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# Tax Day blues? Consider tax-aware investing.

Taxes are top of mind for many now, what with tax reform noise coming out of Washington, D.C. and Tax Day approaching on April 18th (yes, due to a holiday on Friday, April 15th, Tax Day falls on the following Monday, April 18th this year).

While it's too early to understand the potential impact tax reform may have on client portfolios in the future, advisors can help clients better manage taxes today. For instance, many investors fail to connect the Tax Form 1099 they receive with the corresponding reduction in their investment portfolio's after-tax return.

Let's look at 2016 as an example of the impact taxes can have on investment returns.

- The **average capital gain distribution** for the universe of U.S. equity mutual funds (active and passive) that had a distribution, **was 5.6% of the fund's Net Asset Value**. [1]
- This distribution was split, on average, between **11% Short Term Capital Gain** (STCG) and **89% Long Term Capital Gain** (LTCG). (Recall that the STCG is taxed at a higher Federal Income Tax Rate than LTCG for many investors.)

That means, that a hypothetical $500,000 portfolio would have had a $28,178 taxable distribution (500,000*5.6%), resulting in a federal tax bill for investors in the highest Federal Tax bracket of $7,314 (assuming taxpayer is highest federal marginal rate).

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|---|---|
| Assumed investment: | $500,000 |
| Cap Gain Distribution: | 5.6% |
| Taxable Distribution: | $28,178 |
| **Federal Tax Due*:** | **$7,314** |

That four-digit tax bill is uncomfortable for anyone - and feels even worse when you consider the long-term potential impact to the investor and to your own business.

## Potential impact on the investor's wealth

By applying several strategies throughout the year (such as creating tax losses during periods of market volatility, focusing on short term vs. long term capital gains, qualified vs. unqualified dividends and return from unrealized capital gains vs. realized), a tax-managed investment approach could potentially result in material total tax savings and greater portfolio growth for the investor.

For example, imagine if the investor could have a federal tax bill of $0 instead of $7,314, and invested that $7,314 in a hypothetical portfolio that returned 7.0% per year for the next 10 years. Through the power of compounding, that $7,314 could almost double to $14,384. This assumes no tax over those 10 years, but demonstrates the type of value that can be demonstrated by being smart around taxes.

## Potential impact on the value of your advice

Advisors also potentially stand to gain from helping the clients manage the impact of taxes on their portfolios. For one, appropriate tax management for taxable accounts could be in the client's best interest - helping advisors meet fiduciary standards and differentiate themselves in a crowded market place. Further, helping clients grow their wealth can potentially financially benefit advisors, too. After all, as clients' account balances grow, so do the outputs of the advisory fees.

What's more, the impact of managing taxes can be relevant in both low and high return markets.

## Managing taxes in low and high return markets

As we've written previously, market return levels and the size of capital gain distributions do not always move in tandem. As the exhibit below shows, when the market (Russell 3000® Index), was up only 0.5% in 2015, the average capital gain distribution was 10% — resulting in a -2.3% loss of return to taxes. In 2016, the market was up 12.7% and the average capital gain distribution was lower, at 5.6%.


*Hypothetical example for illustrative purposes only. Market return: Russell 3000® Index. Average Taxable Distribution includes average capital gain distribution for all Morningstar U.S. equity categories for listed year. Distribution is assumed to be made the last day of the year and reinvested. Tax rate is 23.8% (Max LT Cap Gain 20% + Net Investment Income 3.8%). Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.*

## The bottom line

Taxes can be a major headwind for taxable investors. The good news is that the impact of taxes on investment portfolios can be managed intentionally, reaping potential benefits for investors and advisors alike. While there is much discussion today about potential tax reform, investors and their advisors shouldn't lose sight of the existing tax rules that affect investment portfolio returns. Make sure your client's taxable assets have a tax-managed approach to help improve their odds of achieving successful outcomes.

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[1] Source: Morningstar and Russell Investments calculations. Includes all open-ended U.S. equity mutual funds to include active and passive funds, and all share classes, in the Morningstar U.S. Fund Large Blend, U.S. Fund Large Growth, U.S. Fund Large Value, U.S. Fund Mid-Cap Blend, U.S. Fund Mid-Cap Growth, U.S. Fund Mid-Cap Value, U.S. Fund Small Blend, U.S. Fund Small Growth, U.S. Fund Small Value universes.

*Federal tax due calculation assumes 5.6% distribution is taxed as 89% LTCG / 11% STCG. LTCG taxed at 23.8% and STCG taxed at 43.4%.

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