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Intelligent Money

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Special Notes of Interest:

- About 50% of investments in open-ended mutual funds are held by taxable investors
- The US Mutual Fund Industry managed $6.76 Trillion on 12/31/02

Current thinking from Haven Financial Advisors

The Importance of a Tax Efficient Portfolio

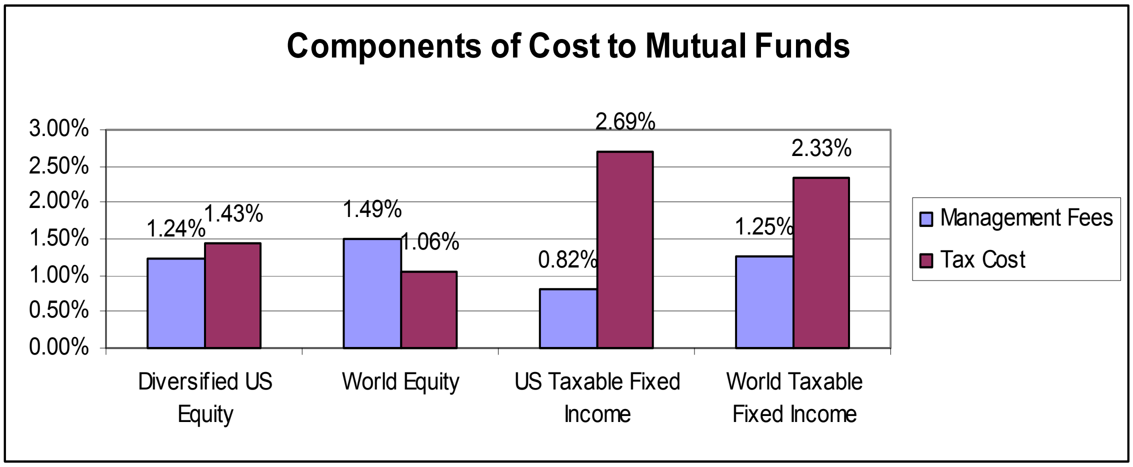
If the only certain things in life are death and taxes, at least the effect of taxes can be made less painful. As we'll see, all investments are not created equal in the eyes of Uncle Sam. Moreover, investment products within the same asset class offer significant differences to the investor in terms of how effectively they manage tax liability.

Recent tax legislation has significantly increased the prospective tax efficiency of stocks in that most dividends and long-term capital gains are now taxed at a new lower maximum tax rate of 15%. The top marginal income tax rate has likewise been reduced to 35% - benefiting all investors.

My illustrations will focus on mutual funds; they are readily tradable and priced every day. Further, excellent data on the tax liabilities they generate for their investors is freely available. That data speaks clearly: the tax burden is significant both in terms of its overall economic importance among all asset classes and in terms of the differences among investment products within the *same* asset class.

Most mutual fund reporting hides a dirty little secret. Indicated returns do not account for the taxes that their investors must pay. Moreover, individual investors have no say in the timing of taxable transactions that portfolio managers incur on their behalf. The costs of premature taxation are high – in most cases, they are higher than the management fees that funds charge.

In its most recent survey, *Lipper Analytical Services* estimated that, in the aggregate, taxable investors give up between 1.5% and 1.8% of their investment to taxes each year. Like management fees, tax liability varies widely among mutual funds. For taxable investors, it pays to shop around. The table below, compiled using trailing five year data from Lipper, illustrates the large impact that taxes have on the returns on several key asset classes. Notably, the average domestic bond mutual fund's direct expenses are less than *one third* the federal tax bill that taxable investors pay.



Tax Efficient Portfolios (continued)

Understanding the factors that drive tax liability helps us pick investments that offer greater tax efficiency. Mutual funds provide economic returns in three significant ways from a tax perspective. They “pass through” interest and short-term capital gains to the investor as ordinary income. Additionally, funds pay long-term capital gains and dividends at reduced maximum rates of 15%. The final component of return is comprised by unrealized capital gains. These gains exist only “on paper” and, thus, generate no current tax liability.

Asset classes such as bonds and money market funds return virtually all their gains as current income. They are inefficient investment vehicles for taxable accounts of individual investors. Conversely, stock mutual funds pay back a comparatively small fraction of their returns as current income.

A key factor affecting the tax liability within the universe of stock mutual funds is the level of asset turnover. Mutual funds that sell large fractions of their portfolio will tend to recognize significant capital gains over time. These gains are passed through to the investor as taxable events. Correlation between asset turnover and tax liability is strong; a more passive investment management style can reduce taxes. Index funds and buy-and-hold managers use such passive management.

The average stock mutual fund generates asset turnover of 120%. That is, each stock is sold 1.2 times over the course of a year. Much of the benefit achieved through the appreciation of stock prices is captured each tax-reporting period as short term capital gains. The investor has to pay taxes on these gains as ordinary income even though he or she did not sell any fund shares.

On the other hand, an index fund adjusts its holdings infrequently. For example, an S&P 500 index executes significant sales only when a stock is removed from the index. Therefore the index fund generates fewer taxable events than an active fund. It is no surprise that the Lipper study identifies equity index funds as the best subcategory of stock mutual funds from the standpoint of minimizing tax burden. The table below illustrates the strong relationship between asset turnover and tax burden.

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Detail of Diversified Equity Funds

	Tax Cost	Asset Turnover
Best Quintile	0.31%	76%
2nd Quintile	0.86%	80%
3rd Quintile	1.29%	76%
4th Quintile	1.80%	97%
Worst Quintile	2.94%	139%

Investors can also enhance their aftertax returns through the efficient use of their existing tax shelters. Despite the lower tax rates implemented in 2003, the *difference* between ordinary income tax rates and capital gains has increased. It’s more important than ever to optimize tax shelters.

*“Despite the lower tax rates implemented in 2003, the **difference** between ordinary income tax rates and capital gains has increased.”*

Fixed income investments, while highly taxed, are an important component of an overall investment strategy. They belong in a qualified or personal tax shelter such as a 401(k) plan or a Roth IRA. Those investments that are best suited to withstand taxes (namely indexed stock portfolios) should be retained in taxable accounts. The least tax efficient investments are generally best placed in tax-deferred or tax-free investment vehicles.

Tax Efficiency of Exchange-Trade Funds

Exchange-traded Funds tend to perform well from a tax perspective. A key reason is that they generally implement passive investment strategies that minimize tax events. Secondly, their redemption features offer managers greater flexibility in meeting liquidity needs. Most ETFs allow for in kind delivery of assets when institutional shareholders attempt to liquidate large blocks. Consequently, lower cost basis shares can be delivered away from the fund with the attendant tax benefits accruing to the remaining investors.