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INVESTMENT PERSPECTIVES

Tax Efficient Investing

Let's face it, we all would like to pay less in taxes. While we don't want to get into a philosophical discussion about the pros and cons of taxation, we believe it is important to discuss in some detail our thoughts regarding the topic of tax efficient investing.

While investment returns are important, investment returns after taxes matter most—in other words, it is not what you earn but what you keep that makes the difference. Many investment managers focus on investing for entities that are exempt from taxation which include pension plans, foundations, and endowments. Retirement plans for individuals including Individual Retirement Accounts (IRAs) and 401(k)s also benefit from tax-deferred growth until the funds are withdrawn. Since Hutchinson Capital Management caters primarily to individuals and family clients, many of whom have taxable accounts, our focus has been and will continue to be directed to our clients' after-tax returns. While we rarely make investment decisions solely based upon tax implications, we also realize that minimizing taxes can be an important part of our role as investment counselors.

Taxes can potentially have a significant impact on investment returns. In fact, one study from research firm Morningstar using data from 1926 through 2013 found that investors gave up on average between 1%-2% percentage points of their annualized returns to taxes.[1] While 1%-2% may not seem to be a lot at initial glance, it can have a significant impact when compounded over long periods of time. While taxes can be a drag on returns, there are numerous strategies we utilize in order to *minimize* taxes when buying and selling stock and bond positions in taxable portfolios. These strategies include the following:

1. Minimize Portfolio Turnover:

   Portfolio turnover refers to how frequently assets are bought and sold in a portfolio. Since inception in 1995, HCM's portfolio turnover has averaged 22%, which translates to a holding period of approximately 4 ½ years for a stock position.[2] By comparison, actively managed diversified U.S. stocks mutual funds have portfolio turnover averaging 65%, which translates to a typical mutual fund manager holding on to a stock position for only 18 months.[3] In addition to a bigger tax bill and by extension lower after-tax returns, higher portfolio turnover also results in higher fees through increased trading commissions.

[1] "Taxes Can Significantly Reduce Returns," Morningstar, Inc., 2014.
[2] Data taken from Advent APX.
[3] Jonathan Clements, "How To Cut The Tax On Your Investments," Wall Street Journal, April 15, 2015.

2. Focus On Long-Term Capital Gains:

   Capital gains are the gains investors realize when they sell a stock or bond for more than they paid for it. Most investors now pay 15% on long-term capital gains (gains on stock positions held longer than one year) at the federal income tax level. Exceptions to this rule are investors in the highest federal tax bracket of 39.6%, who pay 20% long-term gains, and investors below the 15% federal tax bracket, who pay 0% or no long-term capital gains. In the vast majority of cases, at HCM we typically hold an investment longer than one year and therefore any eventually sale would be taxed at the lower capital gain tax rate rather than the higher ordinary income tax rate. Not surprisingly, investment strategies which emphasize short-term trading can lead to bigger tax liabilities.

3. Practice Tax Loss Harvesting:

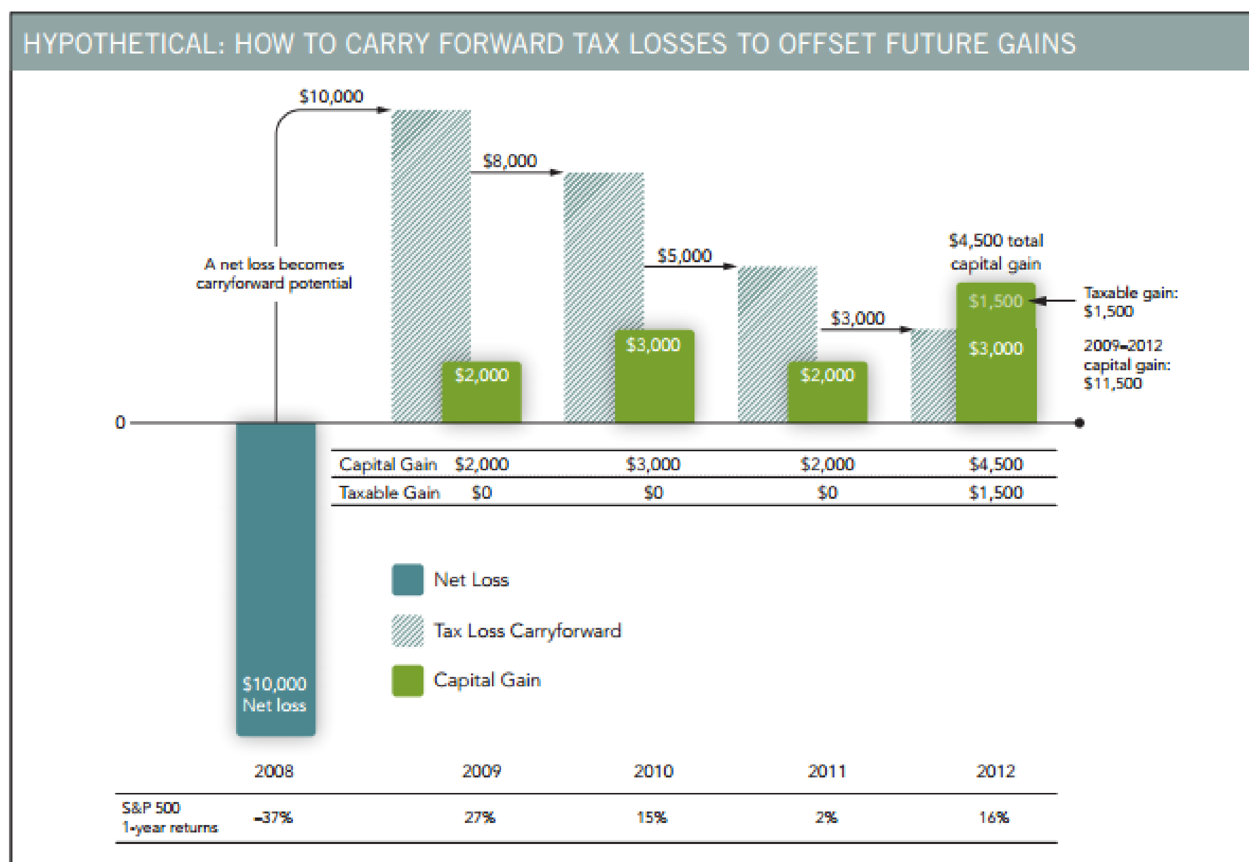
   The practice of tax loss harvesting is selling a security (i.e. stock and/or bond) at a loss and is one of the most important tools we can use to lower clients' tax bills and improve after-tax returns. When a loss is realized or "harvested" it may be used to offset capital gains that may already have been realized. Additionally, if an investor has more losses than gains in a given year up to $3,000 of the remaining capital losses can be used to offset ordinary income. For illustration, for an investor in a 25% federal tax bracket a $3,000 offset to ordinary would translate into $750 less in income taxes ($3,000 times the tax rate of 25%). In order to recognize a loss for tax purposes IRS rules require that investors not repurchase the same stock or bond until 31 days later so as not to trigger was it referred to as a "wash sale" rule violation. We monitor portfolio holdings trading at losses closely and look to realize losses throughout the year.

