SIGMA INVESTMENT COUNSELORS Sigma Summaries

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At the End of the Day, An Investor Only Has One Portfolio Part III

The following question and answer discussion is the last in a series focusing on the determinants of investment returns. In the first interview with Ann J. Conrad, she discussed the role of asset allocation in the determination of investment returns. The second article explored the importance of equity allocation in maximizing the client's long-term after-tax total returns. It addressed some of the reasons why using a sector and industry approach to equity allocation has a better opportunity to enhance returns than matrix investing. This final article discusses additional factors influencing returns

Ann, are there other factors that may have a significant influence on returns?

Some that come to mind are too much fragmentation, excessive transaction costs and taxes, and high or too many fees and commissions.

What do you mean by fragmentation?

Fragmentation means having many assets of many kinds, often managed by several managers at many different places. It means that there is no overall integrated approach to wealth management for an individual. Often such an approach leaves much to be desired. For instance, not only may there be redundancy and conflicting strategies built into an overall portfolio, but the portfolio may be subject to unusual business or volatility that is not recognized by the investor. Similarly, overall portfolios could end up with unwise asset allocation and sector, industry, or company concentrations. Lack of coordination may also result in the loss of such potential benefits as implementing methods of minimizing an investor's tax burden or deliberately controlling turnover in an effort to minimize transaction costs. It is possible that if there is more than one firm involved, each may be doing a good job. But together they may not be doing what is best for the investor. The reality is At the End of the Day, An Investor Only Has One Portfolio. All the securities an investor owns, whether they are owned individually or as part of a fund and whether they reside with one investment manager or several, together they comprise one portfolio.

We had one client who had four different investment advisors, investments in many individual issues and mutual funds. When we listed all the individual securities and all the securities within each fund by sector and industry, we discovered that the investor had 28% invested in industrial goods, much higher than the 9.7% weighting in the S & P 500 Index. He also had approximately 15% invested in one security, 12% with one advisor and 3% with another. Further, there was 40% in fixed income investments and cash and cash equivalents, far too high, in our opinion for a 40-year old investor, with $2 million in his portfolio, a good job and no current income and liquidity needs.

What do you advise?

At Sigma, we take a holistic view of the investor's financial circumstances. We encourage investors to allow us to regularly look at their total investments (whether managed by us or elsewhere). We offer to act as the coordinator so that investments can be configured or reconfigured when necessary to prevent fragmentation from sub-optimizing an investor's financial returns.

You mentioned taxes have an impact on returns?

Investors realize taxes have an impact on returns. What they may not realize is how heavy that impact may be and how important it is that their portfolios be managed in a tax sensitive manner.

Particularly vulnerable to the heavy impact of taxes are investors who believe they must make frequent switches in their stock holdings to keep up with new developments and to offset swings in the market. Similarly, mutual funds, whose managers incur large turnover in their portfolios in an effort to maximize pretax performance since they are rewarded on that basis, may also be subject to heavy taxation. High turnover is fine for tax-exempt investors such as 401K shareholders (if, indeed, such activity does result in better investment results), but it is often counterproductive for taxable investors.

Some investors challenge the notion that tax-sensitive investing is important. Generally, we have found that these investors look at investment results over too short time frames of five, or at most, ten years. This ensures that the impact of tax sensitivity is muted and, importantly, ignores the power of compounding. Focusing on too short time horizons overlooks the fact that even small differentials in annual returns can compound into large wealth differences over long time periods. This is critical because the time horizon of most investors encompasses decades, not just years.

Regardless of the heavy impact taxes can have on an actively managed portfolio, it is essential not to let the tax tail wag the investment dog! The most important job for the investor is to build a portfolio of attractive securities at the desired level of risk. This includes "freshening" the portfolio periodically to prevent the portfolio from degenerating over time into a collection of mediocre, slowly growing mature companies. This activity may result in realized capital gains. Three techniques Sigma employs to minimize the tax burden in taxable equity portfolios are: 1) emphasizing stocks that produce most of their return in the form of appreciation, rather than dividends, 2) minimizing portfolio turnover, and 3) "harvesting" significant tax losses.

Capital gains on a portfolio are taxed at a 20% rate if they are long term. Dividends, however, are taxed at ordinary income tax rates, which are generally higher than 20%. This is the reason for the emphasis on capital appreciation rather than returns generated by current income or dividends. Minimizing portfolio turnover is achieved by emphasizing sectors and industries with the best secular trends and selecting companies with the best long-term sustainable competitive advantages. A good stock can be held for many years. This enables delaying realizing gains and paying the resulting taxes as long as possible. Generally late in the year, we may "harvest" significant tax losses. This entails selling stocks we wish to own long term that are priced below their cost and buying them back 31 days later. Buying them back earlier than the 31 days would result in the Tax Code's wash sale rule. Or we might double up shares that are at a loss by buying the equivalent amount of additional shares and selling the original high-cost shares after 31 days.

Realized losses are very valuable as offsets to either realized gains or up to $3,000 ordinary income in a year when no net gains are taken.

The last factor you mentioned that can have a significant impact on returns is high, or too many, fees and commissions. Could you please elaborate?

I think all investors know that high or too many fees and commissions can hurt returns. What they may not know are what fees they actually are paying, what impact these fees and commissions are having on their returns, and whether they can get the same or better investment results while incurring lower fees or commissions.

Give me an example of a situation where an investor may not know what fees they are paying.

Some brokerage firms offer clients what are called wrap accounts. These are accounts offered by brokers who select other investment advisors to manage the assets. The returns on these accounts are reported to clients after fees, as they should be. However, the fee is never specifically disclosed. Often the fee is as high as 3% of the value of the assets under management. The only way the investor is able to discern the amount of the fee is through the disclosure of the gross return on the account, usually contained in some obscure small footnote. Now 3% might be okay if the return is high enough. However, 3% is a big nut to overcome.

A thorough discussion on commissions and fees could be quite lengthy - a good topic for a future Sigma Summary.

In summary: beware of too much fragmentation, tax inefficiency, and excessive transaction costs, fees and commissions.

Exactly!