LAWSON KROEKER
INVESTMENT MANAGEMENT

As We See It

"One of the most treasured assets a taxable portfolio can have is an unrealized gain."
—Robert Arnott
First Quadrant Corp.

The July, 1993, edition of "As We See It" dealt with the negative impact capital gains taxes have on investment returns. In conclusion we stated that, "Without question, capital gains taxes significantly reduce returns. It is very difficult for managers to overcome the burden of taxes resulting from their trading activity."

This topic has received considerable attention in the *Wall Street Journal* and other business publications in recent months. The articles have referenced the study we noted in our July "As We See It" as well as other research. The studies have concentrated on mutual funds because data are readily available, but the conclusions apply to individual portfolios as well.

"Most mutual funds are not paying any attention at all to shareholder taxation," says John B. Shoven, a professor of economics at Stanford University and co-author of one of the studies. "One of the things that mutual funds often sacrifice is the advantage you can get from . . .postponing capital gains." Unrealized capital gains are, in effect, a tax shelter. As long as the stock is held, any appreciation compounds free of tax. It is only the security's sale (realization of the gain) which results in a taxable event.

It becomes quite costly to sell any stock that has a significant gain. If a stock which has doubled in price from $50 to $100 is sold, the capital gain tax (Federal only) will be 28% of the gain or $14. This leaves $86 to reinvest. Therefore, the new purchase has to rise 16% just to get the investor back to even. Admittedly, the investor's new cost basis would rise from $50 to $86 which would mitigate a future capital gain liability.

Capital gains taxes have a devastating impact on returns. Suppose the aforementioned stock took 10 years to double. Ignoring any dividends, that would be a compound return of 7.18%. Now suppose the stock is sold and capital gain tax is paid. The net (after tax) appreciation (from $50 to $86) is reduced to a compound annual return of 5.57%—a remarkable 22% difference in the rate of appreciation.

Obviously a stock should be sold if the fundamentals of the business have deteriorated to the point where the long-term outlook for the company is unfavorable. But trading for the sake of short-term developments should, in our judgment, be avoided. As money managers, we concentrate on those investment decisions that we feel have a high probability of success over a long-term time horizon. Frequently, there are many doubts about the short term, but that is what makes the opportunity. By concentrating on the long term, trading is reduced thereby taking advantage of the capital gains tax shelter.

A popular Wall Street saying is, "You will never go broke taking a profit." The adage implies that investors should be quick to recognize gains. There is, however, considerable evidence that taxable investors should be more deliberate and carefully weigh the tax consequences of recognizing capital gains.

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