

Porter, White & Company

Investment Management Strategy for Individuals

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Our investment philosophy is based on the view that markets are mostly efficient and that active management is costly and distracts investors from more important determinants of reaching investment goals. For individuals, the impact of taxes is one such determinant. In this memorandum, we describe our approach to managing an individual's investments in order to meet retirement savings goals, taking into consideration the effect of taxes.

I. Personal Balance Sheet

The investment strategy for an individual should take into account personal assets and liabilities, including not only existing assets and liabilities but also the expected future value of labor-derived income. While there are many reasons to save (i.e., vacations, child's education expenses, down payment for house), our primary focus here is the goal of funding the desired level of retirement spending.

The major entries of an individual balance sheet might include the following:

Assets	Liabilities
Intangible	
Job/Wage Capacity	Retirement Spending
	Education Expenses
Physical	
House	Mortgage
Car	Home Equity Line
Investments	
Pension/Social Security	
IRA/401k	
Roth IRA	
Taxable Accounts	Margin Loan

As an individual approaches retirement, the value of one's job and future earning capacity declines substantially, and must be replaced by investment assets. With the move away from defined-benefit style pension plans, individuals are increasingly reliant on their individual investment accounts. Social Security alone is almost never sufficient to provide the desired level of retirement income. Typically, a child's education expenses (the most significant potential expenditure before retirement) is also no longer in the picture.

Individuals also have borrowing capacity against their physical and investment assets, but typically these sources are not used by individuals as they approach retirement. In fact, financial

planners often advise their clients that paying down a mortgage is their single best fixed income investment opportunity as it provides a certain return on their investment with no risk. However, as the interest on home mortgage loans is usually tax-deductible, such loans remain important in the overall asset allocation and asset location puzzle.

II. Literature Survey

In forming our investment approach, we have relied on the research of a number of academics and practitioners. The conclusions of the most important articles are briefly summarized below.

1. "Tax Management, Loss Harvesting, and FIFO Accounting," Berkin and Ye, Financial Analysts Journal, July/August 2003.

The authors show that tax management, including using lot accounting to minimize the gains from distributions or rebalancing, can add 50 to 100 bps of performance. We combine close monitoring of accounts and appropriate investment tax reports to help clients take advantage of the potential of "active tax management."

2. "Diversification and Capital Gains Taxes with Multiple Risky Assets," Dammon, Spatt and Zhang, un-published paper. August 2001.

Individuals sometimes have large positions in single assets (ie, company stock, long-term investments) that have substantial un-realized gains. One must weigh the costs of incurring capital gains against the additional risk incurred by holding a non-diversified asset. Based on the analysis performed by the authors, we believe that selling the low basis single asset, diversifying and incurring the consequent tax liability is generally the optimal approach, except for individuals whose life expectancy is less than 10 years.

3. "Saving for Retirement: Taxes Matter," James Poterba, an issue brief for the Center for Retirement Research at Boston College, May 2004, number 17.

The economic value of investment assets held in various types of investment accounts (IRA, Roth IRA, Taxable Account) is not necessarily equal to the market value shown on an account statement. Investment assets should be evaluated on the basis of expected after tax present values. Differences in taxation of investment assets lead to differences in such expected after tax present values. Generally, interest on investments in debt securities is more highly taxed than dividends or capital gains on equity securities, with the consequence that holding debt securities in tax deferred accounts (such as 401k plans and IRAs) is to be preferred over equity securities in such accounts.

4. "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing," Dammon, Spatt and Zhang, Journal of Finance, Vol. LIX No 3, June 2004.

Given the preference of holding fixed income assets in tax deferred accounts, the authors solve for the optimal asset allocation. For individuals with borrowing capacity, the optimal solution is to invest tax-deferred accounts entirely in fixed income investments and to invest equities in taxable accounts, borrowing funds for equity investments if necessary to achieve the desired equity allocation. Only individuals without borrowing capacity should hold equities in tax-deferred accounts.

III. Debt

Individuals frequently incur indebtedness to spread the payment of large expenditures over a longer period of time. The most frequent of these expenditures is the purchase of a house, although paying for a child's education can also be a large expense. Debt can lead to complications and requires a solid understanding of the individual's personal balance sheet and source of income. There are a number of financial issues and behavioral issues that go into the decision that must be balanced. Financial issues include affordability, cost, risk of default, and behavioral issues include fear of default, savings discipline, amongst others.

The question that many clients ask is whether they should pay down debt or save. While this is a difficult question the answer to which depends significantly on each clients circumstances, there are some general rules that usually apply.

- If the debt level is burdensome, it should be paid down, but only after an individual has fully funded short term general and emergency reserves for living expenses, typically 6 months of expenses, but sometimes more.
- To the extent tax-advantaged retirement savings options are available, they should be maximized. Since income is not taxed inside of these accounts, individuals can usually earn a higher rate of income than mortgage interest rates, which are usually deductible.
- Mortgages should generally be paid off prior to entering full retirement. Once in retirement, interest expense could require invading the IRA account as the individual should either have earnings that would otherwise be saved for retirement or required minimum distributions from the account once the individual reaches age 70.

Important Caveat. Provisions of the Internal Revenue Code, which are subject to change, limit the deductibility of mortgage interest and result in certain adverse consequences related to margin loans. *Individuals should obtain expert tax advice before implementing some of the strategies described above.*

IV. Investment Approach

Combining our investment philosophy, the impact of taxes on individuals, and relevant academic research, we have developed the following investment approach geared primarily towards wealthy individuals with a reasonable level of investment sophistication.

1. Determine the appropriate asset allocation for total net assets based on parameters and risk preferences set forth in an investment policy statement.
2. Maximize contributions to tax-deferred accounts, including the use of Roth rollovers if possible during retirement years.
3. Hold fixed income assets in tax-deferred accounts, hold equities in taxable accounts and achieve optimal fixed income/equity allocation using available borrowing capacity.
4. Diversify risky individual assets even though capital gains taxes are incurred, provided the investor's life expectancy is ten years or more.
5. Invest equities in tax-managed funds (or separate accounts) and use active tax management to maximize after tax returns.
6. Use fixed annuity products or bond ladders to meet non-discretionary retirement needs.

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