

The Best Investments for Taxable Accounts: Part I

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Anyone who reads financial media is aware of the extraordinarily wide divergence of opinion with respect to the future direction of the economy, inflation, energy prices, the value of the dollar, the rising costs of healthcare and entitlement programs, and so on. The investment world abounds with such a large degree of uncertainty that it may be difficult for investors to formulate an intelligent portfolio strategy to deal with the range of possibilities.

For each type of uncertainty investors generally attempt to develop portfolio management strategies that are positioned to provide protection against, or even benefit from, the investor's view of the future. For example, investors who fear inflation may be inclined to hold TIPS, commodities, and equities. Investors who are concerned about the long-term value of the US dollar will increase their allocations to foreign currency-denominated securities, and so forth.

Despite all the uncertainty and risk that faces investors today, there is one highly important factor that affects long-term investment performance and this factor is changing in a known and unfavorable way: the factor is taxation, and the direction is higher. Beginning in 2011 and continuing thereafter, citizens in the U.S. will face significantly higher levels of taxation on all forms of income and capital gains. It is therefore wise for taxable investors to prepare themselves for the changing tax regime and contemplate tax-efficient investment opportunities and portfolio management strategies accordingly.

This article provides a starting point for investors to understand the types of tax-advantaged investments that might be worth consideration for ownership within taxable accounts. Importantly, this article examines only investments which are available through brokerage accounts and does not discuss the potential advantages of certain types of privately held assets, such as real estate or gold bullion.

There are two broad types of investments that have some form of preference to the taxable investor: tax advantaged investments and tax deferred investments.

Tax Advantaged: Tax advantaged investments generally have some form of preference within the tax code stipulating that lower rates of taxation are applied to a given investment cash flow regardless of how long the investment has been held. The single defining characteristic of tax advantaged investments is this: the investor receives a cash flow from the investment, but this cash flow is subject to a tax rate that is lower than the investor's personal tax rate for ordinary income. For example, qualified dividends from stocks are taxed at a much lower rate than income from bonds. At the extreme end of the spectrum you have tax exempt investments. A tax exempt investment is simply a special case of tax-advantaged investment, having a tax rate of zero.

Tax Deferred: Tax deferred investments typically contain some mechanism that delays the realization of income or capital gains until the occurrence of an event that requires such recognition. This event is most often the point of sale of the security by the investor, but may also be something related to the security itself. Tax deferral may not only defer the payment of a tax liability, but may also reduce the ultimate total liability that is owed

by the investor. Ownership of common stock is the simplest example; no capital gains are owed until the investor sells his or her stock, and long-term gains are taxed at a lower rate than short-term gains, thus providing both a reduction of liability and deferral of payment.

With this basic categorization of investments in mind, here are five types of investments and cash flows that may afford the investor with the ability to earn income and gains that are advantaged, deferred, or even exempt from taxation:

- o Municipal Bonds
- o Master Limited Partnerships
- o Qualified Dividends
- o Equities
- o Precious metals

In Part II of this article we'll go deeper into detail about each investment and the nature of its favorable tax status. Needless to say, the tax-efficient investment opportunity set is large, ranging from high quality investment grade municipal bonds to speculative stocks and precious metals investments. There is almost certainly some form of tax-efficient investment available for all types of investors from the most conservative to the most aggressive.

Investors and their advisors should work to understand these investments and their suitability within an intelligently designed portfolio management strategy, but some or all of these may certainly assist those in high tax brackets (which are going higher) and those having large portfolios of investable assets held in taxable brokerage accounts. Please look for Part II of this article for more detailed information on the best investments for taxable accounts.

Blackhaw Wealth Management is an independent financial advisor in Austin, Texas. As an independent financial advisor, our firm works with private clients and foundations to develop, implement, and manage investment portfolios.