



Step 7 ~ Silent Partners

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STEP 7 Silent Partners



"None of my clients are taxable... Once you introduce taxes, active management probably has an insurmountable hurdle. We've been asked to manage taxable money - and declined."

- Theodore Aronson of Aronson+Partners, *Institutional Money Manager*



"It's not brains or brawn that matter in taxable investing; it's efficiency. Taxable investing is a loser's game. Those who lose the least — to taxes and fees — stand to win the most when the game's all over."

- James P. Garland, President of the Jeffrey Company



"It is difficult to systematically beat the market. But it is not difficult to systematically throw money down a rat hole by generating commissions (and other costs)."

- Michael C. Jensen, Harvard University



"The art of taxation consists in so plucking the goose as to get the most feathers with the least hissing."

- Jean Baptiste Colbert



"Inflation is the one form of taxation that can be imposed without legislation."

- Milton Friedman, 1976 Nobel Prize for Economics

7.1 INTRODUCTION

Step 7: Recognize the partners in your returns.

The term "Silent Partners" refers to the parties who silently share in the realized and unrealized gains on an investment. Fees, expenses, taxes, and inflation are silent partners that can set an investor back before returns even begin. Investment costs alone for the average active fund can consume nearly 55% of its gross wealth. By investing in index funds however, high costs and high taxes can be avoided. In this case, the only uncontrollable partner is inflation.

One illustration over a 15-year period demonstrates that 40% of total return is allocated

to silent partners. On a \$10,000 investment, this translates to \$41,000 of compounded return. An index fund limits the partners' take to only 13%. In tax-managed index funds, the percentage is even lower. This step discusses the unnecessary partners involved in your returns and how to keep them from eating slices of your "returns pie."

7.2 DEFINITION

Silent Partners

There are several silent partners that take a bite out of realized and unrealized gains on investments. These partners include:

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- The sales agent or stockbroker who earns a commission or load for individual stock and mutual fund trades
- Federal and state income tax agencies that tax realized gains
- The fund manager who actively invests the stocks in a mutual fund
- Accountants that determine the tax ramifications of active investing
- Firms that charge investment advisory fees
- Market makers who earn a bid-ask spread on transactions
- Transfer agents who handle the share transfers for all those trades
- Mutual fund distributors
- If applicable, the brokerage firm that earns interest on margin accounts

7.3 PROBLEMS

7.3.1 Active Investors are Unaware of all the Costs

Each partner's bite adds up to claim a significant share of an investor's return. The tax effects on

actively managed mutual funds are rarely evident from the reported data. Since investors do not feel the tax bite until the following April 15th, most investors do not consider the more than 17% of their pre-tax returns as lost to taxes. The effect reinforces the substantial value of passively buying and holding stocks in an index fund. Table 7-1 demonstrates that on an after-tax basis, the S&P 500 Index Fund outperformed most of the funds that routinely claim superior performance.

According to a study conducted by John Bogle, the founder of Vanguard, over a 15-year period, investors only get to keep 47% of the cumulative return of the average actively managed mutual fund, but they keep 87% in a market index fund. This means \$10,000 invested in the index fund grew to \$90,000 versus \$49,000 in the average actively managed stock mutual fund, see Figure 7-1 and Table 7-2. That's a 40% gain from the reduction in the portion that goes to silent partners. Everyone should be interested in that!

