
Individually Managed Accounts and Mutual Funds

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Case Study: Individually Managed Accounts and Mutual Funds

ASSUMPTIONS	LOCKWOOD TAX-AWARE MANAGER	AVERAGE DOMESTIC EQUITY MUTUAL FUND
<i>Tax-Efficiency</i>		
Embedded capital gain	0%	7%
Portfolio turnover	20% - 45%	97%
Tax efficiency (15-yr), excluding fees	85% - 95%	79%
<i>Fees</i>		
Advisory fees	0.50%	0.00%
Management fees / Expense ratio	0.50%	1.43%
Brokerage costs	<u>0.25%</u>	<u>0.30%</u>
Total fees	1.25%	1.73%

Source: Morningstar, Inc.; Lockwood Advisors, Inc.; 12/31/00

Individually Managed Accounts and Mutual Funds

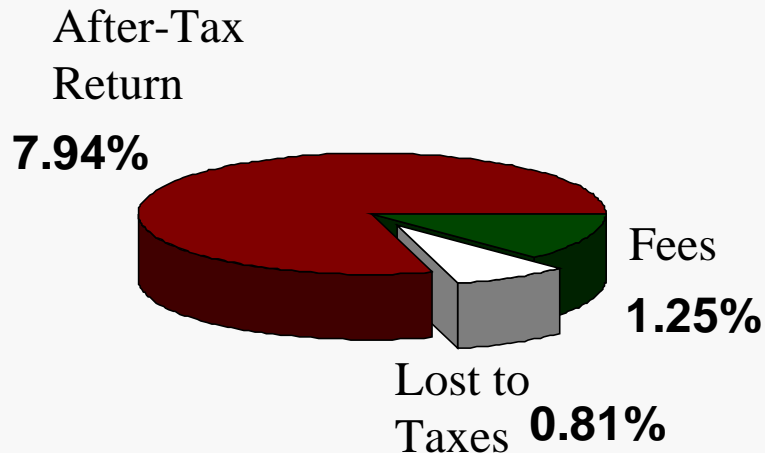
3-Year Return Assumptions

Pre-Tax Return	10%
Dividend Yield	2%
Capital Gains Return	8%

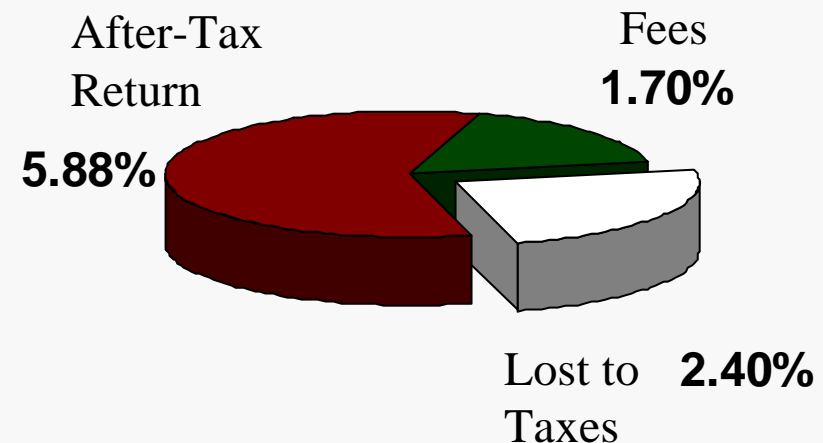
Tax Rates

Capital Gains	20%
Ordinary Income	39.6%

Lockwood Tax-Aware Manager



Average Mutual Fund



Unrealized Capital Gains of the Ten Largest Equity Funds

December 31, 2000

Fund Name	Assets (\$Billions)	Unrealized Capital Gain (%)	Annual Turnover (%)
Fidelity Magellan	92.5	37	28
Vanguard Index 500	89.3	39	6
Investment Comp of America	54.3	5	28
Washington Mutual Investors	45.4	23	26
Fidelity Growth & Income	39.7	41	35
Fidelity Contrafund	39.2	17	177
Janus	39.1	9	63
Growth Fund of America	36.1	21	46
American Century Ultra	33.7	27	42
Fidelity Growth Company	29.1	30	86

