

Market Commentary

Returns First—Taxes Second

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With the April 15 tax filing deadline fast approaching, this seems like a good time to focus on what we think is the right balance between tax and investment considerations. Too frequently investment decisions are made with tax considerations playing an inappropriate role.

Any investor's primary objective is to build their portfolio over the long term. Your portfolio is increased by income and capital appreciation less taxes. Thus investing cannot be considered without consideration of the impact of taxes on returns. At the same time looking only at taxes in isolation can easily skew the analysis of alternative investments. Taxes impact investment returns, but they do not drive investment returns.

Here are a few of the common errors people can make when they let tax considerations drive investment decisions.

Is it always good to "take tax losses" at the end of the year? Selling stocks in which there is a loss to offset other gains does reduce today's tax bill, but there is a cost. Clearly selling a stock you don't want to own based on its investment considerations makes sense. In fact, those stocks should be disposed of independent of tax considerations. However what about selling stocks you do want to own? The common notion is "I'll buy it back".

There are several pitfalls to this strategy. The first is that the stock goes up before it can be bought back. You must wait the minimum 30 day "wash sale" period. Many stocks, which are sold because they have gone down, end up bouncing back early in the calendar year when tax selling pressure is removed. Second, the long term capital gain holding period is reset. You must wait a year to get the lower tax on gains. While a few dollars may be saved in taxes, even more can be lost due to foregone appreciation or a higher tax rate. A third misconception is that these are real tax savings. In fact, the "savings" are really a tax deferral. Eventually taxes are due on that gain. While reducing short term gains may make a lot of sense, offsetting long term gains taxed at historically low Federal rates of 15% may end up being a poor decision if capital gains tax rates are increased.

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Are tax free investments better than taxable investments? Without looking at the relative potential returns on a pre-tax basis, making a judgment based only on taxes will produce a flawed conclusion. For instance, the after tax return on a taxable bond might be higher for some investors than the return on a tax free bond. Similarly a stock which produces dividends which don’t qualify for the 15% tax rate might have a sufficiently high yield to produce better after tax returns than those on a lower yielding stock whose dividends do qualify for the 15% rate.

Are short term gains bad and long term gains good? While clearly it is better to pay taxes at 15% (Federal) than 35%, that doesn’t mean that all short term gains are bad. If a stock appreciates substantially and unexpectedly and must be held for many months in order to make it long term, there are very good arguments for realizing the gain even if it is short term. Stocks which go up quickly can also go down, and there can be as much truth to the “bird in hand” theory as the notion that short term gains are bad.

It’s not good to owe taxes. While clearly it isn’t pleasant to have a tax bill in a year in which investment returns aren’t very good (which can happen), in general a high tax bill due to investments is related to good investment results. If an investor doesn’t make quarterly estimate payments commensurate with investment returns, it is inevitable that there will be taxes due in April. This isn’t bad. First of all it means that you have deferred paying taxes due on investment returns. Second, and most importantly, it means that you have made money on your investments, and in the end isn’t that the real objective?

We are not saying that taxes are not a consideration in investment decisions. However, taxes are but one factor, and by no means the most important one in making investment decisions.

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