The Rennie Quarterly Return

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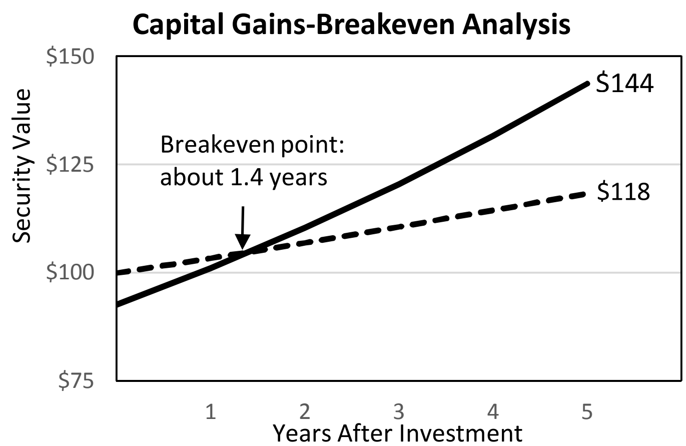
Capital Gains Taxes—Ugh! Not really

People invest for many reasons but the predominant one is to see their money grow. The only way this can happen is for investments to appreciate, i.e., gain in value. In spite of this tautology, some of these gains, naturally, will require the payment of capital gains taxes. If there is one thing we've learned in our 17th year in financial planning, clients simply hate to pay capital gains taxes.



Mutual fund portfolio managers buy and sell securities on a fairly constant basis. Unless a fund's mandate is to mitigate the realization of capital gains, "tax-managed" funds, the portfolio managers invest with one objective—maximize total returns. Naturally, the realization of capital gains in the fund is inevitable. When one security is sold and another purchased, the expectation is that new security will provide a higher total return than the old one.

Turnover, the formal term for selling and replacing securities, has a direct impact on the realization of capital gains. If a fund holds a portfolio of 100 securities and sells/buys about 50 of them annually, its turnover is 50%. Some funds turn the entire portfolio over annually (100%) maximizing the realization of capital gains. The lowest turnover in the industry is around 4% minimizing capital gains. By law, funds must distribute realized capital gains to shareholders annually.

Mutual fund realization of capital gains is also spotty, uneven. A fund can go for several years without realizing significant capital gains, followed by a whopper.

What's to be done by investors? Nothing. Over the long-term, actions aimed solely at tax-avoidance will almost assuredly be counterproductive—lower portfolio rates of return.

The more perplexing capital gains issue for financial planners, however, is convincing clients to sell poorly performing assets which have huge unrealized capital gains. Usually, such assets are inherited, from ones employer or purchased many, many years ago. Still, if these are very likely to underperform in the future, they should be sold.

The above chart shows a simple case. It assumes an investor holds a security worth $100. Its original cost was $50 implying a 100% unrealized gain. The security's value, assuming it earns 4% in the future, is shown by the dashed line on the chart. In five years, it will be $118. If the investor sells the security, pays a capital gains tax of $7.5 (assumes a 15% capital gains tax rate), and reinvests the proceeds in a security likely to earn 10%, the new security will accrue to a value of $144, the solid line. Surprisingly, in only 1.4 years, the cost of paying the capital gains tax has been fully covered. And thereafter, life is good.

The table below shows other scenarios. Column A shows unrealized gains on a poor investment. Column B is the expected return difference between the new, good investment and the poor investment. Column C is the breakeven point in years.

A	B	C
100%	2%	4.0
100%	4%	2.0
100%	6%	1.4
50%	2%	2.6
50%	4%	1.3
50%	6%	0.9

Obvious conclusion: The short breakeven periods suggest that the pain of paying capital gains taxes will be short-lived, and worth the potential long-term gains.

Gary B. Rennie, CFP®, AWMA®
Chief Executive Officer
Phone/Fax: (949) 679-4775
Cell: (949) 769-1343
Email: gbrennie@cox.net

E. P. Rennie, CFP®, CFA®
President
Phone: (949) 650-8622
Fax: (949) 650-6683
Email: ecrennie@att.net

www.rennieandassociatesfp.com

Our Two 1¢

One of the funny things about the stock market is that every time one person buys, another sells and both think they are astute.

William Feather

Quarterly Trivia:

Which is better?

a. Getting $100,000 at once

b. Getting a penny that's doubled every day for a 31 day month

b. You'd have almost $11 million