CLEARPOINT

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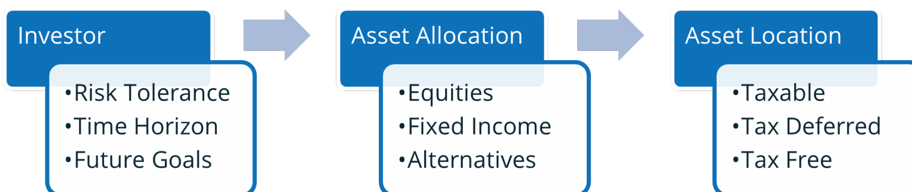
"LOCATION, LOCATION, LOCATION"

BY BRYSE D. CIRJAK, CFP®, SENIOR PLANNING ASSOCIATE

"Location, Location, Location" is a common phrase in real estate, but should investors also consider location in portfolios? The answer is yes and the strategy is called Asset Location. Asset Location involves placing specific types of asset classes based on their expected returns and tax characteristics into different types of accounts to reduce the annual tax drag.

Before deciding Asset Location, investors first need to figure out their appropriate asset allocation, which involves having the proper mix of equities, fixed income, and alternative investments and is based on the investor's risk tolerance, time horizon, future goals, and overall financial situation. Once an investor's asset allocation is defined, the next step is to decide what asset classes should go into the investor's different investment accounts.



First, it is important to understand the tax characteristics of each account when considering an asset location strategy. The three primary investment account types when looking at an individual's net worth are taxable, tax deferred, and tax-free.

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client and Reporting and Operations teams with Jacinto Cuellar and T.J. Conway.

Jacinto Cuellar joined Clearstead as a Client Planning Associate, Tax. Jacinto has a Bachelor's degree in Accounting, Criminology, and Justice Studies from Kent State University and was most recently employed at Novogradac & Co.

T.J. Conway joined Clearstead as a Reporting Associate. T.J. recently graduated from John Carroll University with a Bachelor's degree in Finance, Financial Planning, and Wealth Management.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

Each of these account types has distinct tax characteristics that factor into an investor's consideration of which assets should be held in each account:

Taxable Accounts

Taxable—or brokerage accounts—do not receive any tax advantage when dollars are contributed, as the contributions come from after-tax dollars. Income earned (dividends and interest) and realized (capital gains) are taxed in the year earned. Qualified dividends and long-term capital gains receive the preferential federal income tax rate topping out at 20% (23.8% including the Medicare sur-tax on investment income) for 2022 rates. Non-qualified dividends, interest, and short-term capital gains do not receive the preferential federal rate and are taxed as ordinary income with federal rates topping out at 37% (2022).

Tax-Deferred Accounts

These accounts—traditional 401(k)s, 403(b)s, and IRAs—allow an individual to postpone paying ordinary income taxes on the amount contributed. The amount contributed and the earnings (interest, dividends, capital gains) will grow tax-deferred while held in the account. An individual receives the tax advantage up front, but on the backend, any withdrawals from the account will be taxed at ordinary rates, up to 37% (2022) federal in addition to potential state tax.

Tax-Exempt Accounts

Like Roth 401(k), Roth 403(b), and Roth IRAs, these accounts do not receive any tax advantage when dollars are contributed, as contributions are made with after-tax dollars. Income earned (interest and dividends) and realized (capital gains) are not taxable when earnings and withdrawals from the account are tax-free, if the rules are followed.[1]

ASSET LOCATION

Taking advantage of an Asset Location strategy should not have any effect on overall asset allocation. An investor can simply weight investments differently in each account to take advantage of after-tax returns. Choosing what type of investments to put in a specific account mostly depends on two factors: the investments tax efficiency and its expected return.[2]

Tax Deferred/IRA

A tax inefficient investment is an investment that would produce ordinary income within a tax year through interest, non-qualified dividends, or short-term capital gains. Tax inefficient investments with high expected rates of return should be more heavily weighted towards a tax deferred account like an IRA. This allows the investor to defer paying the tax on the earned income until assets are withdrawn from the account. This reduces the "tax drag" of annual return income that could be taxed up to 37% if it were in a taxable investment. In general, tax inefficient assets are:[2]

