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Applied Insights: Tax Economics

Webcast

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Case Study: Dividends vs. Withdrawals

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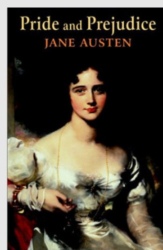
The slides in this presentation are for illustrative purposes only and are not meant to represent any one client's actual portfolio or tax situation.

Rethinking High-Dividend Strategies

- Client wants additional cash flow from equities
- Default choice: increase dividend yield

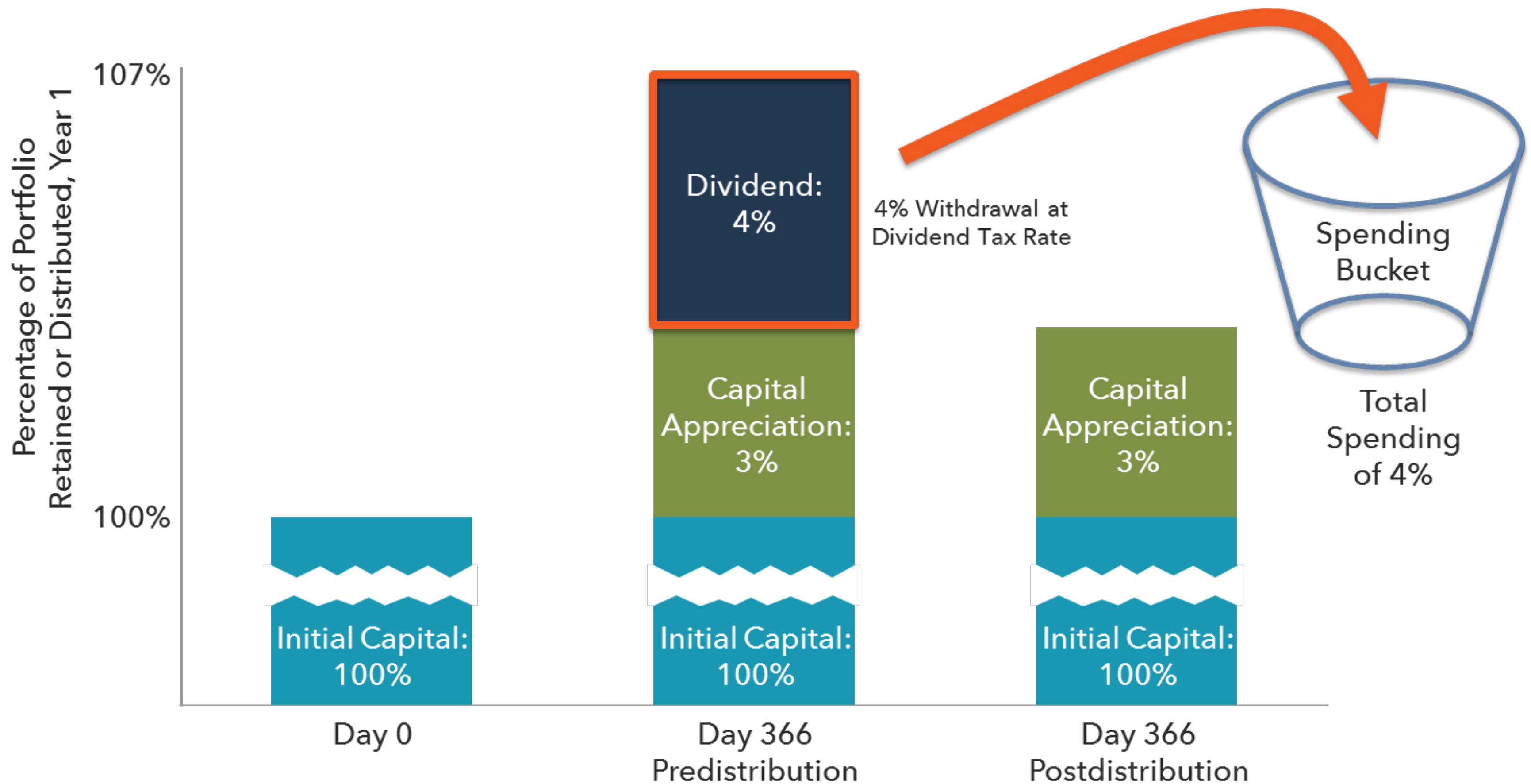
Old Thinking (1813)	New Thinking (today)
• Mr. Darcy from *Pride and Prejudice* • Income = cash flow	• New techniques available • Income ≠ cash flow