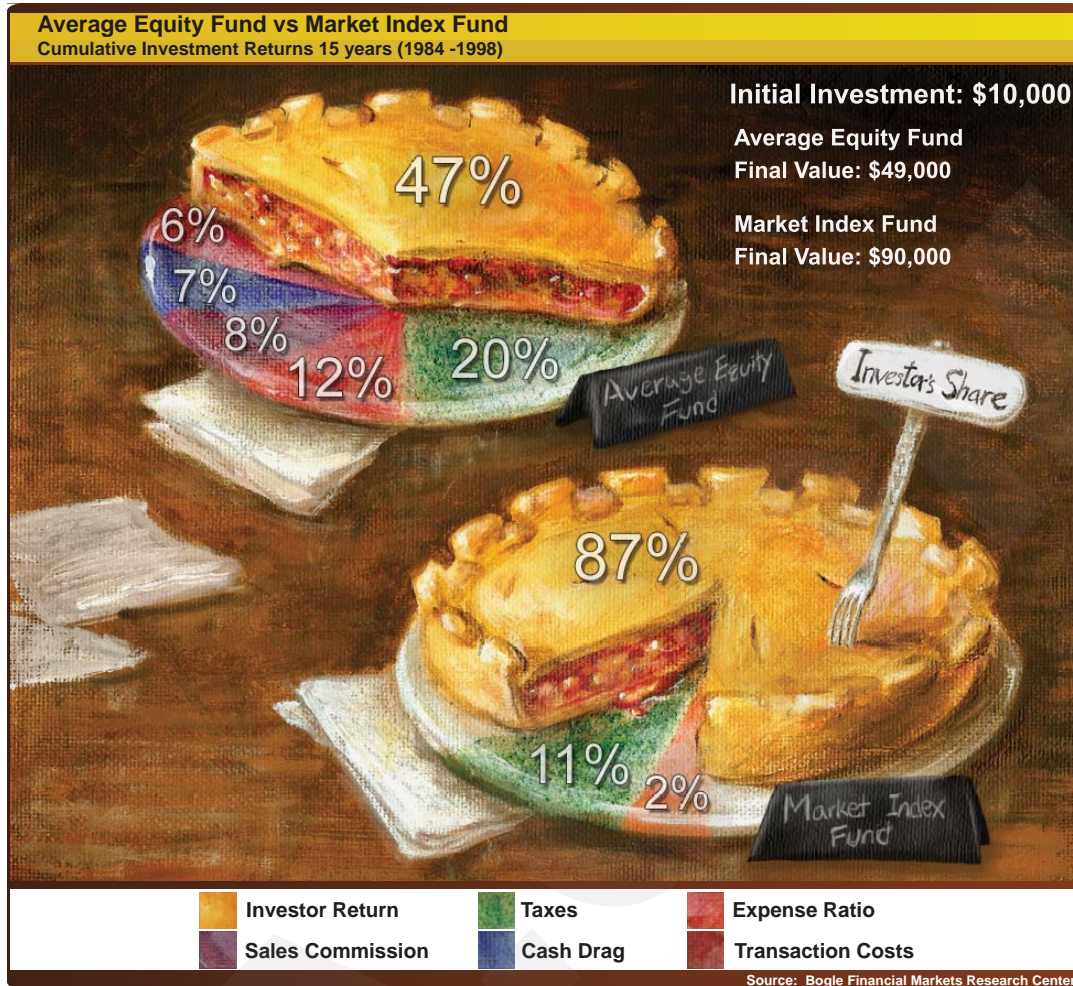
Table 7-1

Value Lost to Taxes for the Top 15 Funds with the Highest Net Assets				
Annualized Returns (%) 10 years (1997 to 2006)		(Sorted by value lost to taxes from greatest to least)		
Fund Name	Pre-Tax Return	After-Tax Return	Difference	Value lost to taxes on \$100,000 over 10 years
Amer Funds CapWrlldGI A	13.79%	11.19%	2.60%	\$75,109
Dodge & Cox Stock	14.23%	11.75%	2.48%	\$74,549
Amer Funds CplncBldr A	11.26%	8.36%	2.90%	\$67,466
Amer Funds Inc Fund A	10.12%	6.99%	3.13%	\$65,686
Amer Funds WashingtonA	9.88%	7.36%	2.52%	\$53,124
Amer Funds Inv Co Am A	10.47%	8.09%	2.38%	\$52,974
Amer Funds Grth Fund A	12.94%	11.04%	1.90%	\$52,692
Amer Funds EuroPac A	11.23%	9.27%	1.96%	\$47,214
PIMCO Total Ret Instl	6.84%	4.29%	2.55%	\$41,589
Fidelity Contrafund	11.01%	9.48%	1.53%	\$36,828
Fidelity Diversified Int	13.16%	12.26%	0.90%	\$26,423
Fidelity Magellan	6.99%	5.73%	1.26%	\$21,956
SPDR Trust Series 1	8.30%	7.70%	0.60%	\$11,995
Vanguard Inst Index	8.47%	7.91%	0.56%	\$11,374
Vanguard 500 Index	8.34%	7.83%	0.51%	\$10,268

