Diversification, Low Portfolio Turnover Key to Tax-Efficient Investing

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This is the second article in a two-part series on tax-efficient investing. In the following interview, Glenn S. Freed, Ph.D., vice president of tax-managed investment services at Dimensional Fund Advisors in Santa Monica, CA, USA, discusses equity strategies to maximize after-tax returns for institutional investors.

AIMR Exchange: What is the basis of tax-efficient investing for institutions?

Dr. Freed: The key is to have a broadly diversified portfolio where taxes are a major factor in the choice of investment strategy. Strategies that require high portfolio turnover generate high trading costs and result in the frequent recognition of capital gains. Tax-efficient investing dictates low-portfolio-turnover strategies implemented with broad market-like portfolios combining stocks in value-weighted proportions. Such portfolios require limited trading to maintain desired risk and return characteristics. If the investor wants a portfolio with higher expected returns than the market, the portfolio can be tilted toward size and style factors with small increases in portfolio turnover.

Are there misconceptions?

Some taxable institutional investors believe tax-efficient investing is buying the S&P 500 because the index doesn't have much turnover. The problem is that the S&P 500 is reconstituted as a result of various corporate actions and may trigger the realization of capital gains in a portfolio tracking the index. Another drawback to the S&P 500 is that some of these large companies pay a substantial cash dividend, and institutional investors might want to defer the taxes on dividends. We say, "You're leaving a lot on the table when you accept dividend income without managing dividends. If you could trade capital-gain income for dividend income, that capital-gain income could be deferred until realized. If you have unrealized capital-gain income, you will have a greater after-tax return."

On the flip side, some institutional investors may want more dividend income due to the corporate-dividends-received deduction, but tracking the S&P 500 does not allow the investment strategy to increase the dividend yield of the portfolio.

What are some strategies for optimizing after-tax returns?

We want to minimize the impact of capital-gains tax and dividend-income tax on the return of the portfolio. The hard part is doing that without altering the investment objective. We start with a well-diversified portfolio of stocks, giving us a continuous supply of gainers and losers to harvest so we can remain capital-gain neutral. The key is to strategically harvest losses while avoiding any violation of the "wash sales" rules.

We offer tax-managed mutual funds and separate accounts that seek to maximize after-tax returns. The mutual funds are structured to capture specific size and style factors that drive returns, while minimizing the tax costs associated with mutual-fund investing. Typical small-cap and value mutual funds generate substantial taxable income because of normal turnover in these investment strategies. The average annual return lost to taxes can be as high as 2 to 4 percent annually.

The down side is that, if there are losses in the mutual fund, they cannot flow outside the mutual fund. You cannot take full benefit of tax-efficient investing by using losses in that diversified portfolio to offset gains outside the portfolio.

Institutional clients can invest in a customized tax-managed separate account that is coordinated with other investments. Many of our clients have fixed-income portfolios. As interest rates have come down, some have had capital gains from their fixed-income portfolio. By investing in a tax-managed separate account versus a tax-managed mutual fund, we can harvest some losses from this diversified portfolio to offset gains in their fixed-income portfolio. Clients can pinpoint their desired asset-class exposures and create a broadly diversified portfolio that is managed to maximize after-tax returns. The ability to tailor exposure to the factors that drive returns gives investors a wider range of possibilities than pure indexing or active management.

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