Tax Alpha 2018

ENHANCING RETURNS THROUGH ACTIVE TAX MANAGEMENT

By Michael O Adair, CFA, AIF*

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What Is Tax Alpha?

Tax alpha refers to the practice of leveraging tax-saving strategies to maximize your after-tax returns. The lack of tax management can cost an investor as much as 25% of their returns. While it’s difficult to pinpoint what percentage of returns is added to your after-tax return through tax alpha, according to our internal study, it may be approximately 121 bps per year. Over time, this can lead to a significant gain (see chart below).

Over Time, a 121 bps Difference Can Have a Significant Impact

Hypothetical Growth of a $1M Portfolio

This study, based on randomly selected real City National Rochdale client accounts, also showed that our strategies generated an accumulated excess return of 12.67% over a ten-year period (see chart on next page).
Tax management is an important part of our strategy at City National Rochdale, and we take a disciplined and methodical approach to it. Our view is that it's a function of open, four-way communication between the investor, tax professional, financial advisor, and portfolio manager. What follows is an outline of our methodology:

**STEP 1:** Planning and Tax Budget  
**STEP 2:** Asset Location and Implementation  
**STEP 3:** Tax Budget Management

### Step 1: Planning and Tax Budget

Our portfolio managers work closely with clients to develop an Investment Policy Statement (IPS), which provides the client’s general investment goals and objectives, as well as the strategies the manager should deploy to achieve these goals. One key element of the IPS is the tax budget, which defines the annual budget for ordinary income, short-term gains (which are typically treated similarly to ordinary income), and long-term capital gains.
This tax budget is developed with the help of the client’s tax professional (CPA). In addition to being part of the portfolio's active management, this is accounted for when transitioning assets to City National Rochdale.

**EXAMPLE**

A prospective client is working with XYZ firm and decides to move his portfolio to City National Rochdale. This portfolio is the beneficiary of a nine-year bull market and has large unrealized capital gains in several positions.

As a result, we at City National Rochdale move these positions over to our firm "in kind" and ask the client for an annual capital gains budget and, if needed, several tax years to implement our strategy effectively. That means we hold many of the client's positions and work around those. If we are comfortable with the positions, we let them take the place of the positions we would have used had the client funded the portfolio with cash.

### Step 2: Asset Location and Implementation

As we begin building the client's portfolio, the first step to tax management is the idea of “Asset Location.” In other words, putting the right securities in the right account to maximize their benefit to the client.

**EXAMPLE**

A City National Rochdale client with a $1M portfolio has half his assets in his IRA and half in taxable dollars. Our asset allocation, as laid out in the Investment Policy Statement, says we need to own 20% in bonds that pay taxable interest. We put the $200,000 in bonds in the IRA so the interest these bonds pay is not taxed in this year (assuming we made no withdrawals form the IRA). This is asset location in action. Furthermore, the IPS says we need to allocate 20% of the portfolio to dividend stocks.

We put the dividend stocks, assuming they're qualified dividends, in the taxable account because typically, qualified dividends are not taxed at the marginal tax level and get a federal tax break as a result. This, too, is asset location in action, as the client portfolio benefits by owning the dividend stocks in the taxable account. Had we placed these in the IRA, the client would have been taxed at ordinary income tax level once the client started withdrawing the IRA, potentially paying higher taxes.
How Asset Location Works

<table>
<thead>
<tr>
<th>Asset Class Return 8%</th>
<th>Asset Class Return 8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>After-Tax Return 5%</td>
<td>After-Tax Return 6.5%</td>
</tr>
</tbody>
</table>

**Tax Sensitive/ Specific Location**
- Tax Alpha
- IRA
- Taxable

**Tax Indifferent/ Pro Rata Location**
- IRA
- Taxable

FOR ILLUSTRATIVE PURPOSES ONLY. Actual results will vary.

See below for a numerical example of our asset location strategy.