Source: Morningstar® Principia®, December 31, 2006

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Figure 7-1



7.3.2 Taxes

Now let's take a look at how the tax-managed index funds can almost eliminate Uncle Sam's big bite out of your returns in taxable accounts. No wonder he looks so sad.

As indicated above, most index funds are very tax efficient. However, some indexes can be further tax managed to squeeze out even more taxes. Tax-managed index funds make an already tax efficient investment even more tax efficient by offsetting realized gains with a realized loss then deferring the realization of net capital gains and minimizing the receipt of dividend income. The result is minimal taxable distributions to investors.

Table 7-2

Average Equity Fund vs Market Index Fund Annual Investment Returns over 15 Years (1984-1998)		
	Average Mutual Fund	Wilshire 5000 Index Fund
Equity Return	16.9%	16.9%
Sales Commission 6% (annual impact)	-0.5%	-
Cash Drag	-0.5%	-
Fund Return	15.8%	16.9%
Transaction Costs	-0.7%	-
Expense Ratio	-1.2%	-0.2%
Investor Return	13.9%	16.7%
Tax	-2.7%	-0.9%
Investor Return	11.2%	15.8%
Reduction in Equity Return	-5.7%	-1.1%

Source: Bogle Financial Markets Research Center

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In a telephone survey by the Dreyfus Corporation, one thousand mutual fund investors were questioned about their tax knowledge. Eighty-five percent of respondents claimed taxes play an important role in investment decisions, but only 33% felt that they were knowledgeable about the tax implications of investing. Eighty-two percent were unable to identify the maximum rate for long-term capital gains.

Taxes on realized (distributed) capital gains, dividends, and interest can be significant. It is estimated that the average active mutual fund investor loses about three percentage points of return to taxes every year. The more an investor earns in active mutual funds, the higher the taxes. This reduces the potential for wealth, which defeats the purpose of investing. A study conducted by Stanford University measured the performance of 62 equity funds for the period from 1963 through 1992. It found that although each dollar invested in this group of funds would have grown to \$21.89 in a tax-deferred account, the same amount of money invested in a taxable account would have produced only \$9.87 for a high-tax-bracket investor. Taxes cut returns by 57.5%! Index funds, however, have low portfolio turnover and their capital gains distributions are also very low, thereby reducing the impact of taxes. Table 7-3 lists eleven funds and their annual turnover for 2006.

Managers of Active Funds Seem to Manage Money as if Taxes do not Matter

Historically, many active mutual fund managers managed pension plans and other tax-free pools of money, so they did not have to worry about the tax impact of their investment trades. As a result, managers of active funds today often disregard the high taxes generated by their stock picks and market timing, not to mention the adverse effect on fund performance. Realized

Table 7-3

Turnover Ratio of Various Funds January to December 2006	
Fund	Turnover
Schwab S&P 500 In e.Sh	3%
Vanguard 500 Index	7%
Dimensional US LgCpVal	9%
Morgan Stanley Growth C	21%
Dimensional US SmCpVal	27%
Vanguard Windsor	38%
Fidelity Contrafund	60%
Fidelity Magellan	74%
Fidelity Growth and Income	120%
Brandywine Advisors	207%
Rock Canyon Top Flight	1,635%

Source: Morningstar® Principia®, Dec. 31, 2006

capital gains taxes are not reflected in active mutual fund performance ratings thereby catching the average active mutual fund investor by surprise.

