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CESTNICK

TAX MATTERS

How to get ahead by finding 'tax alpha'

When I had lunch with my friend Rob two weeks ago, we started talking about his investment portfolio, and specifically about "alpha." Rob is a physicist by profession, and I've learned that if you want to confuse a rocket scientist, just starting talking to him about alpha. "Tim, I don't understand what protons, two neutrons and helium have to do with my money," Rob said, confusing the concept of alpha particles with portfolio alpha.

Last week in this space I explained the concept of alpha in the context of an investment portfolio. As a recap: "alpha" is the investment return that a money manager provides over and above what the equity market itself provides. It's the added value and it's what you pay the money manager for. As I noted, there are some common mistakes people make when searching for alpha.

As important as that type of alpha happens to be, there's another type of alpha that I introduced last week as well. I'm talking about "tax alpha."

Tax alpha is the additional after-tax return you can add to your portfolio by taking steps to minimize the tax burden on your portfolio. And after-tax returns are the only type of returns you can spend or reinvest. The most powerful thing about tax alpha is that it's almost guaranteed. You can calculate ahead of time the added value to your portfolio that results from proper tax structuring. What is this type of planning worth to your portfolio over time?

THE DIFFERENCE

What if you could add, say, 2 per cent or 3 per cent to your annual after-tax rate of return?

Several studies have quantified the impact taxes have on investment returns over time. A study by Stein and Garland, the results of which appeared in The Handbook of Portfolio Management in 1998, showed that even a tax-efficient index-based portfolio will realize a difference between pre-tax and after-tax returns of close to 2 per cent annually. The same study showed that, for most active money managers, this performance difference is in excess of 3 per cent annually.

Another study by J.D. Peterson and his group of researchers appearing in 2002 in the Financial Analysts Journal showed similar results. They found that U.S. equity fund investors in high tax brackets lost an average of about 2.2 per cent annually to taxes.

I assisted in a Canadian study in 2003, led by professor Moshe Milevsky, that appeared in the Canadian Tax Journal in the fall of that year. The study found that an average of 1.35 per cent was lost to taxes annually over a 10-year period on mutual fund distributions alone, on funds managed by Canadian portfolio managers (the actual annual returns lost ranged from nil to 7.13 per cent annually, depending on the money manager). Another 1 per cent was lost upon liquidation of the mutual funds at the end of that time, for total returns lost equal to 2.35 per cent on average.

THE DOLLARS

Let's put this in perspective. Multiple studies have shown that investment returns of between 2 per cent and 3 per cent, on average, are lost to income taxes annually. What difference will this make over time for you? Consider a taxable investment portfolio of $100,000 over a period of 20 years (I'm not talking about your registered plans – RRSP, RRIF or TFSA). Assume a pre-tax rate of return on the portfolio of 8 per cent. If taxes reduce your annual returns by 2 per cent, you'll end up with $320,715 after 20 years. If you take steps to reduce the tax burden, and taxes reduce your returns by only 0.5 per cent, you'll end up with $424,785 over that same time – almost one-third more in your portfolio in this example.

THE RESPONSIBILITY

Whose job is it to make sure your portfolio is tax-efficient? Let's refer to this process as active tax management (ATM). Someone needs to take responsibility to ensure that proper ATM is being executed around your portfolio. Let's be clear: Proper ATM execution requires a detailed knowledge of which strategies should be implemented, when they should be implemented (at portfolio inception, annually, or on disposition), and by whom (the money manager, your portfolio architect or adviser, or you – the investor). I'll finish this topic next week with some ATM strategies.

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