The Importance of Tax-Efficient Investing

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Key Points

- Become a tax-smart investor with these actionable strategies.
- In general, holding tax-efficient investments in taxable accounts and less tax-efficient investments in tax-advantaged accounts may add value to your portfolio over time.

It's not what you make, but what you keep after taxes that counts. And these days, tax-efficient investing is more important than ever.

Return lost to taxes

The Schwab Center for Financial Research has examined the long-term impact of expenses and taxes on investment returns and concluded that, while asset allocation and investment selection are still some of the most important factors affecting returns, keeping costs and taxes low isn't very far behind.

Because mutual funds may distribute capital gains throughout the year, mutual fund investors are often concerned about losing investment returns to taxes. But individual stock and bond investors are vulnerable to taxes as well, depending on how they manage their investments.

As big of a drag as return lost to taxes might be, the good news is you can exercise a good deal of control here. Think about this: Diversification and asset allocation are great tools for helping to reduce portfolio volatility, but we're still going to be subjected to the short-term whims of the market, no matter how diligent we might be in setting up our portfolios and selecting our individual investments. Where we have the greatest degree of control is the area of expenses and tax-efficient implementation. Doesn't it make sense that where we can exercise the most control, we would do so?

How can you try to maximize tax efficiency?

Broadly speaking, investments that tend to lose less of their return to income taxes are good candidates go in taxable accounts. Likewise, investments that lose more of their return to taxes could go in tax-deferred accounts. Here’s where tax-smart investors might want to place their investments:

Where Tax-Smart Investors Typically Place Their Investments

Taxable accounts -

Here, you'd ideally place...

- Individual stocks you plan to hold more than one year

- Tax-managed stock funds, index funds, exchange-traded funds (ETFs), low-turnover stock funds Stocks or mutual funds that pay qualified dividends
- Municipal bonds, I Bonds (savings bonds)

Tax-deferred accounts such as traditional IRAs, 401(k)s and deferred annuities

Here, you'd ideally place...

- Individual stocks you plan to hold one year or less
- Actively managed funds that may generate significant short-term capital gains
- Taxable bond funds, zero-coupon bonds, inflation-protected bonds or high-yield bond funds
- Real estate investment trusts (REITs)

Of course, this presumes that you hold investments in both types of accounts. If all your investment money is in your 401(k) or IRA, then just focus on asset allocation and investment selection. In general, holding tax-efficient investments in taxable accounts and less tax-efficient investments in tax-advantaged accounts should add value over time.

Other considerations

However, there are other factors to consider, including:

Periodically rebalancing your portfolio to maintain your strategic asset allocation will cause additional tax drag on returns, to the extent you rebalance in taxable accounts. This is because, typically, rebalancing involves selling assets that have grown beyond your original allocation and buying assets that have fallen below your original allocation – in other words, taking profits from your winners and buying assets that have underperformed. And in taking profits from assets that have grown, you may incur either long- or short-term capital gains. To minimize the chances of this, you may want to focus your rebalancing efforts on your tax-advantaged accounts and include your taxable accounts only when necessary. Keep in mind, adding new money to underweighted asset classes is also a tax-efficient way to help keep your portfolio allocation in balance.

Active trading by individuals or by mutual funds, when successful, tends to be less tax-efficient and better suited for tax-advantaged accounts. A caveat: Realized losses in your tax-advantaged accounts can't be used to offset realized gains on your tax return.

A preference for liquidity might prompt you to hold bonds in taxable accounts, even if it makes more sense from a tax perspective to hold them in tax-advantaged accounts. In other situations, it may be impractical to implement all of your portfolio's fixed income allocation using taxable bonds in tax-advantaged accounts. If so, compare the after-tax return on taxable bonds to the tax-exempt return on municipal bonds to see which makes the most sense on an after-tax basis.

Estate planning issues and philanthropic intent might play a role. If you're thinking about leaving stocks to your heirs, stocks in taxable accounts are generally preferable. That's because they receive a step-up in cost basis at death, meaning that the cost basis is calculated based on the market value of the stocks at the time of death (rather than at the time they were originally acquired, when they may have been worth substantially less). In contrast, stocks in tax-advantaged accounts receive no step-up in cost basis at death. Additionally, highly appreciated stocks held in taxable accounts for more than a year might be well-suited for charitable giving because you'll get a bigger deduction, and the charity gets a bigger donation, than if you liquidate the stock and pay long-term capital gains tax before donating the proceeds.

The Roth IRA might be an exception to the general rules of thumb discussed above. Since qualified distributions are tax free, assets you believe will have the greatest potential for higher return are best placed inside a Roth IRA, when possible.

The bottom line

You have a lot of control when it comes to maximizing your after-tax wealth. First, decide on a suitable asset allocation. Next, select low-cost investments that make sense for you. Then, be tax-smart about where you hold your investments.