April 2011 – Wealth Creation and Its Preservation: Taxes Always Play an Important Role

One of the most important services that a financial manager provides is to help clients achieve a certain level of financial assets whereby they can be comfortable in knowing they have enough funds to maintain their desired lifestyle. To the extent that a person needs to have more financial assets to achieve this level, a financial manager should focus on growing assets to reach that goal. Such a goal should be large enough to generate sufficient income to pay for the desired lifestyle including the ability to cover extraordinary expenses that invariably come along.

Secondly, when such levels are achieved, the investment manager's focus should change to one of preserving the capital which provides this income and growing it sufficiently to keep pace with inflation, particularly regarding health care costs as we all age.

To that end when we present our investment philosophy, we state:

> "First and foremost, portfolios must be managed to reflect the client's financial goals, ***tax attributes*** (emphasis added), estate planning needs, cash flow requirements, financial resources and risk tolerance."

We also state that portfolios should be handled in such a way as to minimize taxes. However, in our January 2002 newsletter we acknowledge that taxes should only be a consideration and should not dictate an investment decision.

A few examples:

Recently we have had clients who were able to successfully diversify their portfolio without adverse tax consequences because of the step up in basis afforded by estate tax law. These clients were able to increase their income and provide for more growth opportunities with lower overall risk and minimum taxes.

Another client had an account with another advisor in which the manager was able to match the S&P 500 return for 2010, but the portfolio had buys and sells aggregating 800% of the portfolio. (Actually on a $500,000 portfolio the manager bought and sold stocks amounting to over $4 million). This turned the gains into realized short-term capital gains, and, as a result, the client was taxed at a high marginal rate. This caused the client to underperform the S&P 500 on an after-tax basis by over 5%. The really sad part of this story is that all of this trading was done with virtually the same stocks so the make-up of the portfolio never really changed. If no trades occurred, the tax bill would have been zero. In addition to paying the manager a fee, the client also gave 5% of the portfolio to the Federal government in taxes! (Another way of looking at this is that if the client was in the 28% tax bracket, $10,500 in additional taxes would have to

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be paid). If the market had gone down in the last few months of 2010, the client could have very well suffered a decrease in overall value while generating significant ordinary income for income tax purposes. This would have been a terrible result.

In our first quarter of 2006 newsletter, we discussed pros and cons of mutual funds. In discussing the cons, we noted that the typical mutual fund averages about 90% turnover (buying and selling of stock) virtually assuring that the majority of gains will be short-term gains which are taxed at the highest marginal rates. Frequently during down markets net short-term gains may be reported for tax purposes even though the portfolio loses value.

The point of all this is to emphasize that taxes do make a difference and will affect your overall return in the long run. Currently, dividend income and long-term capital gains are taxed at a maximum of 15% whereas the highest marginal rate on short-term gains is over twice that. Clearly your assets will grow faster and generate more income on an after-tax basis if you minimize short-term gains and maximize long-term unrealized gains.

Having said all of this we don't want the "tax tail wagging the economic dog." If conditions warrant, as they did in 2007 and 2008, we shouldn't hesitate to re-allocate from stocks to safer securities during market downturns regardless of tax consequences.

This is tax return season, and we get to see a lot of examples of inefficient trading this time of year; hence, this letter's topic. Generally, we also try to put tax friendly transactions such as dividends and long-term capital gains in taxable accounts and tax unfriendly transactions such as interest income and short-term capital gains in non-taxable accounts such as IRA's.

As always we appreciate your thoughts and questions and the opportunity to help you with your "Wealth Creation and Its Preservation."

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