Advisor Industry Insights
From Morningstar

Uncover Long-Term Tax Savings With Location Optimization

As financial advisors serve more sophisticated investors, tax-efficient portfolio management, including location optimization, is an essential value-added service that differentiates them from "robo-advisors."

Many advisors think of tax-efficient management as simply selecting a custodian's "best tax" cost basis option, but that only defers taxes until the appreciated securities are sold. A more advanced (and rarely used) tax-savings strategy, location optimization, can also create permanent savings. And because automated advice platforms (robo-advisors) do not currently offer it, location optimization can also help you differentiate yourself from the competition.

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Sheryl Rowling has nearly 40 years of experience in the financial services industry. In addition to her role at Morningstar, she is the principal of Rowling & Associates, an investment advisory firm. Sheryl has been named one of the nation's top 250 financial advisors by *Worth* magazine and was named one of *Accounting Today's* Top 100 Most Influential People in Accounting. She writes regular columns for the Advisors4Advisors.com, *InvestmentNews*, and *San Diego Jewish World*, and she wrote the book *Tax and Wealth Strategies for Family Businesses* (CCH, 2006).

Traditional Account-Level Management

Many advisors manage portfolios at the account level. This means that each account is managed separately without regard to what is in the client's other accounts. Account-level management typically puts a full allocation of investments into each account. So, a client with a 60/40 allocation model will have the same investments in the same percentages in each of their accounts, whether taxable accounts, retirement accounts, or Roth IRAs.

If you manage portfolios manually, account-level management is much easier than household-level management. There's no need to coordinate multiple accounts under one model umbrella. From a client standpoint, it's easier to track results. Clients comparing the performance of one of their accounts to another will feel comfortable with the consistency. You won't need to answer questions like, "Why did my IRA perform worse than my taxable account?" And with a full allocation in each account, it's easier to evaluate results with blended indexes.

Even without household-level management, you can use many tax-saving strategies for taxable accounts, including short-term gain avoidance, tax-lot identification (or using the custodian's "tax optimized" method), and tax-loss harvesting. These strategies are somewhat cumbersome when managing by hand (or with spreadsheets), but automated rebalancing makes implementation easy.

As convenient as account-level management can be, it comes with disadvantages to the client. Without being able to locate specific investment types among particular accounts within a client's portfolio, you can miss tax-savings opportunities. Because clients hold the same allocation of investments in each account, you may need to purchase or sell the duplicate position in each account. The goal of holding a "whole pie" in each account requires you to piece together the full allocation within 401(k)s and annuities from their limited offerings. This can mean that the allocation will be less than ideal, possibly because the plan doesn't offer every type of requested investment, such as commodities or emerging markets equities. In that case, the client might be forced to hold sub-par funds (if that is the only offering in a particular category).

Account-Level Management Disadvantages

Limits Tax Savings

Cannot apply location optimization.

Duplicate Holdings

The same holding will be present in multiple accounts within a household, resulting in more transactions.

Outside Accounts Holdings

When attempting to hold a full allocation in an outside account, the advisor might need to utilize funds that would otherwise be unacceptable.

Household-Level Rebalancing and Location Optimization

With household-level rebalancing, the full investment allocation is spread among the various accounts, so that model is represented in total in the overall portfolio. Simply put, location optimization is the act of locating specific types of investments in specific types of accounts to minimize taxes.

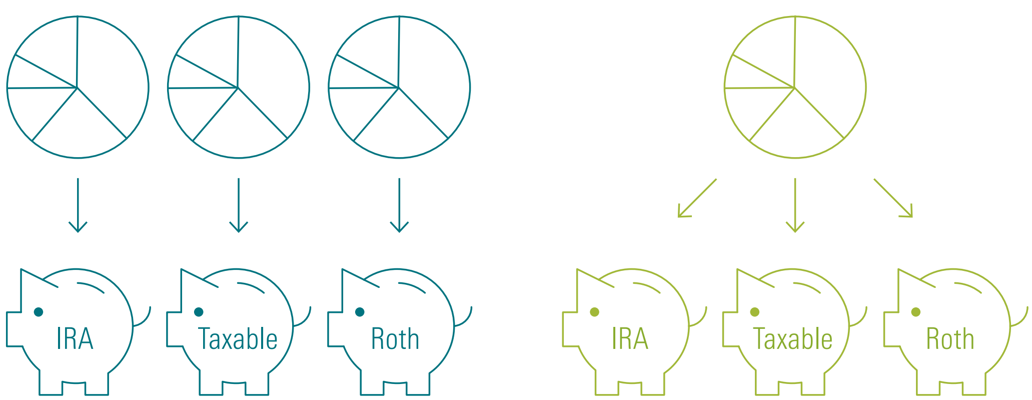
> Location optimization doesn't apply unless an investor holds multiple investment types in multiple account types. For example, if a client's child has a taxable account and a Roth IRA, and one or both accounts holds solely an asset allocation fund, there is no opportunity for location optimization. Likewise, if you have a client with a rollover IRA of $2 million and no other accounts, there is no opportunity for "mixing and matching" tax treatments.

That said, if your client meets these basic criteria for location optimization, you can reduce the overall tax burden by carefully selecting which investments are held within each type of account. In other words, rather than placing a full allocation within each account, you can allocate a portion of a holding within specific accounts.

