



1838

INVESTMENT ADVISORS, LLC  
An **MBIA** Asset Management Company

# Tax Efficient Investing

*100 Matsonford Road, Suite 320, 5 Radnor Corporate Center, Radnor, PA 19087  
610-293-4365*

# Taxable Asset Allocation

Does the efficient frontier change?

	<u>Pretax Return</u>	<u>After-Tax Return</u>
Cash	5.00%	3.02%
Municipal Bonds	4.60	4.39
U.S. Core Bonds	7.00	4.02
U.S. High Yield	8.50	5.38
Non U.S. Bonds	7.90	4.94
Large Cap	10.50	7.25
Small Cap	11.75	8.21
Developed International Eq	12.00	8.40
Emerging Markets Equity	15.00	10.54

*Source: SEI Corp.*

**Because the efficient frontier changes,  
so do future wealth values.**



# Tax Efficiency of Mutual Funds: Historical Evidence

<b>Fund Category</b>	<b>Avg Pre-tax Return</b>	<b>Avg After-Tax Return</b>	<b>Tax Efficiency</b>
<b>Growth</b>	<b>14.3%</b>	<b>11.8%</b>	<b>82.5%</b>
<b>Equity Income</b>	<b>14.1</b>	<b>11.1</b>	<b>78.7</b>
<b>Growth &amp; Income</b>	<b>12.9</b>	<b>10.2</b>	<b>79.1</b>
<b>Small Company</b>	<b>15.2</b>	<b>12.8</b>	<b>84.2</b>
<b>Foreign Stock</b>	<b>12.2</b>	<b>10.1</b>	<b>82.8</b>
<b>Balanced</b>	<b>12.6</b>	<b>9.9</b>	<b>78.6</b>
<b>Taxable Bond</b>	<b>9.2</b>	<b>6.4</b>	<b>69.6</b>

**Over the twenty year period, the average growth equity mutual fund lost a full 2.5% to taxes per year!**



*Portfolio managers, fund sponsors, and distributors know that funds don't pay much, if any, attention to tax concerns. This important fact should be stated in the prospectus: "This fund is managed without regard to tax considerations, and given its expected rate of portfolio turnover, is likely to realize and distribute a high portion of its capital return in the form of capital gains which are to be realized in the form of short-term gains subject to full income tax rates."*

*John Bogle  
The Vanguard Group*

**Mutual Funds Imbedded Tax Liability of \$80 billion**

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# Possible Solutions

**Mutual Funds**

**Low or No Turnover**

**Concentrated Portfolios**

**HIFO Strategies**

**December Planning**



# In Spite of all the Evidence. . .

- ∞ The Money Management Community has paid little attention to taxes.
- ∞ Why?
  - Conventional wisdom dictates that investments be made without regard to taxes
  - This assures styles purity
  - Difficulty in performance reporting
  - Simplification of process - cookie cutter approach