Imagine an active fund, such as Invesco's Asian Growth Fund. At the end of 1997, this company distributed 21% of its net asset value, but lost over 38% throughout the year. An investment of \$10,000 at the beginning of 1997 lost \$3,800 before the \$2,100 gain on which taxes must be paid. Realized capital gains can be taxed in two ways: long-term (12 months or longer) capital gains or short-term dividends. The federal tax code ensures that long-term capital gains are taxed at nearly half the tax rate of short-term dividends whose maximum taxes are about 40%!

Taxes do Matter

Instead of being distributed and taxed, unrealized capital gains are profits that have not yet been realized for tax purposes; taxes need not be paid on these gains. Unrealized capital gains remain a growing part of the net asset value of a fund's share rather than being distributed to the investor. The index fund manager minimizes portfolio turnover, and so maximizes unrealized capital gain. When stocks in an active fund

increase in value and are sold for a profit by the fund's manager, the result is that the fund actually realizes gains as opposed to simply reporting an increase in the value of the portfolio, and investors pay both ordinary income and capital gains taxes on those distributions. On the other hand, by the time an investor is ready to realize an investment in an index fund, it will be a long-term capital gain, untaxed for years. Realized long-term capital gains have a much lower tax rate.

As might be expected, taxes affect active fund performance, not only earnings. Stanford University released the results of a 30-year study in 1993 that examined the difference between the average pre-tax, after-tax, and liquidation performance of 62 actively managed stock mutual funds. Pre-tax performance assumes reinvestment of all distributions, after-tax assumes reinvestment of distributions left after taxes have been paid, and liquidation is selling out completely and paying all taxes, rather than reinvesting in the fund. The study also took into account differing tax brackets, whether high (55% taxes paid), medium (41%) or low (25%). According to the study's results, between 1963 and 1992 it was found that a high tax bracket investor who reinvested after-tax distributions ended up with an accumulated wealth of 45% of the fund's published performance. Investors in a middle tax bracket realized 55% of published performance.

As mentioned earlier, actively managed mutual fund advertisements and published ratings feature only pre-tax returns, often misleading investors. In fact, Robert Jeffrey and Robert Arnott proved with their 10-year study titled "Is Your Alpha Big Enough to Cover its Taxes?" that on an after-tax basis, index funds outperformed 97% of active mutual funds. They also found that although 71 active funds tried to beat the market

with high turnover efforts, the added returns did not outweigh the resulting taxes.

7.3.3 Inflation

Unlike investment costs and taxes, nothing can be done about inflation.

Inflation is an equal opportunity destroyer of an investment's purchasing power. A certain amount of loss from inflation is incurred whether an investment is in stocks or bonds, but investing as large a portion of a portfolio in stocks for as long as possible is the best way to outpace inflation. Stocks have grown in value much more than bonds over the years and have been the best antidote for inflation.

Inflation has averaged 2.7% per year over the last five years, which does not seem too significant. Therein lies the jeopardy! The investment media, politicians, and others may convince investors that a 2.7% inflation rate is insignificant, but this rate can cut purchasing power by 26% in 10 years, 45% within 20 years, and 59% within 30 years! A 2.7% inflation rate is only negligible in very short terms; an investment purchased for \$10,000 in 1970 would cost \$26,094 in 2006, so it is best to buy as soon as possible and not touch that money until the last possible moment. Not even tax-deferred retirement plans can escape inflation, the most inevitable partner.

7.4 SOLUTIONS

7.4.1 Index Funds and Tax-Managed Index Funds

Unless an actively managed mutual fund states that it focuses on after-tax returns, an investor should never assume that it is managed with tax

considerations in mind. A tax efficient or tax-managed mutual fund usually means that the published return and the after-tax return are close to each other.

