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The Perception of Taxes

Taxes are often considered a necessary evil. The topic evokes strong emotions. How we perceive taxes and how we feel about paying them are complex issues. For investors, two significant situations to avoid when it comes to taxes are:

- Focusing solely on how much of an investment gain could be lost to taxes
- Worrying so much about taxes that it adversely affects decision making

Eating Up Gains

Many (if not most) investors focus on the pretax value of their investments, even though they can only spend after-tax dollars. To see why this is so important, consider the 1993 study done by two Stanford University economics professors. They examined 62 stock mutual funds before and after taxes for the period 1963–1992. They found that each dollar invested would have grown to $21.89 in a tax-deferred account, but only $9.87 in a taxable account (for high-income investors).

Many fund companies offer tax-managed counterparts, which strive both to minimize fund distributions and to maximize the percentage of distributions that will be in the form of long-term capital gains (which are currently taxed at lower rates than short-term gains or ordinary income).

Avoiding Taxes, Creating Other Problems

Such tax issues may leave some investors saying, "I'll just avoid paying taxes at all costs." However, avoiding tax bills could end up being a bad decision. For this, let's look at a hypothetical example.

In August 2004, an investor bought 200 shares of Google at $100 per share. This $20,000 investment was 5 percent of his total portfolio of $400,000, which was split evenly between stocks and bonds (meaning $200,000 in each). The stock skyrocketed, as Google crossed $700 about three years later. His stake in Google, now worth $140,000, represented about 25 percent of his portfolio, which had grown to $600,000. This also meant his stock allocation had jumped from 50 percent to 70 percent.

While seeing such an increase in the portfolio was a welcome sight, it also meant the investor's allocation had drifted far from where he started, meaning he was now taking on much more risk than before. However, rebalancing the portfolio would mean paying the tax bill on his appreciated shares. Assuming a federal and state tax rate of 20 percent, there would be $24,000 in taxes on the $120,000 gain. That bill was too much for the investor to swallow, so he decided against rebalancing.

By January 2009, Google fell to $300, leaving his investment sitting at $60,000. Had he sold at the peak, the investor would have had net cash of $116,000 (the stock's $140,000 minus the $24,000 tax bill). Selling at $300 meant his tax bill dropped to just $8,000, leaving him with $52,000 net cash. He still saw a solid profit from his investment, but avoiding the $24,000 tax bill cost him $64,000.

Summary

Taxes are possibly the largest single expense that investors incur, even greater than management fees or commissions. Therefore, ignoring the impact of taxes is one of the biggest mistakes you can make.

However, it is also possible to become so concerned with taxes that you deviate from a prudent investment strategy to avoid the pain of paying them. You would be wise to remember that the only thing worse than having to pay taxes is not having to pay them.

For more on these topics, see Chapters 27 and 47 of *Investment Mistakes Even Smart Investors Make* (2012) by Larry Swedroe and RC Balaban.

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WEALTH • ADVISORS
seeking your success

Siena Wealth Advisors
209 South Bridge Street
Grand Ledge, MI 48837
517-627-1412 Tel
517-627-5575 Fax
sienainvestor.com
A fee-only independent advisor