Source: Morningstar Inc.; 12/31/00

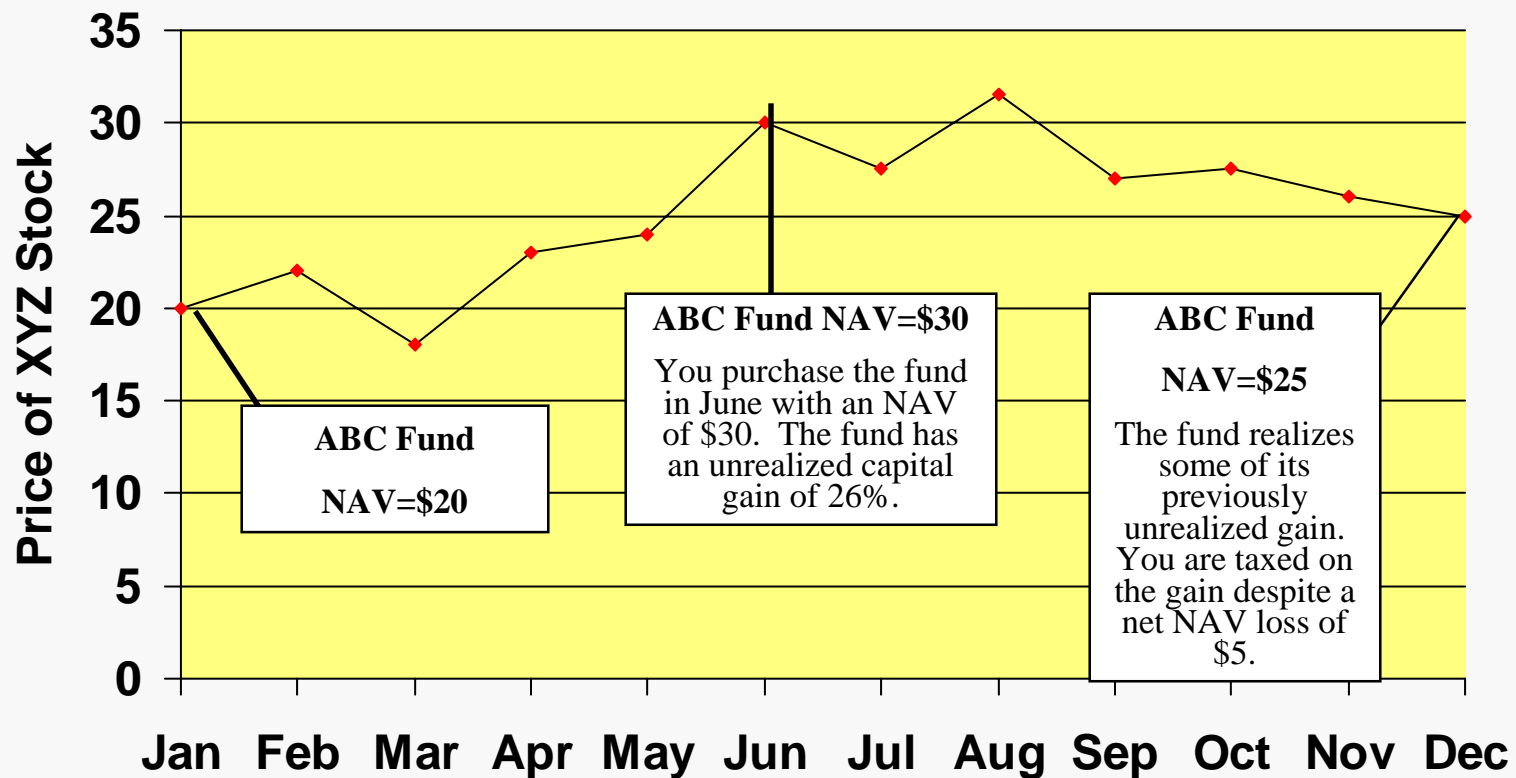
Characteristics of the Twenty-Five Largest Equity Funds December 31, 2000

