The 50% Rule

Keep More Profit in Your Wallet

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What portion of the profits from your investments should end up in your wallet? It's a simple and important question. Unfortunately, most taxable investors and their advisors do not carefully consider this when designing investment strategies, and it isn't measured by most performance measurement systems. **How much you keep should be an important factor in setting investment strategy and choosing your managers.**

Investment profits get apportioned to three beneficiaries: tax authorities, investment professionals, and you. State and Federal taxes are due on the profits in any taxable account, and they are eventually payable on tax deferred accounts like traditional IRAs and 401k plans. Investment managers usually charge a management fee based on assets, not profit. Expenses are mostly a function of the activity in your account, not assets or profit. I refer to taxes, fees, and expenses as "leakages". Whatever is left over after leakages belongs to you, the one whose capital is at risk.

With rare exception, if you're giving up 50% or more of your profits in the form of leakages to government and investment professionals, I would reassess your approach. While you can never be sure what profit your investment will make until after the fact, you can estimate your gross expected return and model how much will be left in your pocket after fees, expenses and taxes. If you're giving away more than half the profits, how do you expect to get superior results? This simple - and arguably overly generous - rule can and should impact your investment strategy and the managers you choose.

In 2013, tax rates in the US increased sharply. Today, the combination of State and Federal long-term capital gains taxes at the highest marginal rate ranges from 23.8% to 37.1%. The top marginal rate on short-term capital gains and income ranges from 31.8% to 52.6%. We are likely to be in a progressive tax environment for a number of years. **The more progressive the tax structure, and the higher the rates, the more important it is to be tax efficient in investing and the more misleading pre-tax results can be for taxable investors.**

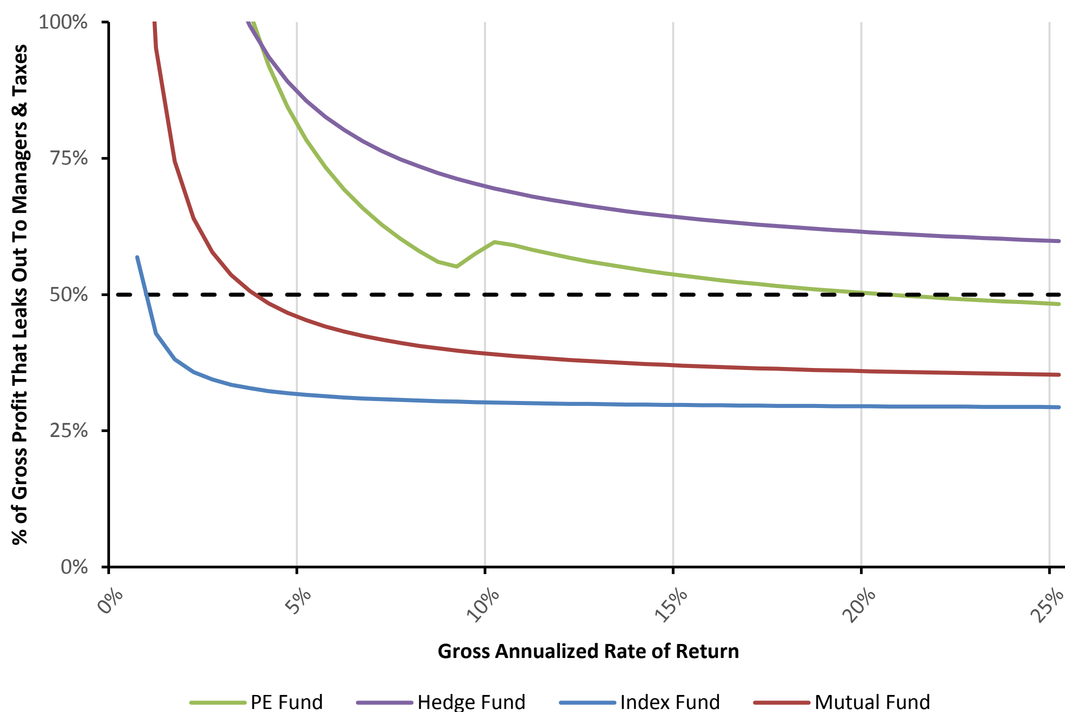
Income taxes are structured as a profit-sharing arrangement. The dollars you pay in tax rise and fall depending on the level of profit but the marginal rate of tax remains, for practical purposes, constant. Profit and tax are proportionate; if you don't realize profits, you don't pay tax. In fact, in many cases when investments lose value, the government shares your pain.