- Fully Taxable Bonds/Bond Funds – Interest generated from these investments are taxed as ordinary income. High yield and private credit debt are the least tax advantaged due to their higher interest rates.
- Real Estate Investments Trusts (REITs) – Generally, the bulk of dividends paid from REITs are taxed as ordinary income rates.
- Actively Managed Equity Mutual Funds – Mutual funds that have high turnover rates may produce short-term capital gains, which are taxed at the higher ordinary income tax rates.[3]

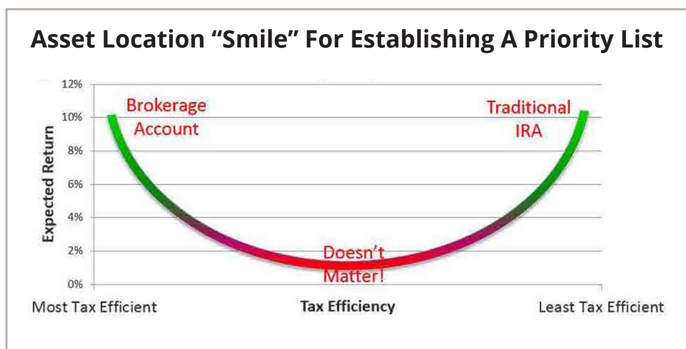
Taxable Accounts

Tax efficient investments include assets that produce little annual income or that produce income but would be taxed at the more preferential tax rate of qualified dividends and long-term capital gains. Qualified dividends and long-term capital gains rates are taxed at 0%, 15%, or 20% depending on an individual's taxable income (not including the 3.8% Medicare surtax on net

investment income). Investments with these types of characteristics should be more heavily weighted in taxable accounts. In general, tax efficient assets are:[2]

- Municipal Bonds/Municipal Bond Funds – Interest on municipal bonds is free of federal income tax and, if you live in the state that is issuing the bond, the income may also be exempt from state income taxes. Deciding if municipal bonds make sense for your portfolio depends on the comparison of after-tax returns of similar taxable bonds. Municipal bonds often make sense for individuals in high marginal tax rates.
- Individual stocks/Equity Exchange Traded Funds – These investments are generally considered tax advantaged when bought and held for long durations.
- Tax-managed Equity Funds – These funds are dedicated to limiting tax burdens to investors, with a focus on tax loss harvesting, if possible.[3]

Choosing where to place investments and assets classes with low expected rate of return does not have as significant of an impact, even if the investment is tax inefficient. If there is not a significant return and or income, an investor will not incur a significant tax drag, and therefore will not lose out much on compounding returns. The most important concept is to prioritize investments that have a high expected rate of return and large inefficiencies in the correct investment accounts. This is what the graph to the right is illustrating, which focuses on the "asset location 'smile' for establishing a priority list" for optimized asset location.[2]



Source: https://www.kitces.com/wp-content/uploads/2014/04/Kitces-Report-March-April-2014-Advanced-Asset-Location-Strategies1.pdf

Tax Exempt

Tax exempt—or Roth accounts—have a different approach to what investments or asset classes should be placed in these types of accounts. With a tax exempt or Roth IRA account the focus should be placing assets with the highest expected return in them, with the first focus of highest expected return assets that are inefficient. Placing these types of investments in a Roth in lieu of a tax deferred/IRA account allows for compounding growth without having the distributions being taxed as ordinary income rates. Individuals should also consider investing in asset classes that have a high expected rate of return that are efficient as well, as the main goal for a tax-exempt account should be growth. The table below provides general guidance on where assets should be placed amongst the three different types of accounts.[2,3]

