

As We See It

“The avoidance of taxes is the only intellectual pursuit that carries any reward.”
John Maynard Keynes

The importance of taxes results from their direct impact on the bottom line rate of return, a fact any investor can attest to at year end. The constraints, limitations, and concerns which guide investment behavior vary greatly among investors. However, one behavior that appears universal is the reluctance to pay taxes.

In a taxable account, each profitable position sold triggers a capital gain, thereby reducing the realized return of the account over time. The more profitable positions traded, the higher the tax costs. By implication, an investor must consider this cost and weigh it against his ability to replace the security sold with one offering superior returns that will *make up* the tax cost resulting from the switch.

For example, if an investor wanted to replace a stock in his portfolio in which he had a 50% gain, the decision process should begin with this calculation:

$$\begin{array}{r} \text{Today's} \\ \text{Market} \end{array} - \begin{array}{r} \text{Stock} \\ \text{Cost} \end{array} = \begin{array}{r} \text{Gain} \\ \text{Less} \end{array} \begin{array}{r} \text{Capital} \\ \text{Gain Tax} \end{array} = \begin{array}{r} \text{Available for} \\ \text{New Investment} \end{array}$$

Then, consider what expected return would he have to earn to be *even* given the expected return of the stock sold? To illustrate: a \$30 stock with a cost of \$20 is sold, realizing a \$10 capital gain. As recently as 1990, an investor would have subtracted the 33% federal long-term capital gain tax (\$3.30) leaving \$26.70 for new investment. If the investor expected the original investment to earn 10% over time, the new investment would have to earn 23.6% to be *even* (\$30 to \$33 is a 10% return, \$26.70 to \$33 is a 23.6% return). A matrix could be constructed of all the possible outcomes, but—suffice it to say—the federal capital gain tax was a large investment hurdle to overcome. The advent of the 15% capital gain tax altered the math as follows: \$30-\$20 = \$10 gain less 15% tax = \$28.50. The investor would now have to expect the new investment to return 15.8% to be *even* with the original holding's expected return of 10% (\$28.50 to \$33 is a 15.8% return). A hurdle, to be sure, but a much smaller one than existed in the higher capital gain tax world.

Another way of looking at the problem is to calculate how much a current holding would have to decline in value to justify paying the capital gain tax and *moving on* to another investment. Using the numbers from our previous example, one would have to expect a \$30 stock with a 50% embedded gain to decline to \$26.70 (-11.0%) to justify paying the tax in a 33% tax rate world, but only \$28.50 (-5.0%) in the current 15% tax environment. Since, 100% of the S&P 500 experienced a decline of 5% at one time or another over the past year, the *tax hurdle* created by a 15% rate appears an easy jump.

Granted, the foregoing examples are greatly simplified. The expected rate-of-return to breakeven and the downside breakeven analysis are affected by not only the rate of federal capital gain tax, but trading costs, state taxes, and the size of the embedded gain. Simply, the larger the embedded gain the larger the *tax hurdle* to overcome. In addition, the investor must consider trading costs and be ever mindful he is dealing with expectations, not realities.

It appears today, that as painful as realizing gains are to many investors, the current tax-rate environment is the most conducive to restructuring portfolios since the 1920s. To further complicate matters, the 15% rate is set to rise to 20% in 2009 absent further revisions in tax law. No investor wants to pay more in taxes than is required. However, good investors realize that while taxes are an important part of any investment vehicle, in most instances, they should be a passenger, not the driver.

April 2005