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## Lower Your Taxes Using Four Successful Strategies

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Every April 15<sup>th</sup>, we all get a reminder that it's not how much you earn on your investments but how much you keep that's important. If you've been frustrated by the amount that Uncle Sam takes every year, you have good reason! Research shows that in 1998, federal, state and local governments collected and estimated \$9,900 per person in taxes. **That's nearly \$40,000 a year for a family of four!** This may have led you to search for tax-advantaged vehicles for protection.

Unfortunately, a lot of confusing and contradictory information exists in the area of taxable investing. Recently, however, extensive research concluded by SEI Investments, a global asset management company from Oaks, Pennsylvania has dispelled some common myths and given us simple yet effective ways of reducing taxes.

### Dispelling the Myths

**Myth #1:** Municipal bonds maximize after-tax returns.

**Fact:** A diversified portfolio that includes stocks has realized higher real after tax returns. In fact, further diversifying a portfolio globally (including international stocks along with US stocks) can also help increase after tax returns and lower risk.

**Myth#2:** Mutual funds with lower turnover rates have higher after tax returns.

**Fact:** There is no significant relationship between portfolio turnover and after tax returns. A portion of the returns on a mutual fund come from the appreciation and trading of securities within the fund. The net profits from these transactions are passed to shareholders as capital gains distributions. Recent research from SEI suggests that there is no statistically significant relationship between portfolio turnover and realized capital gains distributions.

### Four Strategies that Minimize Taxes

**Strategy#1:** Invest a portion of your portfolio in passively managed mutual funds which invest in efficient markets. A passively managed fund might invest in a basket of stocks which mirrors the S&P 500, for example. According to SEI, only 33% of managers who invest in large company stocks outperform their benchmark. On the other hand, 55% of small cap managers and over 80% of international managers outperform their respective benchmarks. Investing with active

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managers in these last two categories namely small cap and international securities, should give you a higher after tax return.

**Strategy#2:** Substitute tax free municipal bonds in place of taxable bonds for the fixed income portion of the portfolio. Use intermediate term bonds in place of long term bonds to provide for greater risk adjusted returns. The addition of high yield or non-U.S. bonds is not enough to compensate for both the effect of taxes and the higher volatility associated with these asset classes.

**Strategy#3:** Limit market timing strategies and asset allocation shifts. These strategies usually involve frequent asset class shifts which can create higher capital gain tax liabilities. This, in turn, can reduce any additional returns these strategies may have produced. Widen rebalancing ranges to 6% when shifting between stocks, bonds or cash.

**Strategy#4:** Employ tax lot accounting by selling securities with the highest cost basis first(at both the fund and account levels)and offset gains with losses where possible to enhance after tax returns.

In summary, the impact of taxes on performance can be a significant drag on total performance, eroding as much as 50% of an investors gain over a long period of time, say 20 years or so. Tax aware investing can generate asset growth significantly higher than an investment strategy that ignores taxes.