What are the tax implications of portfolio turnover?

In a letter to Jean-Baptist Leroy, Benjamin Franklin asserted, "In this world nothing can be said to be certain, except death and taxes." Since those famous words were uttered, we have learned how to postpone death for decades, more than doubling our life expectancy. Unfortunately, we have not exercised the same ingenuity when it comes to capital gains taxes on our investments. If anything, our willingness to relinquish larger and larger portions of our gains to the US and state treasuries has increased over time!

The main culprit behind this wealth transfer is institutional investors who are not attuned to the needs of retail investors. After all, for an institutional investor, there are distinct benefits to frequent trading. By the same token, individual investors have been lax in holding their managers and/or financial advisors accountable for this important source of slippage.

In this brief educational piece we'll attempt to show the impact of long and short term capital gains taxes on portfolio returns.

Impact of Taxes on Portfolio Returns

	Column 1 One time tax at liquidation	Column 2 Annual 20% tax on gains	Column 3 Annual 35% tax on gains	Column 4 Annual 35% tax on gains
Principal Invested	$1,000	$1,000	$1,000	$1,000
Gross average annual return	7.80%	7.80%	7.80%	10.16%
Holding period in years	10	10	10	10
Cumulative Return	$2,119	$1,832	$1,640	$1,895
Tax Rate	20%	20%	35%	35%
Tax bite	$224	$287	$479	$746
Annualized Net Return (%)	**6.60**	**6.24**	**5.07**	**6.60**
End of period after tax principle	**$1,895**	**$1,832**	**$1,640**	**$1,895**

The above table illustrates four scenarios, using $1000 as the principle invested, to demonstrate the magnitude of the tax hit on capital. Column 1 displays a strategy where long term capital gains taxes are paid one time, at liquidation, after a ten year holding period. In Column 2, every holding is kept until realized gains become long term - one year and one day - and then sold. Under this scenario, the annualized returns shrink by 0.36% per year, or by $63, due to long-term gains taxes. In Column 3, all gains are sold within the year, and short-term capital gains taxes are paid out of realized returns. With such a portfolio, an investor can expect to sacrifice more than 22% of gross returns to taxes. Column 4 looks at this issue in reverse, and calculates what gross returns would need to be in order to match the after tax annualized returns of Column 1. Under this scenarios, a manager who exclusively generates short-term gains needs to earn 10.16%, or 2.4% higher than the tax efficient manager who generates 7.8% a year. It goes without saying that the higher returns one needs, the less likely it is to happen.

In summary, capital gains taxes are a very important source of return slippage. The cumulative effect of tax hits over long periods of time results in significant erosion of wealth. We urge the individual investor to be diligent and not be misled by high, before tax returns. Instead, compare funds on an after tax basis and invest accordingly.