As investors evaluate after-tax returns, it is important to recognize that diversification has the benefit of reducing the tax drag on wealth. (UBS)

A year-end look at the impact of taxes on asset allocation

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Since most portfolio analysis is done without consideration of taxes, investors may have unachievable or unrealistic return expectations. On the other hand, attempting to construct a portfolio simply to minimize taxes can also result in opportunity costs that can leave investors with less after-tax wealth. The UBS Chief Investment Office (CIO) discusses the impact and implications of taxes on asset allocation design.

Maximizing after-tax returns

As we enter year-end, investors should have the opportunity to rebalance their portfolio to position them to maximize their prospective after-tax return. Some investments are naturally more tax-efficient than others, however, investors who try to minimize taxes will miss out on opportunities to maximize after-tax returns. By ignoring the impact of taxes at each stage of portfolio design, investors can be left with lower after-tax returns and less capital upon which to compound growth.

Different investments come with a different mix of sources of income that each are impacted by the tax code differently. Taxable investors need to balance the trade-off between tax drag and investment opportunity from the lens of their current and future expected circumstances to maximize after-tax returns. When designing an asset allocation, the goal is to maximize the likelihood of achieving your specific objectives which, in turn, are highly dependent on maximizing after-tax wealth for a given level of risk. This requires a shift from traditional portfolio construction frameworks to one that incorporates the tax treatment of investment returns.

Looking at the data, we also see that certain assets, like equities, tend to have higher tax cost ratios than fixed income funds that exhibit greater tax efficiency. However, when making an investment decision, just because an investment may have a high tax cost ratio does not mean that its after-tax return will be lower than that of an investment with a lower tax cost—it all depends on the strength of the pre-tax return. As it relates to equities, historical pre-tax returns have often been so much higher that the tax drag still results in a higher after-tax return than more tax-efficient investments. This is why the objective when investing should not be to simply minimize taxes, but to maximize after-tax wealth.

The tax impact of your implementation vehicle

From a portfolio construction perspective, investors should consider the tax impact of their implementation vehicle. For example, investors looking for a passive strategy that simply tracks an index can choose to invest in a mutual fund or an exchange-traded fund (ETF). Between two vehicles, however, exchange-traded funds tend to be more tax-efficient because of their structure.

ETFs have two main advantages when it comes to deferring realizing capital gains. First, the exchange trading provides a means for investors to buy and sell ETF shares without causing any trading in the ETF's portfolio for other investors.

Second, when ETF shares are redeemed (done by an authorized participant, not by individual investors), most ETF managers do not need to sell securities within the fund (a taxable event). Instead, securities are delivered out of the fund to the authorized participant to meet the redemption. This is known as an "in-kind" redemption and is not a taxable event for fund shareholders.

Similar to the situation with the tax efficiency of equities versus bonds, the general trend of higher ETF tax efficiency does not mean that mutual funds should be avoided in a portfolio when positioning to maximize after-tax returns. Through security selection, risk management, or other active portfolio decisions, actively managed mutual funds may be able to generate higher post-tax returns than their passive ETF counterparts.

Meanwhile, separately managed accounts (SMAs) offer several benefits, which lead to more tax-loss harvesting opportunities. They are somewhat similar to mutual funds or ETFs, but they allow an investor to directly hold the underlying individual securities and are not pooled with other investors. For example, an SMA tracking the S&P 500 index might proportionately hold individual shares for each and all constituents within the index. By directly owning the underlying individual securities in an SMA, instead of buying a mutual fund or an ETF, an investor has greater control and flexibility which, in turn, can offer more opportunities to enhance after-tax returns.

Diversification provides opportunities to net gains against losses

As investors evaluate after-tax returns, it is important to recognize that diversification has the benefit of reducing the tax drag on wealth. A well-diversified portfolio will naturally have some assets that gain in value while others decline in value. This results in the ability to offset realized capital gains with realized capital losses, thereby providing opportunities to produce greater tax efficiency over time.

The tax code tends to favor US municipals in fixed income, and US equities, which leads to a natural home-bias for US investors. However, even while other investments may be less tax-efficient, those who don't diversify into other regions and sectors are likely lowering their after-tax return potential while taking more concentrated risk.

Important note: Tax strategies can be complex. In addition to federal taxes imposed on ordinary income and capital gains, there may be state and local taxes that must be considered before implementing a tax loss harvesting strategy. Also, transaction costs that may apply from buying and selling securities need to be carefully considered. Each investor should consult his or her own tax advisor concerning the tax consequences of any investment strategy they make or are contemplating. UBS does not offer tax advice.

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Read the full report Constructing and managing taxable portfolios: Insights to help maximize after-tax wealth.

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