The *percentage rate of tax* you pay on your investments is a function of your adjusted gross income, where you live, whether you are subject to Alternative Minimum Tax (AMT) rates, and whether you have limitations on your itemized deductions. The *dollar amount of tax* you pay on investments and *when* you pay are functions of how you manage your assets. The more current taxable income and short-term capital gains your portfolio generates, the more tax you pay, and the sooner you pay (unless it is in an IRA, 401k, annuity or life insurance product).

Management fees and transaction costs are usually structured as a percentage of assets: a "preferred return". In other words, managers get paid regardless of whether or not they generate profits for you; and the lower the profit they generate for you, the greater the proportion of that profit that leaks out to them. Unless your assets are invested in a mutual fund, it is unlikely that you will be able to reduce your tax liability by deducting management fees, which adds to your effective cost of management, especially when returns are low. Some firms charge an additional "carried interest", based upon the amount of pre-tax profit your investments make. The size and structure of carried interests and the gross profits your investments generate have a big impact on how much of the profit actually accrues to you.

In Chart #1 you can see estimates of how much of an Illinois resident's profits leak out in management fees and taxes paid at AMT rates for different types of investment vehicles at varying rates of return. I've tried to use "middle of the road" assumptions and estimates to construct the charts.[1]

CHART #1 – The "50% Rule"



[1] The chart assumes Illinois and Federal taxes payable at the highest 2013 AMT rates (28.8% for long-term gains and dividends, and 36.8% for short-term gains and income). Capital is invested in all funds evenly over four years and each tranche is sold four years after investment. The Index Fund has a fee of 0.14% (tax deductible), annual dividend of 1% and all capital gains are taxed at the end of year five at 28.8%. The Mutual Fund has a fee of 0.66% (tax deductible), annual dividend of 1% and capital gains are taxed each year, 50% at 28.8% and 50% at 36.8%. The Private Equity Fund has a 2% management fee, 20% carried interests on profits above return of capital, fees and an 8% hurdle, with an 80% GP catch up; no dividends are paid and all gains are long term. The Hedge Fund has a 2% management fee and 20% carried interest; all profits are taxed each year, half at 28.8% and half at 36.8%. The model assumes the previous high-water mark is surpassed each year. On the chart's x-axis is the gross rate of return of investments each year before fees or carried interest. The y-axis is the leakage rate to fees and taxes.

Implications for Investment Strategy

Many institutional investors-like pension funds, governments and sovereign wealth funds-don't pay taxes and, in some cases, have enough scale to negotiate lower fees than private investors like us. Because they have lower costs, more than 50% of profits - sometimes approaching 100% - usually end up in their pockets. **For the same unit of risk, well managed institutional investors will either generate better net returns, or accept lower gross returns (i.e. bid up prices) than you. Their clout and tax structure lowers their cost of capital, giving them a significant competitive advantage.**

Although taxable investors have to play by a different set of rules than institutional investors, we still have considerable choice about how we invest and the amount of profit that we actually keep. Let's look at two hypothetical wealthy investors, each choosing an investment with an expected gross return of 10%. The first is an AMT taxpayer in a no income tax state like Texas who purchases a low cost equity index fund and holds it for a year and a day. The second is a California taxpayer at ordinary rates who purchases a hedge fund that generates 100% income or short-term gains. The first investor can expect 25% leakages on that 10% gross profit. The second should expect a leakage rate of 75% or more.[2] If the projected 10% gross return on a $10 million investment turns out to be correct, of the $1 million of gross gains for each investor, the first pockets $750,000, but the second only nets $250,000. That is a huge difference! In a low-return investment environment where gross returns are 5%, or $500,000, the differences are even more enormous. The first investor takes home 3.7% net, or $370,000; the second gives up all but about $9,000 to either the tax man or the hedge fund manager!

I am not suggesting that everyone should move to a low/no tax state. And, most wealthy investors don't have a lot of control over whether we pay tax at ordinary or AMT rates.