**Scenario 1:**
**Baseline**
Taxable bond funds in taxable accounts and index equity funds in tax-deferred accounts.

<table>
<thead>
<tr>
<th>Taxable</th>
<th>Tax Deferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable bond funds</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>$50,000</td>
</tr>
<tr>
<td>Balance before taxes</td>
<td>$1,050,000</td>
</tr>
<tr>
<td>Less taxes on dividends</td>
<td>$18,500</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$1,031,500</td>
</tr>
<tr>
<td>Total asset balance (pre-liquidation)</td>
<td>$2,131,500</td>
</tr>
<tr>
<td>Less taxes on liquidation</td>
<td>$0</td>
</tr>
<tr>
<td>Total asset balance (post-liquidation in one year)</td>
<td>$1,724,500</td>
</tr>
</tbody>
</table>

The tax rate used in this example is 37%.

**Scenario 2:**
**City National Rochdale Asset Location Strategy**
City National Rochdale Large Cap Core, High Dividend & Income, and High Yield Municipal Bond funds in taxable accounts and taxable bond funds in tax-deferred accounts.

<table>
<thead>
<tr>
<th>Taxable</th>
<th>Tax Deferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>City National Rochdale allocations</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Dividends</td>
<td>$20,000</td>
</tr>
<tr>
<td>Long-term capital gains</td>
<td>$5,000</td>
</tr>
<tr>
<td>Unrealized gains</td>
<td>$120,000</td>
</tr>
<tr>
<td>Balance before taxes</td>
<td>$1,100,000</td>
</tr>
<tr>
<td>Less taxes on Dividends</td>
<td>$3,000</td>
</tr>
<tr>
<td>Long-term capital gains</td>
<td>$1,000</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$1,096,000</td>
</tr>
<tr>
<td>Total asset balance (pre-liquidation)</td>
<td>$2,146,000</td>
</tr>
<tr>
<td>Less taxes on liquidation</td>
<td>$24,000</td>
</tr>
<tr>
<td>Total asset balance (post-liquidation in one year)</td>
<td>$1,733,500</td>
</tr>
</tbody>
</table>

The ending asset balance difference is 52 bps, or $9,000, from our asset location strategy alone.

FOR ILLUSTRATIVE PURPOSES ONLY. Actual results will vary.
Asset location also applies to the mutual fund space. City National Rochdale typically prefers to minimize mutual fund holdings in high-net-worth client portfolios, opting to own individual stocks and bonds as core holdings.

However, there are certain situations in which mutual funds are appropriate for a high-net-worth client’s asset allocation. These are usually in very specific market niches, such as international developed stocks or bonds, emerging market stocks or bonds, or opportunistic bonds (e.g., high yields, floating rate, global bonds), that can be difficult to build out with individual securities.

Mutual funds distribute their capital gains annually, which can provide a tax management challenge as investors have no control over what their mutual fund buys or sells—and subsequently the 1099 that they receive each year.

**EXAMPLE**

An investor decides to buy the XYZ Growth Mutual Fund today. This fund bought stock in a tech company 25 years ago for $5/share. The following day, the fund decides to sell the tech stock, which is now worth $170/share.

That entire capital gain of $165/share comes to the investor as part of the 1099 for the year, along with the fund’s other gains/losses during the year, even though that investor only owned the fund for one day. It potentially could have been wiser to own the fund in an IRA account, assuming the client had enough IRA assets to do so, to avoid an unexpected tax bill late in the year.

Many clients received 1099s with large gains from their funds during the 2008-2009 bear market because even though the market declined, many funds had large capital gains and were held in taxable accounts. Given that the markets recently have been near all-time highs, it’s likely that many funds have stocks and bonds in portfolios at substantial gains. This is something to be aware of as we move into the ninth year of the current expansion.
Step 3: Tax Budget Management

City National Rochdale’s portfolio managers take active steps toward managing to the client’s tax budget and finding efficiencies where possible. Below are a few examples.

