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Tweaking Your Portfolio

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by Peter James Lingane, EA, CFP™ and H. Gene Hern, Jr., MD, MS

An occasional discussion of financial issues of interest to physicians.

Congress passed 200 pages of tax changes last May. Tax professionals used to joke that tax laws amounted to full employment legislation. Now they tend to view too frequent change as a malpractice hazard!

For an excellent summary of the rules, see Ernst & Young's "What the 2003 Tax Act Means for Investors" on the website of Fidelity Investments.

You have doubtless read how lower rates on capital gains and dividends might advantage stocks in one category or another. This is of no import if you were convinced by last time's "Simpler is Better" argument and if you invest in funds which own a bit of everything.

If you have been reluctant to rearrange your portfolio because of unrealized tax on your current investments, lower rates make this a good time to act. But don't procrastinate since rates are scheduled to go up in five years and Democrats vow repeal as soon as the electoral tide turns.

Lower rates do make a difference how you allocate your investments between pension and taxable accounts.

Pensions and IRAs and 529 college savings accounts are effectively free of federal and California tax assuming that you follow the rules by waiting until retirement to withdraw funds or using the money for education. This is easiest to see with Roth IRAs and 529 accounts because withdrawals are tax-free but this is also true of pensions and traditional IRAs because you did not pay tax on your contributions.

If your portfolio contains equal amounts of bonds with a 6% yield and stocks with 10% in gains and dividends, your after-tax return is about 8% if you own these investments inside a pension, IRA or 529 account.

Federal plus California tax totals about 40% on interest and short term gains after the recent changes while dividends and long term gains are taxed at about 20%. The return on a taxable portfolio with equal amounts of bonds and stocks is about (60% of 6% plus 80% of 10%) / 2 or 5.8%. This is more than under the old law, and understates the return to the buy-and-hold investor, but this is substantially less than what is possible inside pensions and IRAs and 529 accounts. There is still an incentive to contribute the maximum you can afford to pensions and IRAs.

As an aside, tax rate reductions have eliminated any incentive to invest in annuities unless you are afraid of outliving your investments.

Every effort should be made to save early because of the power of compounding.

Your sixteen-year-old grandchild earns \$500 in their first summer job. Give the child \$500 on the condition they invest in a Roth IRA. Forty years hence, your modest gift will exceed ten thousand dollars after-tax.

A younger physician might have a pension and a savings account for emergencies and for a down payment on a home. In time, a 529 account might be added to the mix. When there is more opportunity to save, taxable investments might be a substantial portion of the total portfolio.

We tend to hold the same sorts of investments in our pension and taxable portfolios *but it is better to hold the investments that generate the most tax inside pension and IRA and 529 accounts.*

We saw earlier that the after-tax return might be 8% in a pension account and 5.8% in a taxable account. If you own the same investments in pension and taxable accounts of equal value, your combined return would equal the average or 6.9%.

Now suppose that you owned bonds in pension accounts and stocks in taxable accounts. The after-tax return of your combined portfolio would be about $(6\% + 80\% \text{ of } 10\%) / 2 = 7.0\%$. If you reversed things and owned stocks in the pensions and bonds in the taxable accounts, your return would be about $(60\% \text{ of } 6\% + 10\%) / 2 = 6.8\%$.

These differences may seem trivial but they mean an extra or two thousand dollars a year on a million dollar portfolio or more than enough to fill-up your SUV a couple of times even at California prices. Achieving these differences require almost no extra effort. The differences grow if the stocks are held for extended periods and if rebalancing is done within the pension accounts.

Few rules of thumb are absolute. For example, differences disappear in this illustration if bonds yield 5% or if stocks return less.

You should probably structure your pension and taxable portfolios on cost issues alone if bond investments have lower costs outside the pension environment and if stock opportunities within and outside the pension environment have similar costs.

For example, individual bonds yield a bit more than Vanguard's bond funds and the yield difference is acerbated if your pension only offers higher cost bond funds. Tweaking makes sense with an IRA because you can buy individual bonds but may not make sense if you have to settle for bond funds.

You have come out ahead in the past by stuffing as much as possible into pensions even though costs might be above average. Reduced tax rates have decreased the advantage of pension investing.

What should you do if your only pension choices involve above average costs? You might invest in a lower cost 529 savings account or invest in the names of your children who pay very low tax rates under the new law. You might be ahead by paying down your mortgage and margin loans. You might open a self directed pension based on self-employment earnings. You might contribute to a Roth IRA or convert to a Roth IRA if your income is not too high.

Optimists might invest in California bonds. After-tax yields are very attractive because of our budget problems.

You probably need detailed analyses to characterize the tradeoffs between taxes, costs and investment opportunities. It is not brain surgery but consider seeking professional help "if you have other things to think about." A good adviser should earn their hourly fee from improved performance in the first year alone.

It is probably to your advantage to defer income and to make charitable contributions and to pay property and state taxes and malpractice premiums before year's end.

Lower federal tax rates will cause more higher income taxpayers to fall victim to the federal alternate minimum tax. Talk to a tax professional if your income exceeds a hundred fifty thousand dollars, especially if you have capital gains or "preference income" from stock options, municipal bonds and depreciation or if you have already paid lots of taxes this year. About the only defense this late in the year is to defer the fourth quarterly state tax payment to January.

Our next discussion will address when you should fire your tax preparer.

Peter can be reached at lingane@post.harvard.edu or (925) 299-0472.

Gene can be reached at geneh@hghed.com or (510) 437-4896.

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