I am saying that taxes and fees should significantly impact investment strategy design in four ways:

[2] This example assumes a starting value of $100. The index fund has an expense ratio of roughly 16 basis points on the starting value of the investment, or about 16 cents and it is deductible for tax purposes. I subtract 16 cents from the gross profit of $10 and tax the remaining $9.84 at a 23.8% rate, for a tax bill of $2.34. $2.34 plus $.16 equals $2.50 or 25% of gross profit, leaving the investor with $7.50 of profit. Some index funds have lower expense ratios, others are higher. Fees depend on the size of the investment, the breadth of the coverage (global is more expensive than US only) and what the manager thinks the market will bear.

The calculation on the hedge fund is a little more complicated. Again the initial value is $100 and the gross profit is $10. There is a 2% non-deductible management fee on the starting value, or $2. A 20% carried interest (which is effectively tax deductible today) is charged on the $8 of net profit, or another $1.60. A tax exempt investor would receive a net profit of $6.40. To calculate the estimated taxable income, you must add back the $2 management fee and tax $8.40 at the CA ordinary income rate of 52.6%, leaving the investor with slightly under $2 of net profit on a $10 gross gain.

In practice, the contrasting results may not be this stark, so please consult your own tax advisors to do an analysis specific to your own circumstances.

1. We should design portfolios and evaluate investment opportunities on risk, reward and expectations of how much of the profits we will keep;
2. As tax-paying investors, we are incentivized to focus on investments that generate mostly long-term capital gains and dividends, and that defer realization of capital gains as long as possible. This is true for all taxpayers, and it is especially true if you pay tax at ordinary rates;
3. In an environment of low-expected returns, alternative investments have to generate particularly high relative returns just to break even relative to an appropriate market index; and, in high target return investments, the tax efficiency of long-term gains is particularly valuable.
4. If you want to own tax-inefficient investments, investigate whether you can hold them in retirement accounts, annuities or life insurance at acceptable added cost and illiquidity.

One of the challenges of investment strategy is managing volatility. Equity portfolios go up and down with the stock market. Many investors, uncomfortable with this level of volatility, allocate a portion of their assets to defensive strategies intended to hold their value when equities decline. In an overall portfolio with only a modest defensive allocation, tax inefficiency may be a reasonable price to pay for lower downside volatility, especially if the investor has already chosen to incur the opportunity cost of investing in lower-return instruments. A successful hedge against sustained weakness in equity markets may be appealing, even if tax efficiency is low. A low-fee manager with an expected after-fee and tax return of 1% to 3% may give comfort to an AMT investor relative to more volatile but tax-efficient alternatives.

Traditionally, fixed income - especially municipal bonds - played this role. For decades, municipal bonds have been an excellent low-risk diversifier. They have also been tax efficient, with lower management fees. Today, however, with interest rates so low, more and more people are looking for volatility-dampening alternatives that generate higher returns.

Increasingly, taxable investors are replacing their municipal bonds with hedge funds, often labeled as “absolute return” hedge funds. Making this switch is likely to be a bad idea. First, hedge fund fees are two, five, even ten times more expensive than was historically the case with municipal bonds. Second, many hedge funds are terribly tax inefficient; management fees aren’t deductible and the funds produce most of their returns in the form of taxable income or short-term capital gains. In order for you to generate a net after-tax return of 3%, your hedge fund manager may have to generate three to four times that level of gross return. Third, do you really think that hedge funds targeting 8-11% gross returns will have the same risk as a high quality municipal bond portfolio with a gross target of 2.5-3.5%; or, have the same probability of achieving their goal? If the risks are truly commensurate, your hedge fund manager must generate more than 600bps of alpha just to earn you the same net return. How confident are you that the hedge fund managers you choose are really that skilled? Don’t forget, too, most hedge funds are not as liquid as high quality municipal bonds.

For AMT taxpayers, the leakages on tax-inefficient hedge funds may be burdensome; for ordinary taxpayers the leakages are even more punitive. For ordinary rate taxpayers, the spread between tax rates on income/short-term gains and long-term capital gains is almost 2.5 times the

spread in AMT[3]. Furthermore, in switching away from municipal bonds and into these more complex investments, you must compete head-to-head with non-taxpaying institutional investors for the same gross returns, while paying substantial and rising tax rates and the same or higher fees.