# The Evidence:

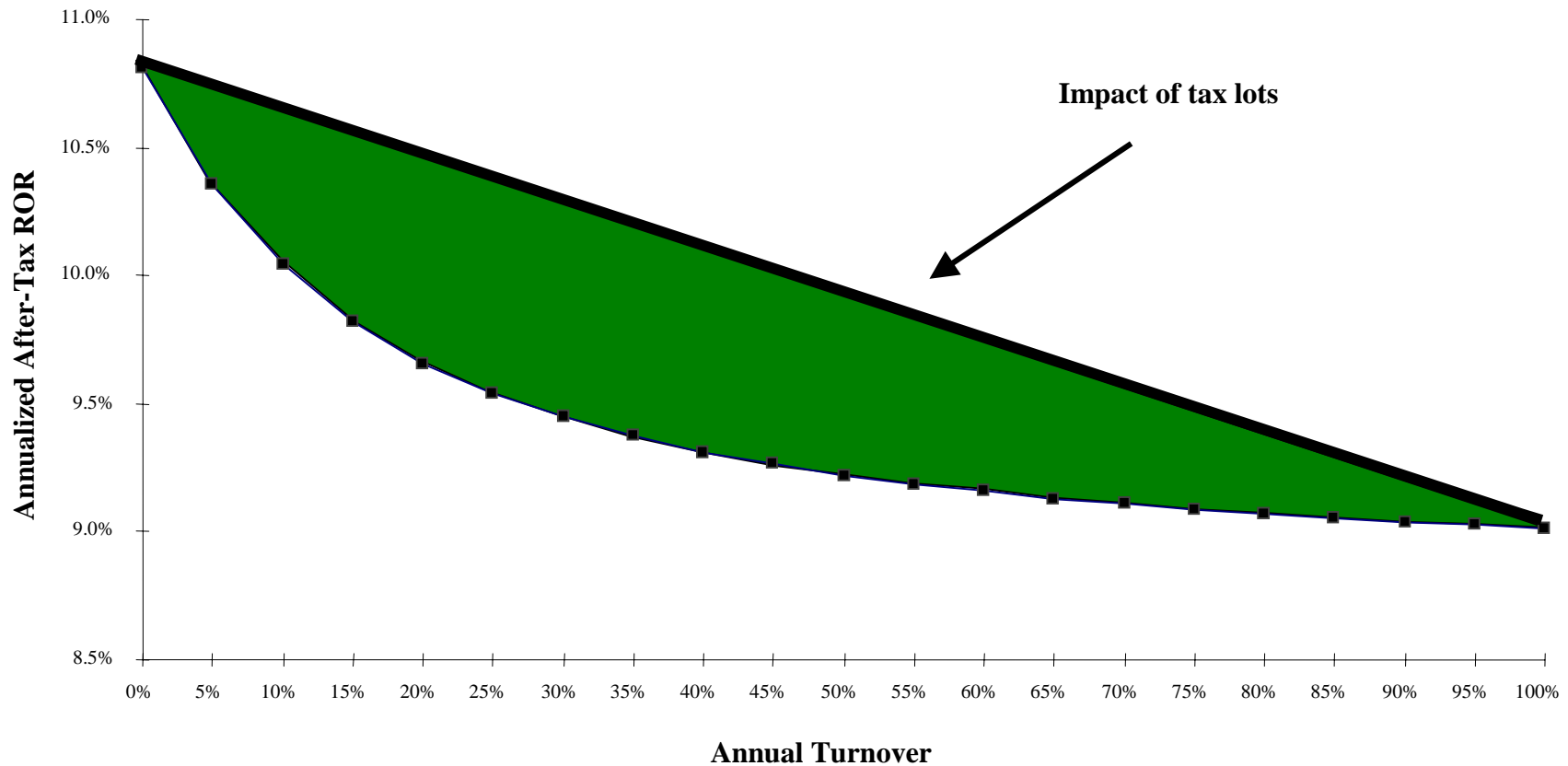
<b>Annualized PreTax Return</b>	<b>Annual Turnover</b>	<b>20 Year Annualized After-Tax Return</b>
<b>12%</b>	<b>0%</b>	<b>10.95%</b>
<b>12%</b>	<b>5%</b>	<b>10.31%</b>
<b>12%</b>	<b>25%</b>	<b>9.16%</b>
<b>12%</b>	<b>50%</b>	<b>8.72%</b>
<b>12%</b>	<b>100%</b>	<b>8.43%</b>

Source: Ghee and Reichenstein, "The After-Tax Returns from Different Savings Vehicles",  
Financial Analysts Journal, July/August 1996; 1838 Investment Advisors



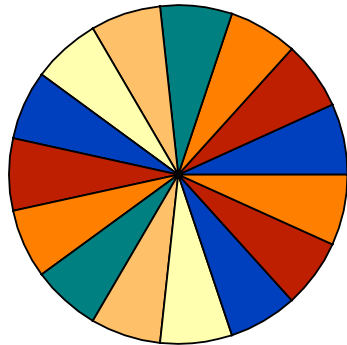
# Impact of Turnover on After-Tax Returns