- ◆ Total Assets: \$815 Billion
- ◆ Average Unrealized Capital Gains: 21.96%
- ◆ Average Annual Turnover: 43.08%

Source: Morningstar Inc.; 12/31/00

Inherited Tax Liability: The Double Whammy

How you can lose money and still owe taxes



Low Turnover Does Not Necessarily Equate to “Tax Efficiency”

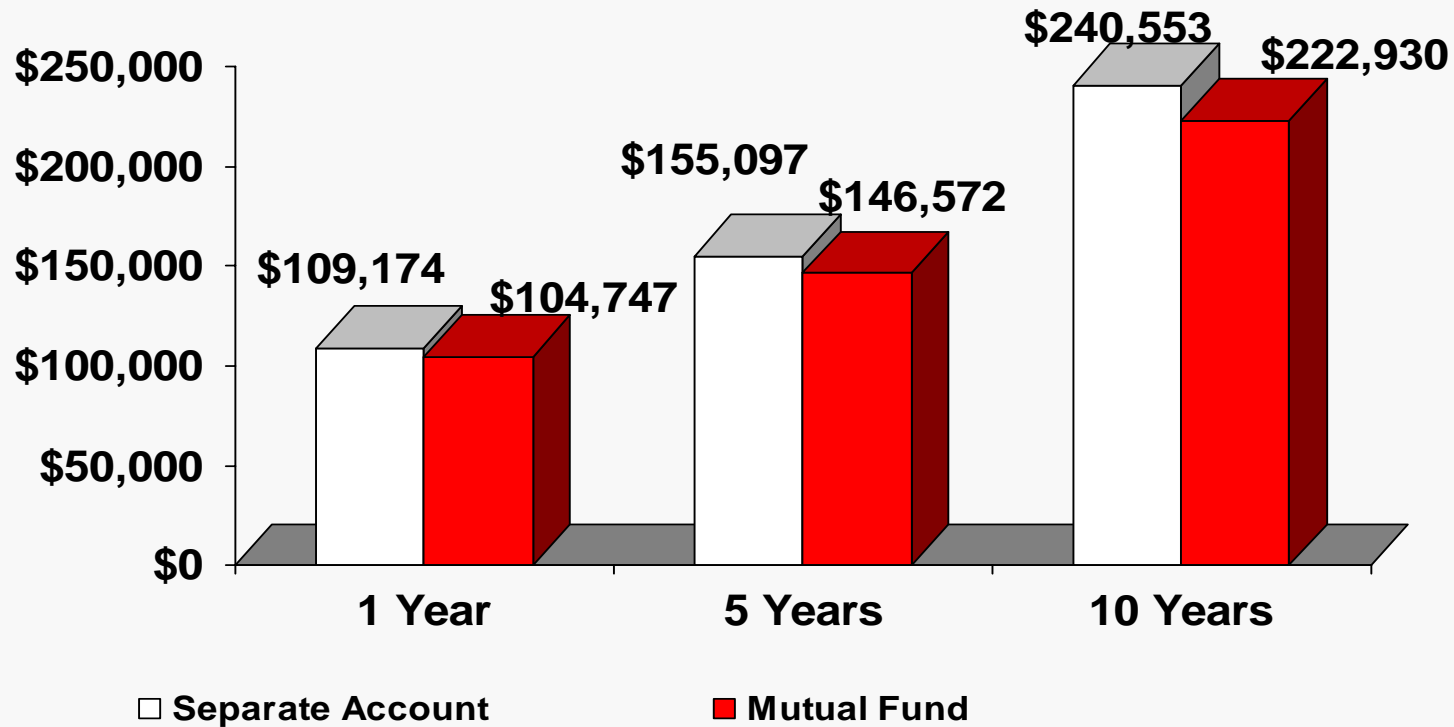
- ◆ “Low-turnover” mutual funds are not necessarily tax efficient.
- ◆ Historically, the average capital gains realization rate for all domestic equity funds is around 50%.
- ◆ Low-turnover may keep brokerage or transaction costs down, but it appears to have no real effect on capital gains realization rates.

