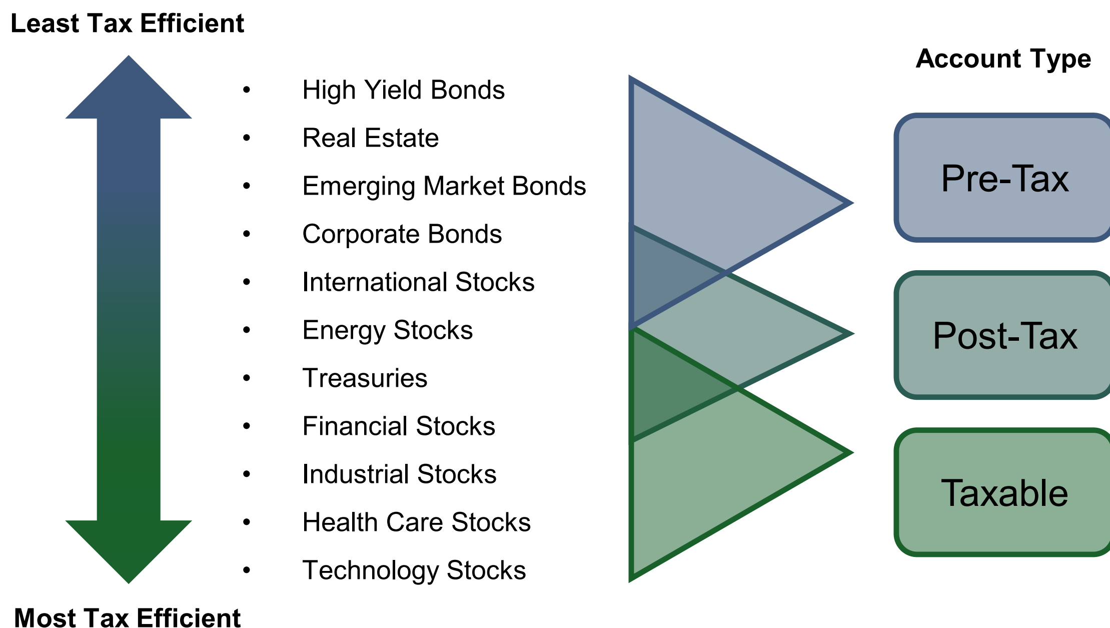
The Importance of Asset Location

In reviewing performance, many investors focus primarily on stated returns. However, what really matters for investment growth over time is after-tax returns, tailored to an individual's specific tax situation. An intelligent tax strategy can lower tax effects on a portfolio, saving investors significant money each year.

Building a tax efficient portfolio relies not only on selecting the right assets but also on where these assets are placed. This concept of "asset location" distributes investments to the most tax efficient account type based on the asset type. That is, holdings are divided between taxable and tax-advantaged accounts to improve a portfolio's after-tax returns. See graphic below.



Asset location is a key strategy for increasing after-tax returns. The accounts in which investments are held (taxable versus non-taxable) have a significant impact on tax savings. Without proper asset location, tax dollars may be left on the table. How much value does this strategy add? According to Morningstar, asset location, when combined with an intelligent strategy for drawing down assets, can produce 0.52% per year of additional return.[1]

Vanguard offers an even more powerful example which assumes a $1 million portfolio with assets split between taxable and tax-deferred accounts.[2] It also assumes the owner is in the top Federal marginal tax bracket. In the first scenario there is no consideration of asset location. The second scenario uses a basic asset location strategy.

In this example, when comparing the two scenarios, the portfolio saved $10,380 (over 1%) per year in Federal taxes simply by locating assets where they are least impacted by taxes. This calculation considers only federal tax consequences. Investors in high-tax states like California and Oregon could also have significant state tax savings. These annual gains then compound over time.

Your team at Sharper Granite uses an asset location strategy for every client who holds both taxable and tax-deferred accounts in their portfolio. Finally, we should note that this is just one component of a complete tax efficient strategy. Other important factors include an individual's tax situation now versus the future, capital gains management, annual income need, IRA and Roth IRA strategies, and asset drawdown at the appropriate time and in the correct order.

They say taxes are one of the two certainties in life; however, you can control tax impact through intelligent investing strategies. If you have additional questions about our asset location strategies or other tax savings techniques, please contact your advisor.

Notes and Acknowledgements:
1. David Blanchett and Paul Kaplan, "Alpha, Beta, and Now … Gamma," Morningstar, September 2012
2. Colleen Jaconette, "Asset Location for Taxable Investors," Vanguard, September 2007.

All forms of securities investing involve risk of loss for which clients should be prepared. There are no guarantees or insurances of principal preservation and market fluctuations of any level may occur and impact portfolio value. Past performance is not a good predictor of future performance. [Spring 2019]