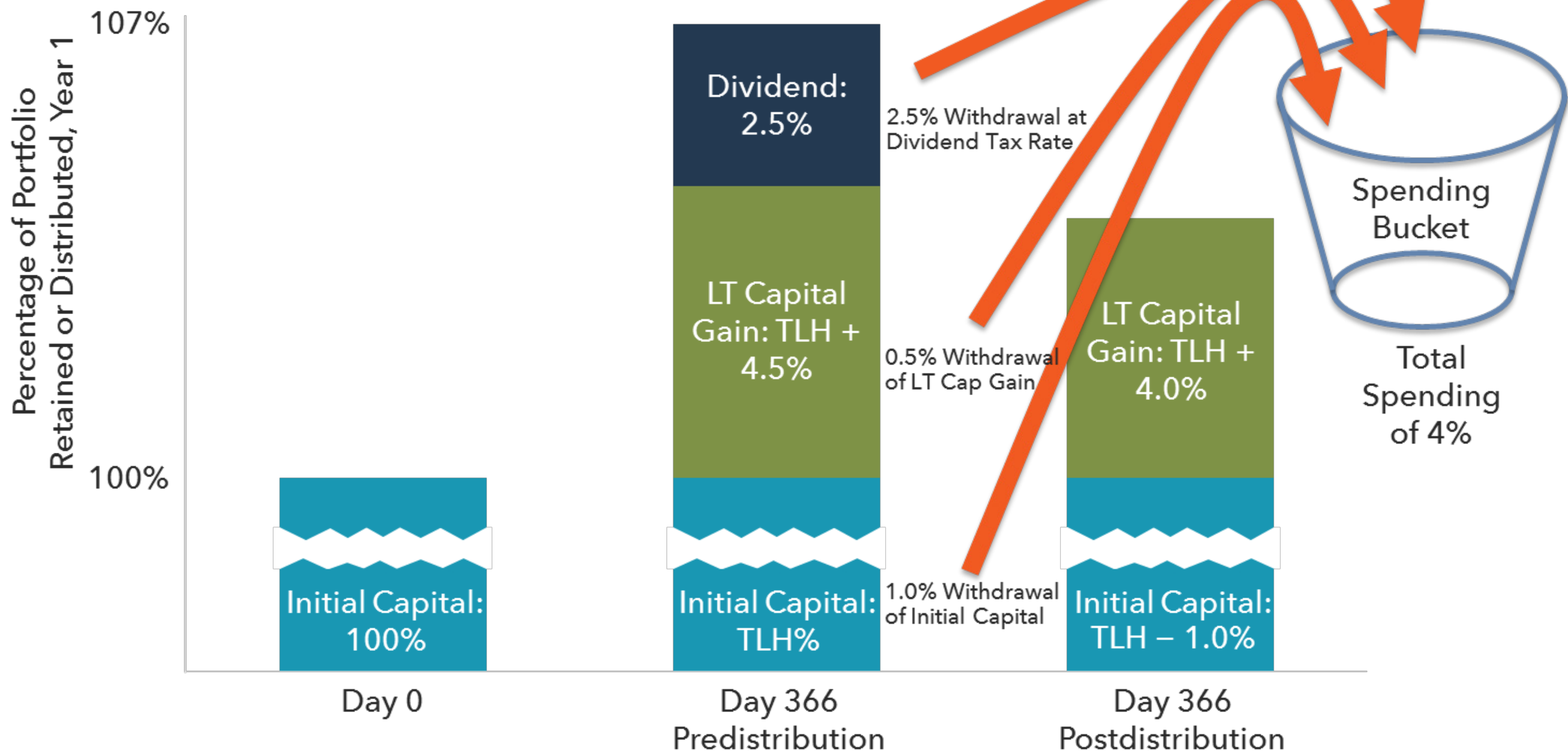
Motivation for High Yield

- Tracking error implications of high yield
- May provide valid factor exposure, if desired
- Alternative choice: raise cash through planned sales as part of tax-loss harvesting
- Result
  - Lower tracking error
  - Better (or at least no worse) tax treatment

Traditional Approach to Increase Cash



Alternative Approach to Increase Cash



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APERIO RESEARCH

Pride and Prejudice Around Stock Dividends—Human Psychology vs. Math

Patrick Geddes

Taxable investors seeking higher income from their stocks through extra dividend yield may have better choices available. Instead of simply increasing the dividend yield of a stock portfolio, investors may be able to implement a simple tax-advantaged selling program to generate the same pre-tax cash flow.