Source: Lockwood Advisors, Inc.; Morningstar, Inc.; 12/31/00

Unrealized Capital Gains

A Game of Musical Chairs

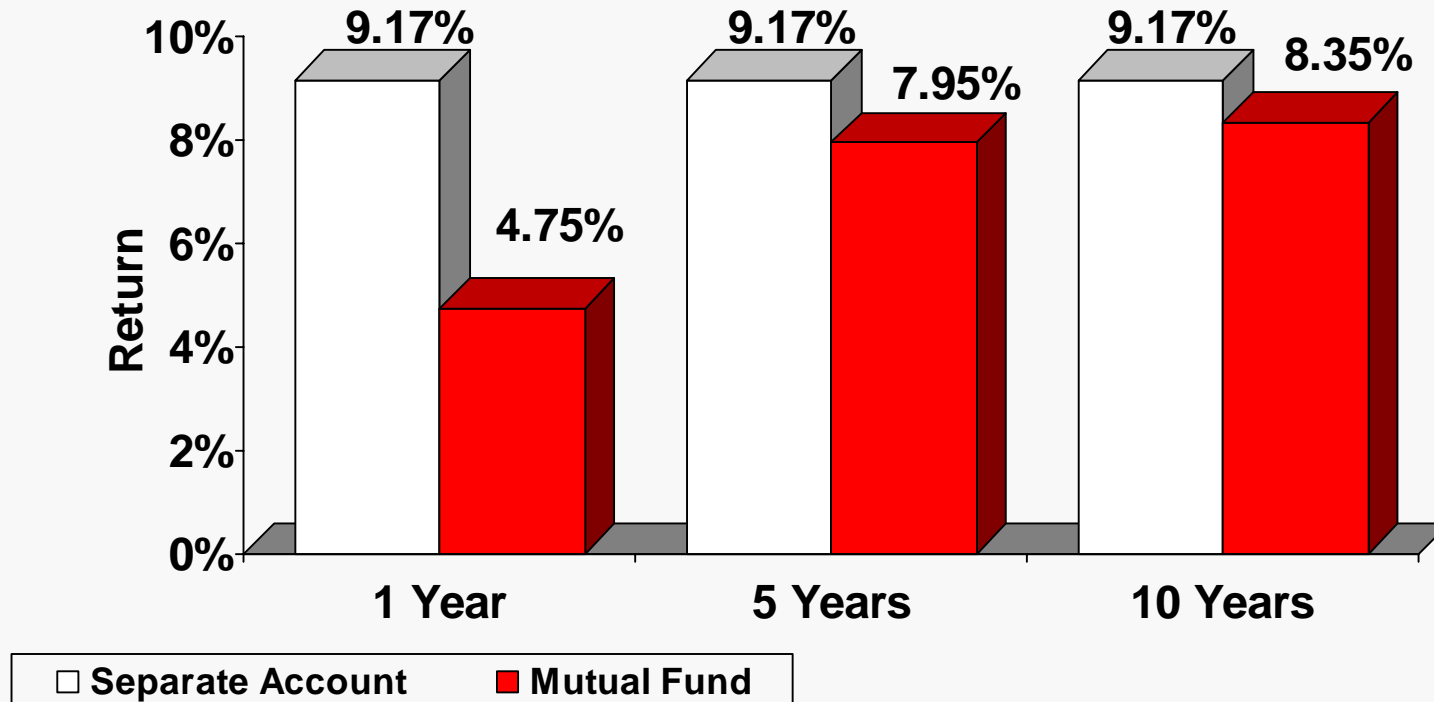
**Potential Impact of Mutual Fund Unrealized Capital Gain Exposure on After-Tax Returns (After Fees)
Based on \$100,000 Investments**