Placing conservatively-managed but tax-inefficient investments in a retirement plan, annuity or insurance product will defer or lower taxes. Investment choice may be reduced and management and administrative costs charged as a percentage *of assets* will rise, but not as much as the tax savings. However, it may be complicated or expensive to make unplanned withdrawals if you need the capital. In the case of traditional retirement plans, there is no guarantee that tax rates won't rise further between now and the time you start taking retirement withdrawals (Roth IRAs and Roth 401ks help to protect you against rising tax rates). With annuities and life insurance, you pick up the additional risk of the insurance company's creditworthiness, higher fees, diminished investment selection and potential switching costs. You will need to assess all these factors to evaluate the tradeoffs, but it's fair to say that the higher your current tax rate, the more attractive these options may be.

There is another alternative. Just say no to high fees and taxes, unless you can reasonably expect big returns. If you are truly a long-term investor, train yourself to withstand interim volatility, keep your hurdle rates (or expected returns) high and seek to avoid permanent loss of capital. Invest most of your capital in long-term equity investments, whether public or private, corporate or real assets, and keep turnover low and fees reasonable. Instead of a strategic allocation to low-volatility investments, supplement your core equity portfolio by layering in additional investments that are purchased opportunistically and held for long- term growth. In this way, you continuously seek out new long-term investment opportunities in a disciplined fashion and actually use volatility to your advantage by episodically buying low and selling high. In the core equity component of your portfolio, institute tax loss harvesting techniques to help you defer taxes on realized gains on your opportunistic investments, thus enhancing the net results of the aggregate portfolio.

Implications for Active Manager Selection

Investment managers charge a wide variety and range of management fees. It is extremely important to understand the nuances of managers' compensation structures. Subtle differences in fee structures can make a big difference in how much ends up in your pocket. Index funds can cost 10 basis points or less. Some long-only active investment managers charge 50 basis points per year or less; but the average mutual fund charges two or three times that amount. Hedge funds charge between 100 and two hundred basis points per year, and sometimes more - plus a profits interest; colloquially "2 and 20". The same applies to private equity managers, though the management fee is based on committed capital, not the market value of invested capital. For both hedge funds and private equity, there are other nuances in fee structures and how those fees flow through your tax returns. A "back of the envelope" estimate of the fee impact won't give you an informed picture and can be misleading.

Turnover and tax efficiency also have powerful impacts on how much you keep. Although selected managers of public equities may turn their portfolios over once every three years, generating

[3] Estimated tax rates provided courtesy of Aperio Group LLC.

minimal short-term capital gains, the average turnover among US equity mutual funds exceeds 100% per year. Even if you are considering low-cost active management, remember that well-run, broadly-diversified equity index funds shouldn't generate any net realized short or long-term gains until *you* decide to sell shares in the fund, which could be twenty years or more from now. Given how hard it is for even top managers in public markets to add enough value to overcome the added tax and fee burden, is choosing active managers in this space a good use of time and resources? For most people, including most investment professionals, I don't think so.

Not all investment managers operate in efficient markets. Alternative investments, like hedge funds and private equity funds, offer *the promise* of generating enough extra return from exploiting opportunity and inefficiency to overcome their higher leakages. Hedge funds claim to find value where others don't through their trading strategies. Many also claim to dampen volatility while generating superior returns. Even if these claims are true, their hunt for alpha creates turnover and a larger tax bill for private investors (but, remember, not for most institutions). In addition, hedge funds' typical 1-2% management fees and 20% carried interests are much higher than typical long-only managers' fees. Combining the leakages of "2 and 20" fees plus taxes, no hedge fund will meet the 50% rule no matter how much profit it generates. In the Illinois example, even at "1 and 20", leakages never drop below 55%. That's a big hurdle to overcome in public markets, especially with so many hedge funds operating today.

The leakage rates from private equity funds aren't a lot different than hedge funds, though at the gross returns of 20% or higher that most private equity target, leakages can drop below 50%. For my money, even a 20% gross hurdle rate is too low. Even though it sounds the same, "2 and 20" means something different when applied to private equity.[4] At higher returns, the fees are significantly lower than hedge funds. (Though in a low-return environment, they are the same or higher.) Private equity funds generate mostly long-term capital gains on investments held for 4 to 5 years, sometimes longer.

