Return, Risk, and Taxes

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- One of the guiding priciples of investing is to establish an appropriate asset allocation, or the mix of stocks, bonds, cash, and perhaps alternative investments, for your portfolio. The asset allocation decision establishes your expected return and risk.
- However, the asset location decision, commonly overlooked, dictates how much in taxes you are likely to pay (or avoid).

A rational and knowledgeable investor seeks the highest after-tax return for a given level of risk. Two investment concepts are critical here: asset allocation drives the return versus risk outcome, while asset location helps dictate the taxes an investor pays. These two concepts are reviewed in this article.

Asset Allocation

Asset allocation is an easy investment concept to understand, but it is also a key determinant on where the investor's portfolio lies on the return versus risk continuum. Asset allocation is the proportion of different assets used in a portfolio. In a traditional sense, asset allocation is the mix of stocks, bonds, and cash. Generally speaking, to structure a portfolio for greater return potential, but also greater risk, an investor needs to increase the proportion of stocks in their portfolio. To reduce risk and therefore the potential for returns, the proportion of bonds should be increased.

In a broader sense, other assets can be included as well, including real estate, commodities, and other alternative investments.

Several factors are often examined to determine an appropriate asset allocation for an investor, though the asset allocation decision is admittedly part science and part art. These factors include the investor's financial goals and objectives, investment time horizon, risk tolerance, and risk capacity. Many mutual fund and brokerage firms offer on-line questionnaires that can assist in gauging an investor's risk tolerance and, ultimately, a recommended asset allocation. However, without a complete profile of the investor, such on-line questionnaires should be used cautiously.

The asset allocation decision is not static. For example, as time passes, an investor's time horizon shortens. In response, their asset allocation should become more conservative (in the traditional asset allocation scenario, a greater allocation to bonds and a lesser allocation to stocks) because they will have less time to live through the highs and lows of the stock market.

Asset Location

While asset allocation drives the return versus risk outcome, asset location impacts the taxes you pay as an investor. Asset location is too often ignored to the detriment of the investor's pocketbook. Wisely locating which type of investment is located in which type of account can provide a tax-minimizing strategy.

Once an asset allocation is established, the tax-wise investor will place their income-producing, less tax-efficient investments in their retirement accounts. When taxable bonds and real estate investment trusts (also known as REITs) are placed in retirement accounts, their income is sheltered from taxes. However, if those same investments are placed in an individual or joint brokerage account, or a trust account, that same income is taxable.

Consequently, the extent to which an investor can place their income-producing investments in their retirement accounts is dependent on their asset allocation target and the dollar amounts invested in retirement versus non-retirement accounts.

Summary

In order to structure a portfolio designed to generate the best returns for an appropriate level of risk, as well as minimize the taxes paid, COMPASS Wealth Management, LLC finds that the asset allocation and asset location decisions are critical. Each decision is based on the specific circumstances of the individual client. Failure to follow these principles could lead to a suboptimal outcome, such as lower returns, higher risk, and/or more taxes paid than is necessary.