Index funds can be tax-managed as well. Index funds have natural advantages from a tax standpoint. Managers of index funds employ tax-managed trading strategies, while managers of active funds manage money as though taxes do not matter.

Critics of tax-managed funds warn that an investor should not let tax considerations outweigh investment judgment. As author Charles Ellis said in his book, *Investment Policy*, “Never do anything for tax reasons.” This is excellent advice, but when faced with taxes of 15% to 40%, any tax-managed strategy a fund manager uses takes on great importance.

One strategy used by an index fund manager is to identify and “harvest losses” by selling stocks at a loss to offset other realized capital gains. Another is to sell the stocks with the highest cost basis. As a result of these strategies, a fund will incur losses before any gains are realized. This helps an index fund maximize net after-tax return. By nature, index fund managers attempt to defer realization of short-term capital gains until they become long term. Also, a tax-managed index fund seeks to discourage short-term trading among its investors by assessing redemption fees.

7.4.2 Reduce Taxes and Turnover Costs with Index Funds

Index funds tracking the S&P 500 or Wilshire 5000 use a buy and hold approach. Capital gains are minimized, with the exception of adding and deleting stocks from these indexes. Highly liquid U.S. large company stocks dominate these index-

es, and index funds tracking these stocks have a natural tax advantage.

Other index funds, however, are generally less tax efficient. Some funds sponsored by Dimensional Fund Advisors (DFA) are invested in small company stocks or value stocks. Any stocks in these index funds that become larger or seem to be growing quickly must be sold by DFA so that the funds can remain exposed to small stock or value stock risk factors. This results in higher turnover and greater realized capital gains than other indexing strategies, whereas attempting to avoid taxes by not selling these stocks would reduce exposure to small company or value risk factors. Index funds that invest in higher expected return indexes are not very tax efficient.

To help with this dilemma, DFA launched three new tax-managed index funds in 1998 and one new tax-managed fund in 2001. They are the DFA Tax-Managed U.S. Small-Cap Portfolio, the Tax-Managed U.S. Small-Cap Value Portfolio, the Tax-Managed U.S. Marketwide Value Portfolio and the Tax-Managed U.S. Equity Portfolio. DFA’s research shows that the increase in after-tax returns associated with these funds can range from 1% to 1.5% per year. DFA has also run simulations with its tax-managed U.S. Market Wide Value Fund, which show that if the fund dropped 20% from its value, it could sell nearly 40% of its assets without realizing any net capital gains. Vanguard, for its part, has a handful of tax-managed funds including its Tax-Managed Balanced Fund, Tax-Managed Growth and Income Fund, Tax-Managed Capital Appreciation Fund, Tax-Managed Small-Cap Fund and Tax-Managed International Fund.



The Feast

SUMMARY

There are many silent partners eating a piece of investment returns. The best solution to this problem is to buy and hold a diversified portfolio of index funds, including tax managed funds in taxable accounts.

7.6 REVIEW QUESTIONS

- The only uncontrollable partner in investing is:
 - income tax
 - inflation
 - commissions
 - margin account interest
 - transaction costs
- What is the difference between realized and unrealized gains?
 - realized are taxed and unrealized are not
 - old money and new money
 - fund based and investor based
 - IRS only reviews unrealized gains
 - realized gains are the only real gain
- What are the advantages of low portfolio turnover?
 - lower taxes
 - fewer trading costs
 - maximum capital gain
 - less cash drag on returns
 - all of the above
- Tax managed index funds add to after-tax returns because:
 - they minimize dividend paying stocks
 - tax loss harvest among stocks in the portfolio
 - they generate large amounts of short-term capital gains
 - they distribute more dividends than the regular index fund
 - both a and b
- According to a study by Vanguard, the average equity fund investor kept about 47% of the cumulative investment return over a 15-year period. A market index fund kept:
 - 23%
 - 48%
 - 87%
 - 13%
 - 59%