Unrealized Capital Gains

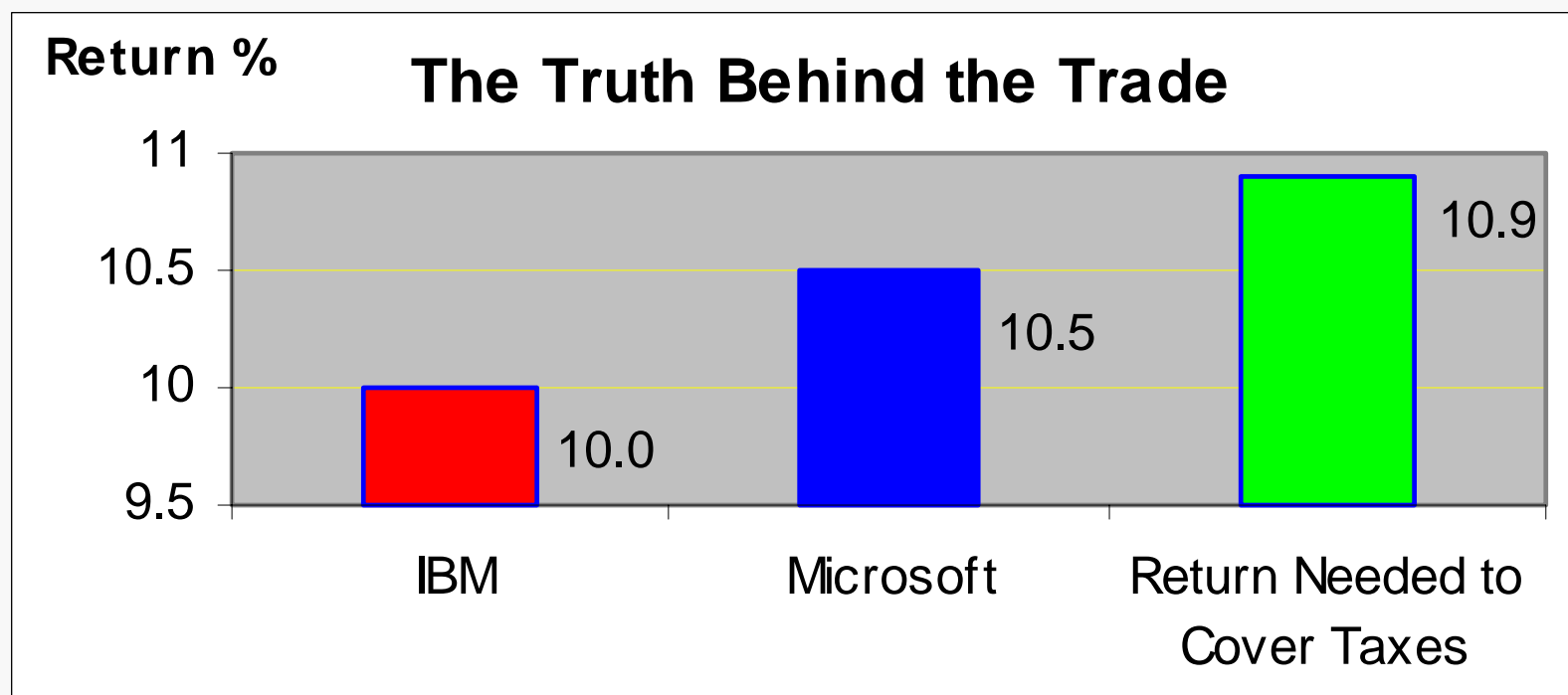
A Game of Musical Chairs

Potential Impact of Mutual Fund Unrealized Capital Gain Exposure on After-Tax Returns (After Fees)



The Impact of Taxes on Investment Results

The Tax Bite on Wealth Creation



Assumptions: 39.6% tax rate for less than 1 year/20% greater than 1 year

Implementing Investment Strategy

*Optimal Asset Allocation Structure should
take tax exposure into consideration.*

- ◆ Tax Deferred - No current tax exposure, no tax protection required.
- ◆ Taxable Assets - Should be positioned to minimize tax liability.
- ◆ The combined strategy may appear unusual.

