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Be Tax-Smart with your Tax-Deferred Accounts

Asset Allocation and Asset Location

The financial advisory community has generally done a good job of educating investors about the benefits and importance of asset allocation. In a well-structured investment program, asset allocation, the high-level choice among broad categories of investments like domestic stocks, international stocks, bonds, cash, and so forth, will be the most important determinant of the variability in portfolio performance. Many of the world's most sophisticated investors concentrate on the asset allocation decision as the primary driver of portfolio risk and opportunity.

Optimal portfolio planning goes well beyond asset allocation, however. Many individuals and households have assets invested through a number of accounts, which receive various types of tax treatment. At a minimum, many have tax-deferred investments in IRAs and 401(k) plans, alongside investments in taxable trusts or conventional individual accounts. Investors wishing to take full advantage of their tax-deferred accounts need to go beyond asset allocation and consider asset *location* – the question of which investments should go into which account.

One type of asset location error to avoid is a mismatch between investment products and accounts. For example, it usually would not be a good idea to buy a variable annuity in your IRA. Variable annuities typically have tax advantages, but they also often have high fees and high withdrawal penalties. In an IRA, they still have the high fees, but the tax advantages are meaningless.

Asset location should also vary by asset class. Investors often simply mirror their overall asset allocation in both taxable and tax-deferred accounts. If their overall asset allocation is 60% equity and 40% fixed income, then they give their trusts, personal accounts, and tax-deferred accounts all that same 60-40 allocation. In doing so, they miss the essential point of asset location – different investments receive different tax treatment, so it stands to reason that the tax characteristics of an account should influence the type of assets that end up in it.

In the US, taxable bonds produce interest, which the government taxes as ordinary income. Stocks, on the other hand, produce a combination of dividends and capital gains. Under current law, dividends receive favorable tax treatment, and so do capital gains, after a holding period of more than one year. On this basis alone, it stands to reason that taxable bonds benefit the most from the shelter of a tax-deferred account, so you should tend to place your bonds in your IRA and 401(k). What about equities? Not only do they enjoy lower tax rates than bonds, but you also have a great deal of flexibility in deciding when to realize capital gains and losses. This "timing option" is valuable, but only in a taxable account. Finally, remember what happens when you finally withdraw from your tax-deferred account. The money you withdraw is taxed as ordinary income, even if it came from capital gains on a stock you held in your IRA for many years. So concentrating equities in your taxable accounts makes sense, too.

New academic evidence on asset location

I have been an advocate of concentrating fixed income in tax-deferred accounts and equity in taxable accounts for some time. This policy has now received strong validation from the academic world. A paper on the topic has just appeared in the June 2004 issue of the *Journal of Finance,* one of the leading peer-reviewed academic journals in finance. The authors of the paper are Professors Robert Dammon and Chester Spatt of Carnegie-Mellon and Professor Harold Zhang of the University of North Carolina. Its title is "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing."[1]

The new paper addresses the optimal policy by which taxable investors with both taxable and tax-deferred accounts should choose which investments to place in which account. It presents the results of detailed, careful analysis, both purely theoretical and numerical. In typical academic fashion, the analysis is somewhat stylized, but the authors have preserved the essential features of the problem, and their findings provide good insight for investors.

Dammon, Spatt, and Zhang derive their conclusions from a set of conditions designed to mirror the investment opportunities available to taxable investors: Equities are riskier, but have higher expected returns, than bonds; and interest income is taxed at higher rates than capital gains. In such a world (which resembles the world of a US investor), they find the following policies work best, with limited exceptions:

1. Place the highest-yielding assets in the tax-deferred account first. If you run out of the highest-yielding class and still have room in your tax-deferred account, go on to the second-highest, and so on. Under the current tax law,

[1] The full citation is Robert M. Dammon, Chester S. Spatt, and Harold H. Zhang, "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing," *Journal of Finance* 59, 999-1037, June 2004

which taxes dividends at the same rate as long-term capital gains, count qualified dividends the same as capital gains (not as yield) for this purpose.

2. Only mix stocks and bonds in your taxable account if your tax-deferred account is already filled with bonds, and your equity allocation isn't big enough to fill your taxable account.

3. Only mix stocks and bonds in your tax-deferred account if your taxable account is all equities, so your equity allocation spills over into your tax-deferred account.

4. Under many circumstances, you may actually reduce your overall allocation to equities if you have a heavy proportion of your assets in tax-deferred accounts.

5. If you have a significant risk that you'll suddenly need cash some time in the future, then you *might* place a little mix of fixed income into your taxable account, but only if the liquidity need is likely to be correlated with a big drop in the equity market. Otherwise, manage your anticipated, or possible, liquidity need by reducing your contribution to tax-deferred accounts.

6. None of the conclusions above depend on the tax-timing option in equities (loss harvesting, gain deferral, and so forth). Given that those options exist, the case for concentrating equities in taxable accounts becomes still more compelling.

7. Other papers have suggested that it may be optimal to place tax-exempt bonds in the taxable account and equities in the tax-deferred account. This only makes sense if your equity strategy produces lots of short-term capital gains and reliably out-performs the market by a wide margin.

Your performance will vary –!within your portfolio

Capturing the full benefit of an optimal asset location policy really requires a unified approach, approaching your investments as a single portfolio spanning multiple accounts. If you build your portfolio piecemeal, it is difficult to arrange the components based on their tax treatment. If you take the unified approach, then your taxable and tax-deferred accounts will likely look quite different. In one natural case, your taxable accounts could be all equities, and your tax-deferred accounts all bonds. As a result, your taxable and tax-deferred accounts will most likely have significantly different performance. When this happens, remember that the comparison between the two is not what matters. What matters is the overall return you earn, after tax, on all your investments. This is the return that you are trying to improve through your unified approach. You allocate your investments across asset classes to strike a suitable balance between risk and opportunity, and you distribute them across accounts to give your investments the most favorable tax treatment. It may be easier to understand your

performance when your IRA and taxable account both have the same asset allocation, but it may be easier to reach your financial goals if they do not.

Conclusion

A successful, integrated approach to managing your investments must include attention to taxes. A key element of tax-sensitive investment management for individuals is the placement of different types of assets in different accounts. In general, if you have both taxable and tax-deferred accounts, you are likely to garner more of the advantages available under the US tax code if you concentrate taxable bonds in your tax-deferred accounts and equities in your taxable accounts. It is only really possible to arrange your assets this way by taking an integrated approach to the management of your entire portfolio, even though it spans multiple accounts. This policy will result in significant portfolio and performance differences between taxable and tax-deferred accounts, but in the long run it stands a good chance of enhancing your after-tax results for your overall portfolio – the results that matter. This policy recently received an important boost from the academic world, with the publication in one of finance's most influential academic journals of a paper arguing strongly in its favor.

A carefully designed, comprehensive portfolio plan includes not just asset allocation and the selection of instruments, but a plan for their distribution across different account types as well. Many investors pursue a single investment objective through multiple accounts of different types. Like teammates playing different positions, these multiple accounts often have distinctive roles, equipment, and appearance – but they are all working together toward a common goal.

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