## Assumed pretax 12% ROR, 20 year Horizon

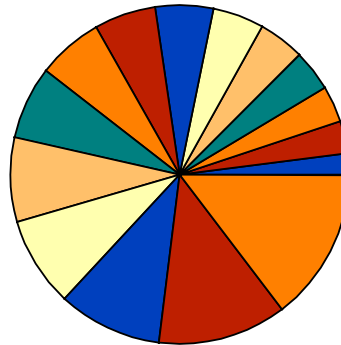


# Concentrated Portfolios

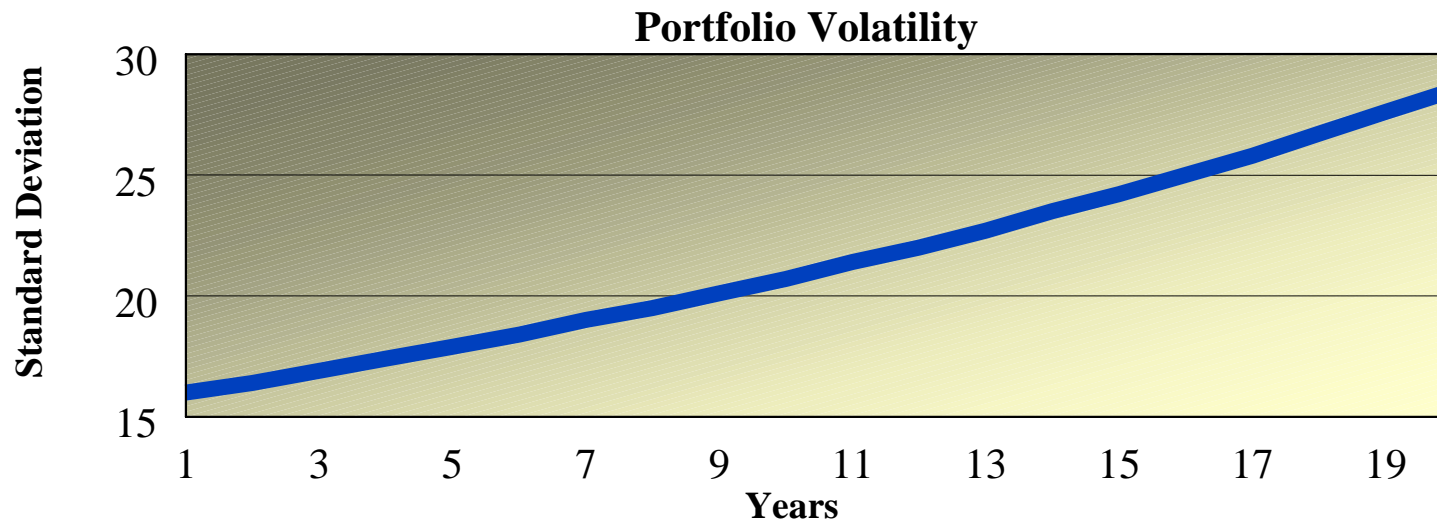
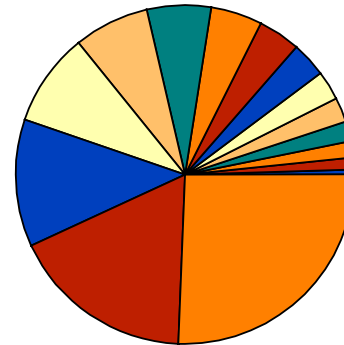
Initial Portfolio



After 10 Years



After 20 Years



# Employ FIFO Strategies

		<b>Cost</b>	<b>Market Value</b>	<b>Tax Rate</b>	<b>Tax Liability</b>
Buy 100 IBM	7/1/98	8,500	10,000	20%	\$300
Buy 100 IBM	12/1/00	9,000	10,000	39.6%	\$396



# Balancing Vital Objectives



*“Taxes are best viewed as a transaction cost to be intelligently minimized, not as something to be avoided at all costs.”*