Implementing Investment Strategy

Tax-Deferred Assets

- ◆ Taxes are not a transaction cost
- ◆ Mutual funds are often a suitable choice
- ◆ Great freedom in implementing a chosen strategy
- ◆ Can be used effectively as an asset allocation modulator

Implementing Investment Strategy

Tax Deferred Assets as Asset Allocation Modulator: Example

Client Assets

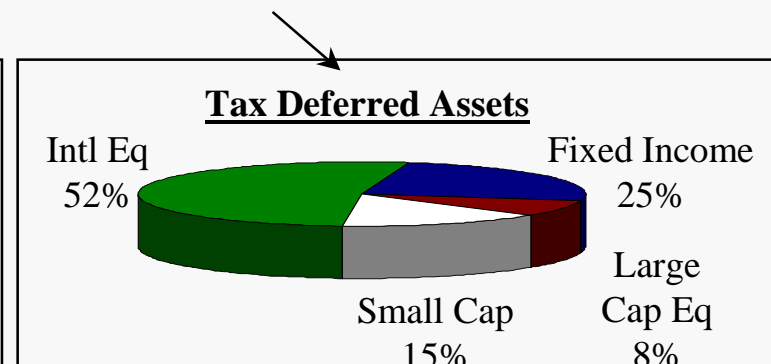
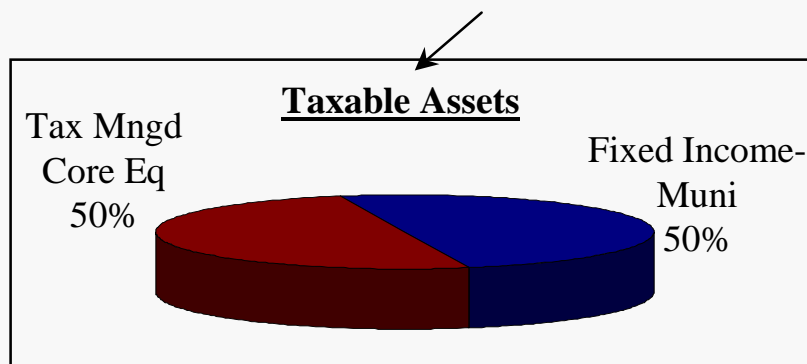
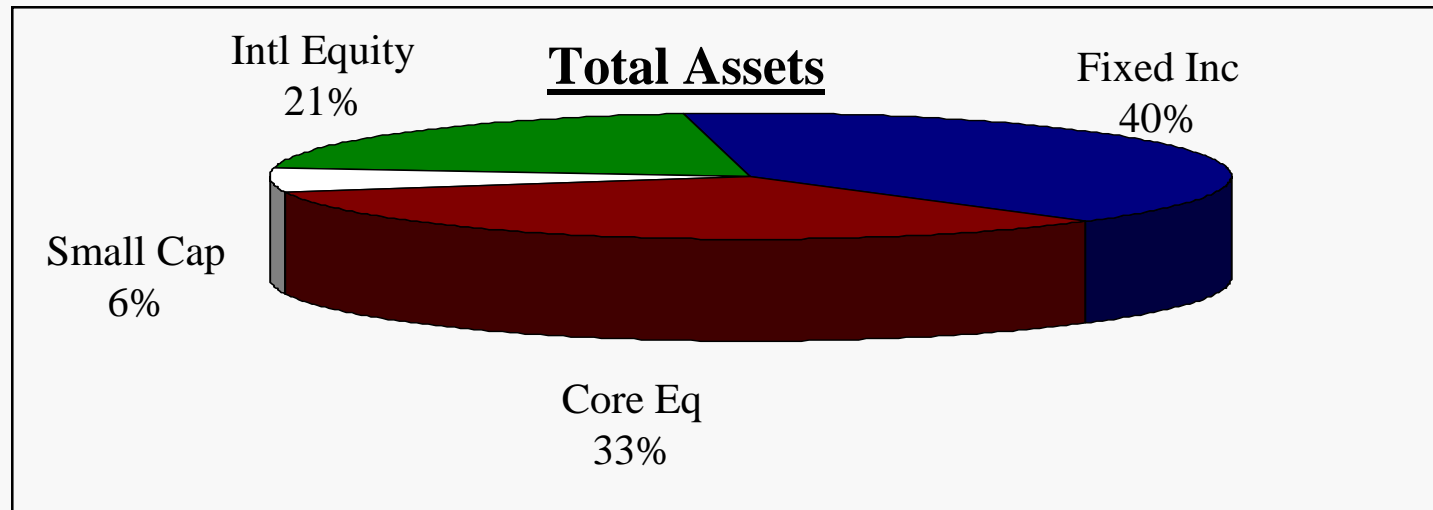
– Taxable: \$600,000 Tax-Deferred: \$400,000

