

Improving Your Tax Position

When it comes to managing your investments, our goal is to maximize your AFTER-TAX return on a portfolio that meets your needs, risk tolerance, and time horizon. After all, what matters is how much you get to keep AFTER the Federal and State governments take their tax cut from your earnings. If not managed well, taxes can eat up your returns and reduce your spendable income.

We use a variety of strategies to improve your tax position. Among the most important are:



- ◆ Your overall asset allocation (the amount of fixed income securities, including municipal bonds);
- ◆ The implementation of tax-advantaged accounts, like IRAs, Roth IRAs, retirement plans and annuities;
- ◆ How we allocate your investments among different accounts (placement of securities, such as bonds, in your IRA versus your taxable account);
- ◆ Year-end tax planning (when we coordinate efforts with your tax preparer to improve your tax situation for the calendar year); and
- ◆ The order and manner in which we sell investments for cash needs (e.g., minimizing gains by focusing on high basis, long-term holdings).

All gains are not created equal. For Federal tax purposes, long-term capital gains (held more than 12 months) are taxed at a 15% rate, while short-term capital gains and ordinary income can be taxed at rates of 35%. States such as California levy their own set of ordinary and capital gains taxes on earnings (for a combined tax of about 21.2% on long-term gains and a whopping 41.2% on short-term gains). The type of account holding your investments will further determine how your earnings will be taxed. For tax-deferred accounts (IRAs, 401Ks, variable annuities), the investment activity is not taxed while the assets remain in the account, but distributions are generally taxed at the highest rate, as ordinary income. One danger here is the creation of long-term capital gains (subject to a 15% rate) that are distributed as ordinary income (at a 41.2% rate). Investments in tax-free accounts (Roth IRAs) are not taxed in the account or when they are distributed, so Roth IRAs can hold the most tax-inefficient assets. Taxable accounts are taxed at the above tax rates, but only as gains are recognized (assets sold). In 2013 high income taxpayers will be subject to an additional "Unearned Income Medicare Contribution" of 3.8% on all investment income.

Why do we need a tax-sensitive investment strategy?

What investments are right for my tax situation?

Investment Selection

Where appropriate, we will use investment vehicles that by their nature lend themselves to being more tax-efficient. These may include:

- ◆ Stocks to be held for the long-term, generating unrealized appreciation until sold, and then recognizing long-term capital gains
- ◆ Index mutual funds or Exchange Traded Funds that have very low turnover
- ◆ Mutual funds with built-in loss-carryforwards
- ◆ Separately managed accounts that are managed for tax-efficiency
- ◆ Tax-exempt municipal bonds
- ◆ No-load, very low-cost variable annuities with tax deferral similar to an IRA

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Should certain investments go in certain accounts?

Investment Location

After determining an appropriate asset allocation for your portfolio, we look at the relative values of the tax-deferred, tax-free and taxable accounts and attempt to select the most appropriate investment vehicles. We strive to put the more tax-inefficient investments in the tax-advantaged accounts, such as IRAs and variable annuities. Examples of tax-inefficient investments include securities that generate a lot of ordinary income, such as taxable bonds, REITs and alternative investments. High-turnover stock funds generate a lot of short-term capital gains which are taxed at high ordinary income tax rates. In taxable accounts we may emphasize tax-exempt bonds and stock funds that generate long-term capital gains, or better yet, unrealized gains.

Sell Strategies

For portfolios with taxable accounts, we attempt to minimize gains without sacrificing net returns. We will, for example, seek to offset realized gains by identifying positions with unrealized losses and selling an appropriate amount of other securities. We engage this strategy each calendar year for all taxable accounts, and attempt to coordinate with the clients' tax preparer. Additionally, if we decide to sell investments to rebalance the portfolio, we may look first to sell investments within the tax-advantaged accounts so as not to trigger recognized capital gains.

Will sales of securities always result in a big tax liability?

If I need cash from my investments, what should be sold so as not to hurt my returns or my tax situation?

Liquidation Order:

When presented with a need to distribute funds from the portfolio— for example, at the request of a client— we consider the most tax-efficient account and investment to liquidate. A range of factors may affect our sell-decision, but typically we will tap the least tax-efficient accounts first (in order: taxable, tax-deferred, and last, tax-free) in order to allow non-taxable gains to continue to compound. If a taxable gain is generated, we attempt to use long-term, high basis positions to minimize the gain, and also consider offsetting those gains by selling other positions with an embedded loss.

There are a lot of ways we try to help improve your tax situation. Higher tax rates make all of these strategies even more important and valuable.

Should you have any questions or concerns regarding the above information, please do not hesitate to contact Randy, Scott, Kevin, Steve, or Peter at 925-838-1234.