An investor's motivation for higher yield should be clearly understood. Investors may seek higher dividends for perfectly valid reasons, such as an expectation that high-dividend stocks may perform better than the market on a risk-adjusted basis. However, if taxable investors are simply looking for higher cash flow and don't have an opinion on higher-yielding stocks doing better or worse, then a tax-managed withdrawal program may offer better risk and after-tax return.

Focusing on cash flow is often superior to focusing on income. Traditionally, investors have focused on income, which may be an outdated concept, when in fact, what they need is cash flow. By prudently selling securities in a tax-advantaged way, taxable investors can potentially earn better after-tax returns at slightly lower comparative risk by selling stocks than by emphasizing stocks that pay higher dividends.

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References to returns, risks, performance, tracking error, and other such characteristics describing portfolios in this paper are based on hypothetical analysis techniques (also known as back-testing) and do not represent actual portfolios. Since returns included herein are hypothetical and based on back-testing, it is important to note that they are for illustrative purposes only. Past performance, whether illustrative or actual, is not a guarantee of future performance. Please refer to the important disclosures within and at the end of this paper.

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Generating Cash Flow More Tax Efficiently

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A taxable investor needing to withdraw cash from an account may wish to consider a tax-efficient sell-and-withdraw program rather than a high-dividend-yield-and-withdraw strategy.

INVESTMENT PROBLEM

Many investors who require consistent cash flow from their accounts may initially gravitate toward higher-yielding portfolios from which they can sweep out the cash that comes from the dividend payments.

However, by using a separately managed account without a dividend-yield tilt, a selling program can achieve the same cash-withdrawal target while leading to fewer taxes now.[1]

For illustrative purposes only.

EXAMPLE

Consider the following example of two securities (such as a stock or an exchange-traded fund), each of which has a 7% total return in a calendar year, and a client who wants to withdraw 4% of the initial value.

The first security's total return comes from 4% dividends and 3% capital appreciation. The second security's total return derives entirely from capital appreciation.

As shown in the table to the right,* the first security's approach would involve paying substantially more in taxes for this period.

	Security A	Security B
Initial Value	$1,000,000	$1,000,000
Dividend Income	$40,000	$0
Unrealized Gain	$30,000	$70,000
Current Value	$1,070,000	$1,070,000
Cash Withdrawal		
Dividends Withdrawn	$40,000	$0
Security Sold & Withdrawn	$0	$40,000
Total Cash Withdrawn	$40,000	$40,000
Taxes		
Realized Gain	$0	$2,617
Taxes on Dividends	$9,520	$0
Taxes on Realized Gains	$0	$623
Total Taxes	$9,520	$623

HIGH-DIVIDEND-YIELD STRATEGIES: HIGHER TAXES & HIGHER TRACKING ERROR

Aperio can offer a high-dividend-yield tilt on client accounts, and we typically target a dividend yield of 1.5 times the benchmark yield. This yield tilt seeks to provide greater *income*—but greater income comes with greater *income tax*. Moreover, the yield tilt adds to the active risk of the portfolio.[2] Clients who are restricted (by contract) from spending anything other than income will have more spending available from portfolios that deliver higher income.

Taxes and Qualified Dividends

Dividends paid by most companies can qualify for a lower tax rate than non-qualified dividends. While non-qualified dividends are taxed as ordinary income (top federal marginal tax rate of 43.4%), qualified dividends are taxed at the long-term capital gains rate (top federal marginal tax rate of 23.8%).[3] Thus, most dividends and long-term capital gains are currently (August 2017) taxed at the same rate. Going forward, any changes in tax rates may impact these calculations, and given the long-term nature of these strategies, investors may wish to consider this risk.

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					Deferral Value vs. High Yield[4]
					0.00%
					0.54%
Standard Harvesting	2.5%	0.0%	2.5%	1.15%	N/A

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Analysis assumes total return of equity portfolio remains constant irrespective of dividend yield. Market dividend yield reflects rounded estimate based on the Russell 3000 figure of 1.9% as of 06/30/2017.

The deferral value of the alternative approach represents the time value of money from pushing income tax payments further into the future or avoiding them entirely if a portfolio passes through an estate. When comparing the alternative strategy to the high yield, we note that the benefit reflects the average annual improvement in after-tax return from the combination of tax-loss harvesting and raising the additional cash required. Since, on average, the alternative strategy generates some of the additional cash without paying capital gain, it's more tax-efficient than the high-yield strategy, where the taxable investor pays taxes on 100% of the additional cash flow. As shown on slide 5, on average, the 1.5% extra cash needed comes from two sources: 0.5% from sales at a long gain and 1.0% from what is effectively return of capital.