**LONG-TERM CAPITAL GAINS**
Short-term capital gains are taxed at the investor’s marginal tax bracket, just like their income, while long-term capital gains are taxed at a lower rate. For that reason, we make an effort to own securities for at least one year so they qualify as long-term capital gains.

**REALIZING LOSSES**
Toward the end of the calendar year, City National Rochdale portfolio managers look through a client’s portfolio to locate stocks or bonds that have gone down since purchase. These assets can then be sold. After 30 days, they can be repurchased. This allows us to realize a loss for tax purposes. Occasionally, a portfolio manager may purchase a replacement security to hold in the place of the sold position during the 30 days. This replacement may be an ETF, an index fund, or another stock or bond with similar characteristics. We are mindful that an investor can only realize so much in tax losses per year on their tax return. This is considered part of the “active tax management” concept that we embrace at City National Rochdale.

**OFFSETTING GAINS WITH LOSSES**
After recognizing how much an investor has realized in gains for the year, the portfolio manager goes through the portfolio and sells investments that have losses—as many as possible. This helps offset the gains and minimize the tax bill.

**REALIZING GAINS**
Since investors can only deduct a certain amount of losses each year, some clients who have accumulated losses from prior tax years may ask their portfolio managers to realize as many gains as possible, which can be used to utilize their realized losses. We typically see this in periods of growth which follow recessions (where losses are generally realized).

**TAX LOT MANAGEMENT**
A tax lot is a record of an opening transaction in a client’s portfolio, for example, a single purchase of a stock. An example of a tax lot is: A client purchases 100 shares of XYZ stock on two different occasions. Each purchase is its own tax lot:

1/1/2015 Purchase 100 shares of XYZ for 25 per share
1/1/2016 Purchase 100 shares of XYZ for 35 per share

On 2/1/2016, if XYZ stock is trading for 40, tax lot one has a long-term gain of 15 per share and tax lot two has a short term gain of 5 per share.
One can have multiple tax lots within a security's overall position. The portfolio manager can select specific tax lots to use as cost basis to help minimize a client's taxes. Selling highest cost positions first (which can be tracked by tax lot), attempting to avoid short-term gains (which are taxed less favorably and held the least amount of time), and avoiding high turnover of the portfolio (which can generate commissions, transaction costs, and higher tax liabilities), are all strategies the portfolio manager may employ.

**BILLING**

Historically, management fees may have been tax deductible in certain circumstances, though the recent Tax Cuts and Jobs Act has made this more restrictive. However, in certain situations, clients may still be able to reduce the after-tax fee associated with the account by deducting the fee (in some trust and business tax situations). Talk to your CPA to see if this is an appropriate approach for you.

Another strategy, for portfolios with taxable assets and some nontaxable assets, is for the client to household the billing and have the entire fee taken from the taxable account so it may potentially be deductible. This varies by circumstance and situation. We always ask and advise clients to consult their tax preparer or CPA to make sure any tax management makes sense and is appropriate for their situation.

City National Rochdale’s View

The key to tax management is ensuring that the financial advisor, the accountant, and the portfolio manager are all on the same page with regard to your tax plan and management. Communication and implementation are key. City National Rochdale helps clients create their own custom plan, which is reviewed annually, and leverages resources and experience to take an active role in creating tax alpha. As you can see, it takes time and effort to actively manage your tax plan.

We take pride in the work we can do in this area, and we encourage you to speak to your financial advisor and portfolio manager if you want to implement more of these strategies in your portfolio. It is one of the pillars of having a successful investment plan, and it takes the combined effort of you, your accountant, advisor, and manager.
Important Disclosures

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City National Rochdale, as a matter of policy, does not give tax or legal advice. Before implementation, you should consult with your other advisors on the tax, accounting, and legal implications of the proposed strategies based on your particular circumstances.

The information presented does not involve the rendering of personalized investment, financial, legal, or tax advice.

As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money.

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2Average tax alpha generated between 2008 and 2017 from five randomly selected real client accounts (from five separate senior portfolio managers) used in a City National Rochdale internal study.