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Essential Components of Tax-Efficient Portfolios

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Tax-efficient investing should include the following components: tax-efficient instruments, an investment style capable of providing most returns through long-term capital gains, and sophisticated optimization to maximize the after-tax risk adjusted return. New Frontier has all three: tax-efficient ETFs, a moderate turnover strategy that rarely issues short-term capital gains, and an optimized full-portfolio solution that goes well beyond simply substituting municipal for taxable bonds.

Having a portfolio with the right instruments and an appropriate strategy is important. The tax efficiency of ETFs is widely discussed for good reason. First, most ETFs manage to trade in kind, which means they rebalance without incurring capital gains. Second, ETFs solve the problem mutual fund investors have long experienced where one investor may have to pay capital gains on the trading resulting from the redemptions of another investor. Also, a moderate turnover strategy can be carefully managed to almost completely avoid short-term capital gains, dramatically reducing the portion of portfolio return paid out in taxes. So, an ETF portfolio managed with moderate turnover provides a good start to tax-efficient investing.

Sophisticated tax-sensitive optimization provides further benefits, but is surprisingly rare in practice. Many so called tax optimized strategies simply replace taxable bonds with municipal bonds. But maximizing risk-adjusted after-tax return is not that simple. A substitution strategy that focuses solely on tax exemptions ignores the other efficiencies of an optimal portfolio as well as the complexity of taxable assets. Assets have income, dividends (some of which may not be qualified), and capital gains from turnover based on both volatility and persistence in the strategy—all of which impact their after-tax risk and return. New Frontier includes all of these factors in our optimization, thereby creating efficient portfolios designed for taxable investors.

With high quality tax-sensitive optimization, all of the ETF weights differ from the tax-free versions. Unsurprisingly, tax-exempt bonds typically dominate fixed income exposure, but taxable bonds may still have a role. More conservative portfolios may have an exposure to treasuries to further lower portfolio volatility. A limited exposure to a credit risk premium may still be appropriate even after adjusting expected returns for taxes. REIT exposure

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may decrease due to their relatively high income. Similarly, there may be modest shifts from higher dividend value stocks into growth stocks.

The result is a more appropriately allocated portfolio for the tax-sensitive investor with the whole portfolio optimized for tax efficiency and risk control. This is a vast improvement over simply substituting in some municipal bonds and promising not to trade more than once a year.

Disclosures: Past performance does not guarantee future results. As market conditions fluctuate, the investment return and principal value of any investment will change. Diversification may not protect against market risk. There are risks involved with investing, including possible loss of principal.

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