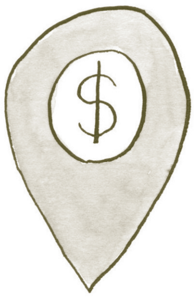
BY **Loren Knaster, CFA, CFP®**
V.P., Wealth Advisor



# Making Asset Location Work for You

*Location, location, location.* Everyone knows this favorite mantra of real estate agents. For an investment plan, the L-word takes on a different meaning, but one that can be just as important. Asset location, or the type of account a person places a certain investment in, can have a tremendous impact on the overall tax efficiency of a portfolio. This is especially true for high-net-worth investors, who typically have a wide variety of account types in their portfolios, sometimes with restricted assets that can't be easily moved or sold. As illustrated in the example below, by making just a few small shifts or conscious decisions when building an allocation, you can profoundly affect the tax efficiency and total return of your portfolio.

Let's start by reviewing the different tax characteristics of the three traditional types of accounts available to an investor.

**Taxable Account** This is the "standard" account and receives no tax benefits. Investment gains are taxed at capital gains rates if the investments are held for a year or longer, while investment income is taxed at ordinary income rates.

**Tax-Deferred Account (401(k), Traditional IRA)** In these accounts, the owner receives a tax deduction on all contributions to the account. All gains are deferred until distribution, at which point distributions are taxed at ordinary income rates.

**Tax-Exempt Account (Roth IRA)** Here, the owner receives no tax break when funding the account but instead realizes tax benefits upon distribution. Gains and income are never taxed, even when they are distributed out of the account. The accounts are subject to strict income limitations and are often unavailable to high-income earners.

Corporate executives are often eligible to participate in other types of accounts, such as deferred compensation, defined benefit plans (pensions), and plans constructed to deal with company stock (employee stock purchase plans, or ESPP). Some of these may have characteristics similar to the three main types of accounts, but each has its own nuances and restrictions.

When you work with your advisor to construct a diversified asset allocation that fits your own goals and risk tolerance, placement of assets should not be overlooked. As shown in the following case study and Exhibit 1, by consciously distributing assets across various types of accounts, you can use smart asset location to help optimize your portfolio's return.

## CASE STUDY

Hae Park became a client of mine a few years ago.[1] Still in her early 30s and at the beginning of her career, she had recently secured a big position at a high-profile technology company and was presented with a litany of benefit options. She talked with me about her needs and wants for the future. Recognizing her long-term investing horizon, Hae said she'd like to try taking on some more risk. She also emphasized that, as a big believer in »

**EXHIBIT 1 TAX IMPLICATIONS OF ASSET LOCATION**

| Asset description | Tax treatment of expected returns | Taxable | Tax deferred | Tax exempt |
|---|---|---|---|---|
| Tax-free municipal securities and municipal mutual funds | Exempt | ■ | ▲ | ▲ |
| Equity securities held long term for growth | Taxed at long-term capital gains rates | ■ | ● | ● |
| Equity index fund/ETFs (other than REITs) | | ■ | ● | ● |
| Tax-managed mutual funds and managed accounts | | ■ | ▲ | ▲ |
| Real estate investment trusts (REITs) | Taxed at ordinary income rates | ▲ | ■ | ■ |
| High-turnover stock mutual funds that deliver effectively all returns as short-term capital gains | | ▲ | ■ | ■ |
| Fully taxable bonds and bond funds (e.g., corporates) | | ▲ | ■ | ■ |

*Source: Fidelity Viewpoints.*

■ More appropriate ● Appropriate ▲ Less appropriate

high-dividend stocks, she wanted exposure to these where possible. Hae and I developed a plan to optimize asset location in support of these goals.

First, based on her risk tolerance and investment goals, we decided on a 5% allocation to municipal bonds in her investment portfolio. Interest earned on municipal bonds is exempt from federal taxes; therefore, it would be a waste to own these types of bonds in a tax-sheltered account like a 401(k) or Roth IRA. So Hae and I slotted these assets into a taxable investment account to capitalize on their tax-exempt status.

To help her get exposure to some high-dividend stocks, we incorporated a dividend stock-paying strategy into her allocation. I suggested we put this strategy in a Traditional IRA. That way, when the dividends hit the account, they'll be tax-free, and they'll continue to grow that way until distribution.

And finally, because of her desire to take on more risk, I recommended a 10% overall allocation to emerging markets. This is an asset class with high expected volatility but also high returns over time. We decided that a riskier investment like this would be perfect for her Roth IRA, which she doesn't plan to touch for 30 years. This time horizon will help her ride out volatility swings, while the higher return we're expecting will let the investment grow tax-free for decades.

The more complex an investor's situation, the more important it is to be strategic about asset location. The process can start by grading each investment strategy by tax efficiency, with the most tax-efficient investments (for example, municipal bonds and growth stocks) likely ending up in taxable accounts and the least-efficient investments (such as corporate bonds, dividend stocks, and REITs) ending up in tax-deferred accounts. ■

*1 The name and details have been changed for this case study to protect client anonymity.*