<u>Asset Allocation</u>	<u>Initial (%)</u>	<u>Goal (%)</u>
Fixed Income	40	50
Large Cap Equity	33	30
Small Cap Equity	6	3
International Equity	21	17

Problem: *How to accomplish an asset allocation change that makes sense, after taxes?*

Implementing Investment Strategy

Example



Implementing Investment Strategy

Tax-Deferred Assets as Asset Allocation Modulator: Example

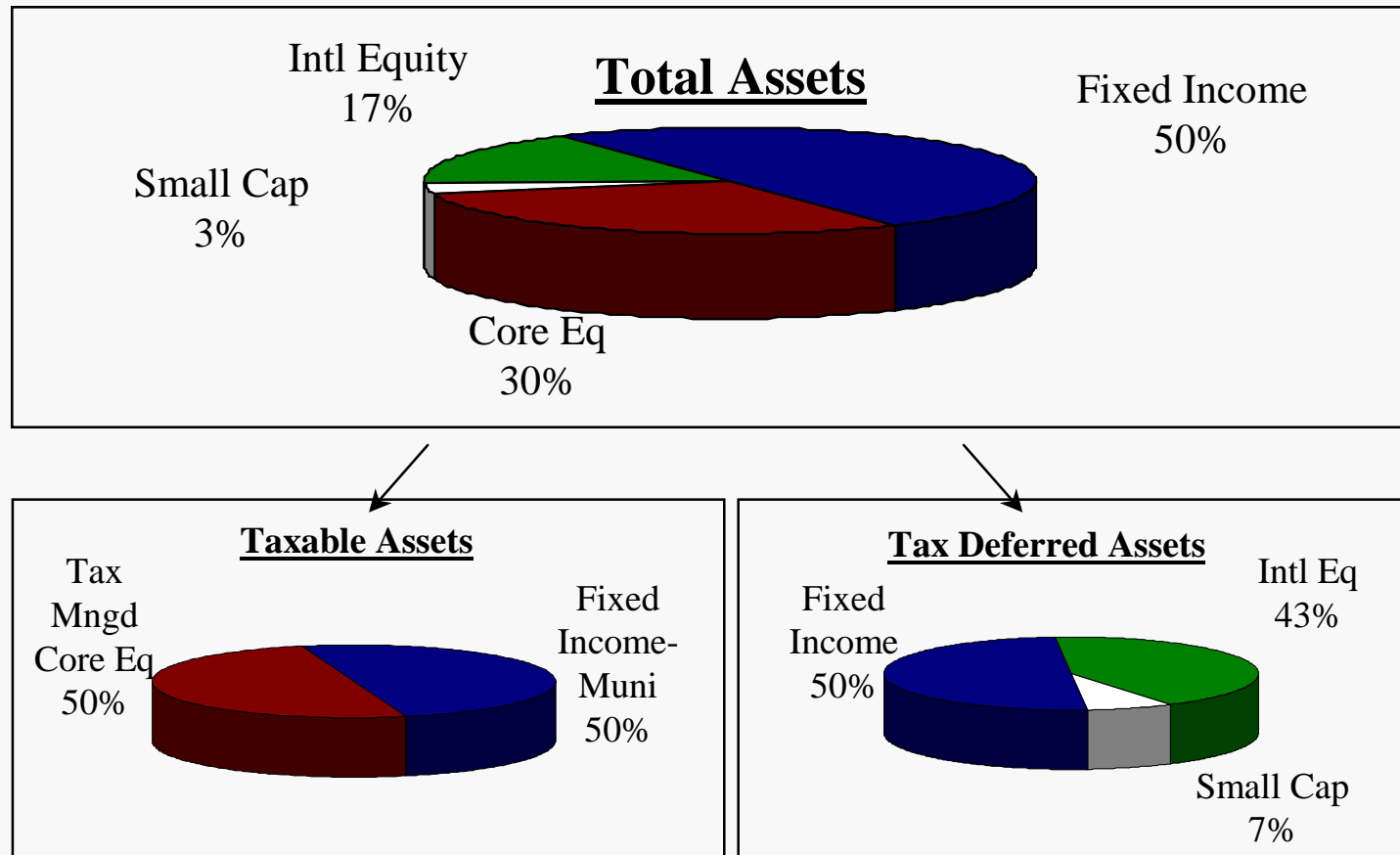
<u>Taxable Assets</u>	<u>Initial</u>	<u>Goal</u>
Fixed Income	\$300,000	\$300,000
Tax Aware Large Cap Eq	\$300,000	\$300,000