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[4] Hedge funds charge a management fee of 2% on invested capital. On any profits over and above a 2% gross return, the hedge fund takes an additional 20% carried interest each year. Private equity funds charge their management fee on committed capital during the investment period, but offset a portion of their management fees through the preferred return to limited partners (LP) and the general partner's (GP) obligation to reduce management fees by some or all other fees the GP may earn. There is another big difference between the two fee structures; carried interest in hedge funds is calculated on a high-water mark basis: if asset values subsequently decline before you sell, carry is not rebated to the LP. Thus there are circumstances where the carried interest on profits can rise well above 20% if the fund doesn't achieve the high-water mark again before the LP sells. Some hedge funds that grow quickly and then collapse in value can generate profit to the GP that exceeds 100% of the profit to LPs. In private equity funds, the carried interest is usually based on total profits returned to LPs. Either carried interest payments are deferred until capital is returned to LPs and target levels of profit are realized, or there is a "clawback" provision requiring the GP to return money to LPs if future values decline.

Regular taxable dividends are usually minimal. As a result, their investments can be almost as tax efficient as broadly-diversified index funds, even though management fees aren't deductible. These funds also operate in less-efficient, less-transparent private markets. Private asset funds can use superior insights to buy and sell at attractive prices, and many try to add value to the companies' operations and balance sheets during their ownership. There are no guarantees that they will generate enough value to exceed the leakage drag, but some have more tools at their disposal and a lower hurdle to overcome.

Implications for Your Advisors and Their Incentives

Today, in the wealth management industry, few client service models, investment strategies or manager selection processes focus on optimizing clients' after-tax returns. Active investment managers – that is, most mutual fund and hedge fund managers – have little economic incentive to focus on after-tax performance. The majority of investment capital belongs to institutions – pension funds, sovereign wealth funds, and endowments – that are unconcerned about tax efficiency because they don't pay tax. The most tax-efficient investment vehicles – diversified index funds and exchange traded funds – generate low fees and aren't very profitable for the managers, custodians, brokers or other service providers. Active managers recognize that pre-tax measures of performance are more flattering than after-tax measures because active management nearly always reduces tax efficiency relative to broad market indexes. Almost all data that is collected, widely available and analyzed about portfolio performance is pre-tax data (mutual funds must provide estimates of after-tax results but these data are not widely aggregated, analyzed and marketed). For all these reasons, reporting of pre-tax returns drives marketing, most academic research, manager rankings, the design of performance measurement platforms and, ultimately, your perception of your own performance.

This focus on pre-tax returns puts the tax-paying client at a real information disadvantage. Unfortunately, true measurements of after-tax, after-fee performance and value added are virtually impossible using standard data and analysis. The performance systems available today simply do not collect data that facilitates such comparisons. This lack of after-tax data can easily lead you to incorrect conclusions. If you, a taxable investor, employ a low-cost tax-efficient investment strategy, it is possible, even likely, that your aggregate pre-tax performance is below your pre-tax benchmark. Furthermore, the existing reporting infrastructure (and the economic incentives for vendors) signals you toward the other path: to use higher-fee active managers that look like they've done better because they outperformed on a pre-tax basis.

If you follow the 50% Rule, you will substantially reduce investment management fees and taxes. Broad-based index funds have fees that are a quarter to a tenth of active management fees, and most private investment funds have lower fees than most hedge funds. You also benefit from lower tax rates and payment triggers that can be deferred for years and sometimes decades. For lower-risk, lower-return investments, stick to low-cost bond funds or train yourself to exploit volatility rather than fear it. It makes no sense to put your capital at risk while giving away 75% to 100% of your profits. With your advisor's help, you should optimize your portfolios on after-tax returns even though they may generate lower results on the pre-tax metrics that are widely followed. Although

standard performance metrics may make it appear that you are losing even when you are winning, and traditional competitors' clients often appear to be winning even if they're losing; at the end of the day, you are putting more money where it belongs, into your wallet.

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Stuart Lucas is the Chairman and Chief Investment Officer of Wealth Strategist Partners LLC, which acts as an outsourced Chief Investment Officer for a select number of individuals and families of exceptional net worth. Wealth Strategist Partners is typically hired to design and oversee a comprehensive investment management program for a client's total investable assets. Stuart is the author of *Wealth: Grow It and Protect It* (Second Edition, FT Press, 2013). He designed and teaches the Private Wealth Management program for wealth owners at the University of Chicago Booth School of Business. He co-leads the investment committees of National Public Radio and the Stuart Foundation.

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