4. Use Tax Lot Accounting:

   The IRS allows different accounting methods for calculating capital gains and losses in taxable portfolios. The portfolio management accounting software HCM uses provides the ability identify specific tax "lots" of a stock to be sold. For example, if Wells Fargo's stock was initially purchased at $16 per share and was subsequently added to at $25 per share and there was an investment decision to reduce the position, the higher tax lot ($25 per share) could be specified to be sold first. Therefore, by indentifying the specific tax lots that have the smallest gain the client's overall tax liability can be reduced. Importantly, since we manage portfolios with individual stocks and bonds we can use tax lot accounting to a client's advantage by controlling capital gains with more specificity. In contrast, mutual funds, which are commingled investment vehicles, are less customized for a client's unique situation.

5. Utilize Capital Loss Carry Forwards:

   A distinct advantage of the federal income tax code is the ability to carry forward tax losses. While no one likes to lose money, at least in a taxable account an investor can offset those losses in a calendar year against future capital gains in another year. We felt the following chart is a good example of how capital loss carry forwards can be utilized over a multiyear period to the investor's advantage.[4]



Tax savings will depend on an individual's actual capital gains, loss carryforwards, and tax rate, and may be more or less than this example. This is a hypothetical example for illustrative purposes only and is not intended to represent the performance of any investment.

   Specifically, a loss of $10,000 in 2008 could have been carried forward to future years. In the example above, an investor utilized this loss over a four year period to offset $10,000 of capital gains in ensuing years. In 2009, the capital gain of $2,000 was fully offset and the carry forward was reduced by $2,000 to $8,000, and so on for subsequent years. Eventually in 2012, the entire loss carry forward was fully utilized.

6. Purchasing Bonds with the Highest After-Tax Yield:

   As mentioned previously, we focus on the returns that clients keep after taxes. This concept is especially prevalent when buying bonds; we focus on a metric called "after tax yield". After considering a client's marginal tax rate, we calculate the after-tax yield of the bonds for that specific client. For example, a corporate bond (taxable) that has a 4% coupon would generate

[4] "Tax Efficient Investing," Fidelity, 2015.

$40 of interest income in a given year. Assuming the client is in a 35% federal tax bracket, he or she would give $14 ($40 x 35%) away to taxes leaving him or her with $26 in income net of taxes. However, if we purchased a municipal bond (tax-free) for the same client with a 3% coupon that paid $30 of interest income every year but paid no federal or state taxes, this would leave the client with $30 in income. As you can see, the client receives more after-tax income from the municipal bond than the corporate bond ($30 versus $26), even though the stated coupon of 3% is lower.

Conclusion

At the end of the day, there are many different strategies an investor can use to minimize their taxes and we have admittedly only touched on a few in this letter. More important than the tax efficient strategies that we employ on a firm-wide basis are the personalized strategies that we work with you on individually for your unique situation. Other strategies to consider include funding IRAs and 401(k)s used to defer taxes for retirement, gifting highly appreciated stock positions for charitable giving, and funding tax free 529 Plans for college savings. We seek to understand your personal situation and look to collaborate with your other professional advisors, specifically your accountant and estate planning attorney. We want to reiterate that we are not accountants and look to lean on their expertise for specific tax related advice. For clients who do not have the trusted partnership of a good accountant or estate planning attorney, we would be happy to provide you with a recommendation. In summary, while our investment decisions will not be solely based on tax implications, we hope we have demonstrated that taxes can have a meaningful impact on investment returns and are an important factor that should not be overlooked by investors. At HCM, we will continue to seek manage portfolios in a tax-efficient manner.

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Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

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