<u>Tax-Deferred Assets</u>	<u>Initial</u>	<u>Goal</u>
Fixed Income	\$100,000	\$200,000
Large Cap Eq	\$30,000	--
Small Cap Equity	\$60,000	\$30,000
International Equity	\$210,000	\$170,000

*Result: Asset Allocation Change Accomplished
With No Tax Impact*

Implementing Investment Strategy

Example

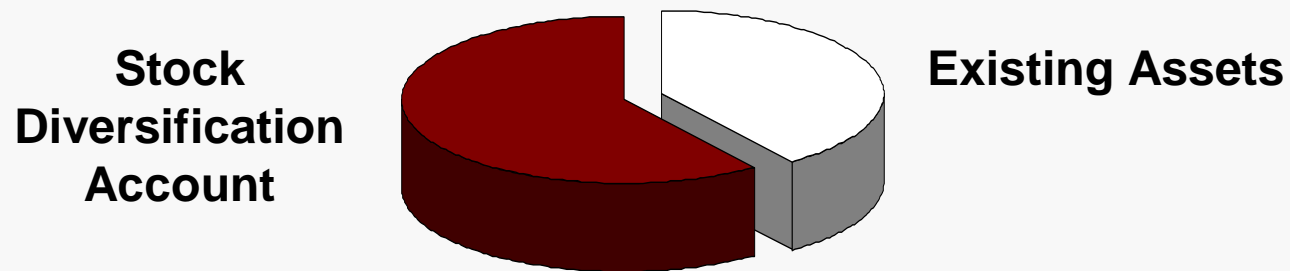


Taxable Assets: The Problems

- ◆ Low cost basis stock - Unintentionally non-diversified portfolios.
- ◆ Large positions in company stock, private businesses or real estate.
- ◆ Existing portfolios with large unrealized capital gains.
- ◆ Mutual fund overdiversification - Many investors have inadvertently created high-cost index funds.

Taxable Assets: The Solution

Stock Diversification Account Complements Existing Assets



Stock Diversification Account

Liquid Securities
Flexible Structure - complements risk exposures
Diversifies Company-Specific Risk
Diversifies Industry Exposure
Diversifies Economic Sensitivities
Diversifies Market or “Factor” Sensitivities
Managed to an after-tax return objective

Existing Assets

Large Unrealized Gains
Unique Risk Characteristics
Company-Specific Risk
Industry-Specific Risk
Economic Sensitivities
Market or “Factor” Risk
Sensitivities
Return potentially very volatile

Summary

- ◆ Every investor should have a customized strategy that includes both taxable and tax-deferred assets
- ◆ The strategies we recommend balance often-conflicting goals of return maximization, tax minimization and risk control
- ◆ The tax-minimization capabilities of individually managed accounts make them the preferred investment for taxable assets