# 1838 TaxSmart Profile

Prospect Profile		Largest Holdings Profile				TaxSmart Profile																																							
<b>Prospect:</b>	TaxSmart Prospect	--Portfolio Weight (%)--				<b>Marginal Tax Rate:</b>	39.6%																																						
<b>Prospect ID:</b>	1838Tax	<b>Company</b>	<b>Current</b>	<b>Proposed</b>	<b>Model Holding</b>	<b>Return Amortization Period (years):</b>	2.0																																						
<b>Advisor:</b>							<b>Current</b>	<b>Proposed</b>	<b>1838</b>																																				
<b>Advisor Phone:</b>							<b>Portfolio</b>	<b>Portfolio</b>	<b>Model</b>																																				
<b>Advisor Fax:</b>		ANDRX CORP	7.9	1.9		<b>Unrealized Gains:</b>	\$543,837																																						
<b>Broker:</b>		MICROSOFT CORP	7.8	6.7	Yes	<b>% of Total Market Value</b>	31%																																						
<b>Broker Account#:</b>		AMGEN INC.	7.0	0.8		<b># of Total Holdings:</b>	24	42	44																																				
<b>Asset Allocation:</b>		FIFTH THIRD BANK	6.7	6.7	Yes	<b># of Model Holdings:</b>	7	31	--																																				
<b>Equity:</b>	\$1,768,845	NASDAQ - 100 SHA	6.0	0.0		<b># of Non-Model Holdings:</b>	17	11	--																																				
<b>Fixed Income:</b>	0	JOHNSON & JOHNS	5.3	5.3		<b># of Model Holdings Not Held:</b>	37	13	--																																				
<b>Other:</b>	0	SILICONIX INC	5.2	0.8		<b>Alpha:</b>	1.0%	2.0%	2.1%																																				
<b>Cash:</b>	0	EXXON MOBIL COR	4.5	4.5	Yes	<b>Tracking Error:</b>	15.0%	4.8%	--																																				
<b>Total:</b>	\$1,768,845	DELL COMPUTER	4.5	3.3	Yes	<b>Turnover:</b>	--	34%	85%																																				
<b>Cash Withdrwl:</b>	\$0	APPLE COMPUTER	3.9	0.8	Yes	<b>Proposed Realized Gains:</b>																																							
<b>Minimum Cash Level:</b>	\$0	<b>Total</b>	<b>58.8%</b>	<b>30.7%</b>		<b>Short-Term</b>	\$100,164	\$142,288																																					
<b>Model:</b>	TaxSmart					<b>Long-Term</b>	\$71,753	\$303,913																																					
						<b>Total</b>	\$171,916	\$446,202																																					
<b>Sector Profile</b>																																													
<p>The bar chart displays the weight percentage for eight sectors: Basic Industries, Consumer Cyclicals, Deregulated Industries, Energy, Financial, Healthcare, Consumer Staples, and Technology. For each sector, three bars represent the Current (blue), Proposed (yellow), and Model (green) scenarios. The Y-axis ranges from 0 to 35%.</p> <table border="1"> <caption>Sector Profile Weight (%)</caption> <thead> <tr> <th>Sector</th> <th>Current (%)</th> <th>Proposed (%)</th> <th>Model (%)</th> </tr> </thead> <tbody> <tr> <td>Basic Industries</td> <td>5</td> <td>10</td> <td>10</td> </tr> <tr> <td>Consumer Cyclicals</td> <td>7</td> <td>7</td> <td>12</td> </tr> <tr> <td>Deregulated Industries</td> <td>3</td> <td>7</td> <td>9</td> </tr> <tr> <td>Energy</td> <td>12</td> <td>10</td> <td>8</td> </tr> <tr> <td>Financial</td> <td>15</td> <td>17</td> <td>15</td> </tr> <tr> <td>Healthcare</td> <td>25</td> <td>15</td> <td>13</td> </tr> <tr> <td>Consumer Staples</td> <td>10</td> <td>5</td> <td>8</td> </tr> <tr> <td>Technology</td> <td>25</td> <td>31</td> <td>28</td> </tr> </tbody> </table>										Sector	Current (%)	Proposed (%)	Model (%)	Basic Industries	5	10	10	Consumer Cyclicals	7	7	12	Deregulated Industries	3	7	9	Energy	12	10	8	Financial	15	17	15	Healthcare	25	15	13	Consumer Staples	10	5	8	Technology	25	31	28
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						<b>% of Total Market Value</b>	9.7%	25.2%																																					
						<b>Capital Loss Carryforwards</b>	\$0	\$0																																					
						<b>Year-To-Date Realized Capital Gains</b>	\$0	\$0																																					
						<b>Net Realized Capital Gains</b>	\$171,916	\$446,202																																					
						<b>Tax Liability:</b>	\$54,015	\$117,129																																					
Net capital losses in excess of \$3,000 must be carried forward to future years.																																													

