely incomplete. They are not the returns that individual investors ultimately retain. Only tax-exempt institutions reap and keep pre-tax returns.

The crucial number is *after-tax* return. Actual tax due at year-end varies widely, depending on individual securities owned and the composition of the portfolio as a whole. For instance, a portfolio with high turnover – lots of buying and selling – will incur more capital gains and more taxes than a buy-and-hold portfolio. Has your investment advisor computed and provided your after-tax return for 2006?

Tax efficiency is no accident

As it is clearly more desirable to make 15 percent in pre-tax returns and keep 14 percent than to make 20 and keep 12, tax efficiency is critical. And possible. A review of one our client's dividends, income, gains and losses from 2006 showed that she kept more than 90% of her total annual return in a global diversified portfolio. Her pre- and after-tax returns were close to identical. How? What's the secret?

The answer is not a secret – the tax code is certainly no secret – but a practice, **the three-step practice of tax efficient portfolio management.**

Step one: Tax-favored accounts

This one is easy, but very important. IRAs, SEPs, 401(k)s and other tax-deferred accounts make all gains tax-free until distribution many years down the road. Therefore, these accounts should be stuffed with investments that



would otherwise generate a big tax bill – for instance, actively managed portfolios with high turnover and high income.

Step two: Tax-favored investments

Not all investments are created equal. Returns from some securities get preferential tax treatment. There’s no such thing as a “free lunch” with the IRS, but here are a few tasty snacks that limit exposure to taxes:

- Taxes on dividends are at a historic low – 15 percent, making stocks with high yields more attractive than ever. [*Consider:* Wisdom Tree Japan High Yield – yes, there are high yielding Japanese stocks.]
- Distributions from REITs and timber REITs avoid double taxation and can lower basis through return of capital when assets are sold.
- Five classes of US government and agency securities, including T-bills and Federal Home Loan issues, are taxable federally, but escape state and local taxes. This is a big deal in Massachusetts and other high tax states.
- Tax-exempt bonds provide tax-free income and capital protection. [*Consider:* Pimco High Yield Muni Fund – a higher risk step in muni diversification, with an additional 100 basis points in yield.]

Step three: Portfolio tax efficiency

The real art and science of tax efficiency happens at the portfolio level where investment strategy, tax optimization, and risk management come together. Disciplined application of best portfolio practices can dramatically reduce tax liability *and* increase return:

- **Boldly hold:** First, and most importantly, not selling is a foolproof tax-deferral method. Look for investments that can rise for decades, not weeks, and hold them. [*Consider:* Ishares IEV – the 350 largest companies of Europe are large and strong enough to grow forever.]
- **Reinvest:** 40 percent of the return from the S&P since 1920 has come from reinvestment of dividends. Even after paying the modest tax on dividends, a reinvestment strategy pays off.
- **Find it:** Some holy grails exist. In tax, it’s the ability to convert ordinary income into capital gains. Risk tolerant investors can buy the financial “casinos” [*Consider:* Fortress, Goldman Sachs, and soon Blackstone]. You can earn dividends now on these stocks and defer any potential gains, instead of, or in addition to, receiving ordinary income from their



hedge and private equity partnership distributions. You can go to Las Vegas, but also own a piece of the house.

Step zero: Avoid strategy shifts

There's another element that ideally precedes the three step quest for tax efficiency described above. Step zero is minimizing changes in strategy. As any significant shift in strategy (or advisor) will necessitate liquidation of many positions and receipt of capital gains, the cost in taxes can be huge. The best approach is to find an advisor with a built-in, long term bias for tax-efficiency, set a tax-aware strategy based on principles above, and stick with it.

What's it all mean?

When it comes to setting specific tax-focused investment strategies, remember one key word: indexing. A well constructed index has negligible turnover and taxes, and typically beats similar actively managed portfolios. Indexes are diversified by definition, and are ideal for buy and hold strategies. Exchange Traded Funds (ETFs) are an important advance in indexing, as they let you control your basis, and are very low cost. (See our December 2006 article, "The Power of Indexing" at www.osboncapital.com)

[*Consider:* Eaton Vance Global Tax Aware Buy Write Fund – a liquid hedge fund (long stock, short options) designed for individuals who pay taxes.]

The OCM advantage

At OCM we practice tax-efficient global diversification for capital preservation. Tax efficiency lets you keep more, global access gives you more choice, and diversification lowers risk.

Another important idea: there are many moving parts in a tax-efficient portfolio. As such, it is a great idea to connect your investment advisor and your tax advisor and let them work together to minimize the tax bite.

How efficient is *your* portfolio?

Osbon Capital Management offers a **complimentary tax-efficiency analysis of your portfolio**. The result is a clear view of your 2006 pre- and after-tax returns. Contact John Osbon at 617-217-2772 or josbon@osboncapital.com