	TAX IMPLICATIONS	TAX DEFFERED	TAX-EXEMPT	TAXABLE
Municipal Bonds/Municipal Bond Funds	Exempt Income	-	-	+
Individual Stocks/Equity Exchanged Traded Funds	Taxed at long-term gains rate	=	=	+
Tax-Managed Equity Mutual Funds	Taxed at long-term gains rate	-	-	+
Real Estate Investment Trusts (REITs)	Dividends; Ordinary income	+	+	-
Actively Managed Equity Mutual Funds (high turnover)	Short-term gains; Ordinary income	+	+	-
Taxable Bonds/Bond Funds	Interest; Ordinary Income	+	-	-

+	Most Appropriate
=	Appropriate
-	Less Appropriate

In most cases Asset Location strategies naturally allocate higher expected growth assets to taxable and Roth accounts which helps reduce Required Minimum distributions from tax deferred accounts. This will reduce an individual's ordinary income

in retirement. Considering the growth characteristics of each type of account is also important regarding heirs of an estate. Having higher expected growth assets in taxable and tax-exempt/Roth accounts is also beneficial to an individual's heirs. The most preferential account to pass on to an individual's heirs under the current tax legislation would be in the following order.[2]

(1) Tax-exempt/Roth Accounts – At the account owners' death, heirs can hold assets in inherited Roth IRA account that remain tax free for up to 10 years. Distributions from the account are also tax free.

(2) Taxable Accounts – At the account owners' death, investments in a taxable account would receive a tax basis adjustment to the fair market value when passed to heirs.

(3) Tax-deferred/Traditional – The same rules apply as the tax-exempt account, except tax-deferred account distributions are taxed as ordinary income rates. For example, an heir's inheritance of a $1,000,000 IRA would amount to $650,000 after tax, if we assumed they were in the 35% federal marginal tax bracket.

Overall, Asset Location seems straightforward on paper, but when applied to an individual's real-life situation, she or he may find that the strategy can look different for each person due to complexity, needs for liquidity, marginal tax rates, and the value of each type of account that they own. The potential benefit of Asset Location will also look different depending on each individual's overall financial situation. Morningstar's whitepaper "The Value of a Gamma-Efficient Portfolio" states that more complex clients in high marginal tax brackets with multiple account types have a potential to benefit significantly (approximately 0.50% on an annual basis). For the average investor, they conservatively assume the benefit would be approximately 0.25%.[4] While this benefit might not seem significant in the near term, this strategy is meant to be in place for the long-term and, with time, can be beneficial to an investor.

Sources:
(1) https://www.fidelity.com/viewpoints/investing-ideas/asset-location-lower-taxes
(2) https://www.kitces.com/wp-content/uploads/2014/04/Kitces-Report-March-April-2014-Advanced-Asset-Location-Strategies1.pdf
(3) https://www.schwab.com/learn/story/tax-efficient-investing-why-is-it-important#:~:text=Making%20tax%2Defficiency%20part%20of,time%20to%20file%20their%20returns
(4) https://www.morningstar.com/content/dam/marketing/shared/research/foundational/831611-GammaEfficientPortfolio.pdf

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Performance data shown represents past performance. Past performance is not an indicator of future results. Current performance data may be lower or higher than the performance data presented.

MARKET BENCHMARK RETURNS

July 31, 2022		1M	3M	12M	YTD
US Large Cap	S&P 500	9.2%	0.4%	-4.6%	-12.6%
US Small Cap	Russell 2000	10.4%	1.5%	-14.3%	-15.4%
Developed Intl	MSCI EAFE	5.0%	-4.0%	-14.3%	-15.6%
Emerging Intl	MSCI Em Mkt	-0.2%	-6.5%	-20.1%	-17.8%
Real Estate	NAREIT	8.7%	-3.5%	-2.6%	-12.3%
Core Fixed	BarCap Agg	2.4%	1.5%	-9.1%	-8.2%
Short Fixed	BarCap 1-3Yr	0.5%	0.4%	-3.2%	-2.6%
Long Fixed	BarCap LT G/C	3.8%	0.4%	-19.4%	-18.9%
Corp Debt	BarCap Corp	3.0%	1.2%	-12.2%	-11.2%

Source: Bloomberg

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