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Asset Location, Asset Location, Asset Location

Studies show that over 90% of an investment portfolio's return variability is attributable to its asset allocation. Accordingly, many investors keep a watchful eye on their asset allocation, or mix of stocks, bonds, REITs and cash. Few investors, however, pay much attention to *asset location*.

Not to be confused with asset allocation, asset *location* refers to the placement of certain asset types in tax-deferred accounts - IRAs and 401(k)s - and other types of assets in taxable accounts. The concept is simple: place the most highly taxed assets in tax-deferred accounts, while putting more lightly taxed assets in taxable accounts. This means putting bonds and REITs, whose payouts can be taxed at income rates of up to 35%, in tax-deferred accounts. Investors should favor higher-yielding taxable bonds in their IRAs and 401(k)s over municipal bonds in taxable accounts. Equities, whose capital gains and dividends are taxed at a federal rate of 15%, should be invested in taxable accounts.

In addition to the benefit of lower capital gain and dividend tax rates on equities, many other reasons exist for favoring equities in taxable accounts. First, the taxation of capital gains can be deferred as long as investors continue to hold their positions. Second, capital gains can be avoided entirely if investors hold their stocks until death, at which point they are eligible for a step-up in basis when passed on to heirs. Third, capital losses on poor-performing equities can be used to offset realized gains on other stocks. This ability to tax-manage an account is not present in tax-deferred accounts. Finally, low cost basis positions can be gifted to children or charity, thereby escaping taxes entirely.

Investors should favor taxable bonds in their tax-deferred accounts over municipal bonds in taxable accounts for similar reasons. Coupon rates are generally higher for taxable bonds than tax-exempt bonds, so over the long-term investors will benefit from a higher return. This is true even for investors in the highest tax brackets: the advantage of a higher yield and tax-deferral of income outweigh any benefit of owning tax-free bonds in taxable accounts, even though withdrawals from IRAs and 401(k)s are taxed at ordinary income rates.

Despite the logic and simple math behind it, asset location is largely ignored. Vista has always paid close attention to asset location, having managed client portfolios on what we call a "consolidated" basis for years. Recent studies show our efforts in this area are the exception, rather than the norm. A 2004 Federal Reserve survey revealed Americans invest their taxable accounts and tax-deferred accounts almost identically, with about 65% of each devoted to equities. Investors who do this leave a lot on the table: according to Carnegie Mellon finance Professor Robert Dammon, allocating assets to the wrong type of account can reduce a portfolio's ending value by more than 20%.