Household-Level Rebalancing Explained

Standard Account Allocation

Allocation with Location Optimization



Standard Account Allocation:

- Management not at household level
- "Full" pie in each account

Allocation with Location Optimization:

- Management at household level
- Ordinary income production in IRA
- Appreciation in taxable account
- High return in Roth IRA

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Right Place, Right Time

In general, it is best to group tax-inefficient investments in retirement accounts, tax-efficient investments in taxable accounts, and high-return investments in Roth IRAs. Why place investments this way? Appreciating assets held in an IRA will eventually be taxed at ordinary income rates. And, this tax will even apply to heirs. If held in a taxable account, the appreciation is not taxed unless the holding is sold – at capital gain tax rates. Therefore, holding appreciating investments in retirement accounts is like telling Uncle Sam that it's okay to pay twice as much tax. And, don't forget that if the client holds the appreciated positions in a taxable account, heirs can receive them at a stepped-up basis, resulting in no tax at all.

> Holding appreciating investments in retirement accounts is like telling Uncle Sam that it's okay to pay twice as much tax.

Holding tax-inefficient investments, like U.S. bonds, in a retirement account effectively defers tax until drawdown. Although this will eventually incur ordinary tax when earnings are realized, the income would have been subject to ordinary tax anyway. It is true that municipal bonds can be held in a taxable account, but these still come with a tax "haircut" through lower returns. (And, don't forget that when reporting gross returns to clients, the total returns will be less than if they were holding taxable bonds.) Also, fixed income tends to produce lower long-term returns than equities, resulting in lower required minimum distributions and less potential for income in respect of a decedent (taxation that passes to heirs).

Holding the highest return investments in a Roth IRA ensures the greatest tax efficiency from an account that will never be subject to tax. Because this account will likely be the last account tapped for cash flow needs, it can handle volatile investments that will produce higher returns in the long run.

Complicating Factors

When applying location optimization, investments are categorized according to tax characteristics. Some investments throw off ongoing ordinary income, like taxable bonds. Other investments are held primarily for long-term growth. There are many variations in tax characteristics beyond this simple dichotomy, such as:

- Qualified dividends and interest
- Non-qualified dividends and interest
- Tax-free dividends and interest
- Federal tax-free dividends and interest/state taxable dividends and interest (and vice versa)
- Dividends and interest subject to alternative minimum tax
- Foreign dividends qualifying for foreign tax credit
- Short-term capital gain distributions
- Long-term capital gain distributions
- Short-term gains
- Long-term gains

When determining tax characteristics of an investment, you should consider both the types and timing of taxable income. In most cases, an investment will produce a combination of income types subject to various types of taxes (Federal ordinary tax, Federal capital gain tax, Alternative Minimum Tax, foreign tax) at different times (annually, upon sale, as dividends are declared, as withdrawn).

Worth the Effort?

Minimizing taxes is an appropriate goal as long as it maximizes after-tax return. Location optimization is designed to do this. However, to apply location optimization, you must manage portfolios at the household rather than account by account. Is the complexity worth the savings? Automation can make location optimization much easier and efficient to implement. Perhaps more importantly, will your client believe that the complexity is worth the savings?

To create understanding, you'll need to educate your clients on the advantages of household-level management. And, reports should all be consolidated at the household level. Providing individual account performance reports would be irrelevant.

By utilizing a disciplined location optimization strategy, clients will benefit from lower current and future taxes.

Automating Location Optimization

Morningstar® Total Rebalance Expert (TRX) automatically considers location optimization when creating trade proposals, within the constraints of the default trade logic that prioritizes tax efficiency and minimizes number of trades. In other words, TRX will seek the best locations when buying or selling—based on your settings—only to the extent it will not recognize unnecessary gains or increase the number of trades.

While the default rebalance isn't looking to improve location optimization savings, TRX always generates an alternative trade proposal. This alternative proposal looks to maximize location optimization savings by proposing additional trades to move positions held in "wrong" accounts to "right" accounts (as designated by the advisor). This can often result in more trades – and additional gains. It's up to you to then review the two trade proposals to determine if the benefits of the "location optimization" proposal outweigh costs of the default proposal.

Asset Class	Sell	Buy	Priority
Corporate Bond	Roth	IRA	6
Emerging Markets Bond	Roth	IRA	2
High Yield Bond	Roth	IRA	1
Inflation-Protected Bond	Taxable	IRA	13
Intermediate Government	Taxable	IRA	11
Intermediate-Term Bond	Roth	IRA	4
Long Government	Taxable	IRA	5
Long-Term Bond	Roth	IRA	3
Multisector Bond	Taxable	IRA	7
Nontraditional Bond	Taxable	IRA	9
Short Government	Taxable	IRA	12
Short-Term Bond	Taxable	IRA	8
Ultrashort Bond	Taxable	IRA	14
World Bond	Taxable	IRA	10
Diversified Emerging Mkts	IRA	Roth	1
Europe Stock	IRA	Roth	6
Foreign Large Blend	IRA	Roth	8
Foreign Large Growth	IRA	Taxable	10
Foreign Large Value	IRA	Roth	4
Foreign Small/Mid Blend	IRA	Roth	5
Foreign Small/Mid Growth	IRA	Taxable	4
Foreign Small/Mid Value	IRA	Roth	2
Large Blend	IRA	Taxable	8
Large Growth	IRA	Taxable	9
Large Value	IRA	Taxable	2
Mid-Cap Blend	IRA	Taxable	1
Mid-Cap Growth	IRA	Taxable	6
Mid-Cap Value	IRA	Roth	7
Small Blend	IRA	Taxable	5
Small Growth	IRA	Taxable	7
Small Value	IRA	Roth	3
World Stock	IRA	Taxable	3
Commodities Broad Basket	Roth	IRA	19
Global Real Estate	Roth	IRA	17
Long-Short Equity	Roth	IRA	16
Multialternative	Roth	IRA	18
Real Estate	Roth	IRA	15

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