

# THE EDUCATED INVESTOR

FEATURE ARTICLE

December 2003

**FOCUS**  
Asset Management Company

## Asset Location Tips

Financial assets can be classified into various groupings (equity, fixed income, etc.). The process of dividing these different types of assets between tax-deferred, tax-free and taxable accounts to maximize the after-tax return of an investment portfolio is known as asset location (not to be confused with asset *allocation*). Note that maximizing tax-deferred contributions regardless of their specific allocation is the top priority of tax-efficient investing. However, the following asset *location* guidelines can help further maximize total after-tax return.

To the extent possible, investors should consider placing their tax-efficient equity holdings in taxable accounts and their fixed income securities and real estate in tax-deferred or tax-free accounts. We have identified five reasons to put tax-efficient equity funds in taxable as opposed to tax-deferred accounts:

- 1) Preferential capital gains treatment as opposed to ordinary income taxation
- 2) The ability to tax-loss harvest
- 3) A stepped-up basis upon death
- 4) The ability to donate shares to charity
- 5) A foreign tax credit for international investments in taxable accounts that does not apply to international investments held in tax-deferred accounts

Investors can also maximize after-tax returns by placing tax-managed equity funds, when possible, in taxable accounts. Thus, if a tax-managed (TM) fund is available for one asset class but not for another, an investor should consider placing the asset class with the TM fund in the taxable account. (TM funds, of course, should never be used in tax-deferred or tax-free accounts.)

Real Estate Investment Trusts (REITs), fixed income and other tax-inefficient investments typically should be held in tax-deferred or tax-free accounts. Generally, tax-inefficient investments should not be held if the investor does not have room in tax-deferred or tax-free accounts, he or she is in a high tax bracket, or there are other special circumstances. This is true because REIT dividends are taxed at ordinary income rates and commodities may distribute significant short-term capital gains. If the investor does not have room to hold REITs in tax-deferred or tax-free accounts, he or she might also consider holding them in low-cost annuities.

Investors who cannot hold all of their equity in taxable accounts might consider reducing their equity allocation and tilting more toward TM small-cap and value funds. This improves the asset location efficiency of the portfolio without reducing the pre-tax expected return, because the increased tilt toward small-cap and value stocks offsets the reduced equity allocation. Thus, on an after-tax basis and over the long term, the portfolio with all the equity in taxable accounts should incrementally outperform the portfolio with a portion of the equity in tax-deferred accounts.

However, there are caveats to this strategy. First, the investor's risk profile should take precedence over optimization of asset location. For example, a small business owner or employee of a value company (who already have significant exposure to small-cap and/or value risk) may find the incremental gains associated with this strategy unacceptable compared to the risks incurred. Second, this strategy will incur additional amounts of tracking error relative to the S&P 500 and other well-known market indexes. Tracking error means that the portfolio may significantly underperform (negative tracking error) or outperform (positive tracking error) indexes like the S&P 500 during various periods of time. While tracking error in itself does not impact expected returns, it can lead to loss of discipline, which can cause investors to buy or sell holdings at ill-advised times. If significant negative tracking error is likely to tempt an investor to abandon the strategy, that strategy should be modified. Further, the investor may wish to consider whether he or she should tilt toward value or small-cap stocks in the first place.

The tips listed above are initial guidelines. For further guidance regarding asset location efficiency, investors can benefit by seeking the assistance of an investment advisor.

---

*This material is derived from sources believed to be reliable, but its accuracy and the opinions based thereon are not guaranteed. The content of this publication is for general information only and are not intended to serve as specific financial, accounting or tax advice. To be distributed only by a registered investment advisor. Copyright © B.A.M. Advisor Services, 2003.*