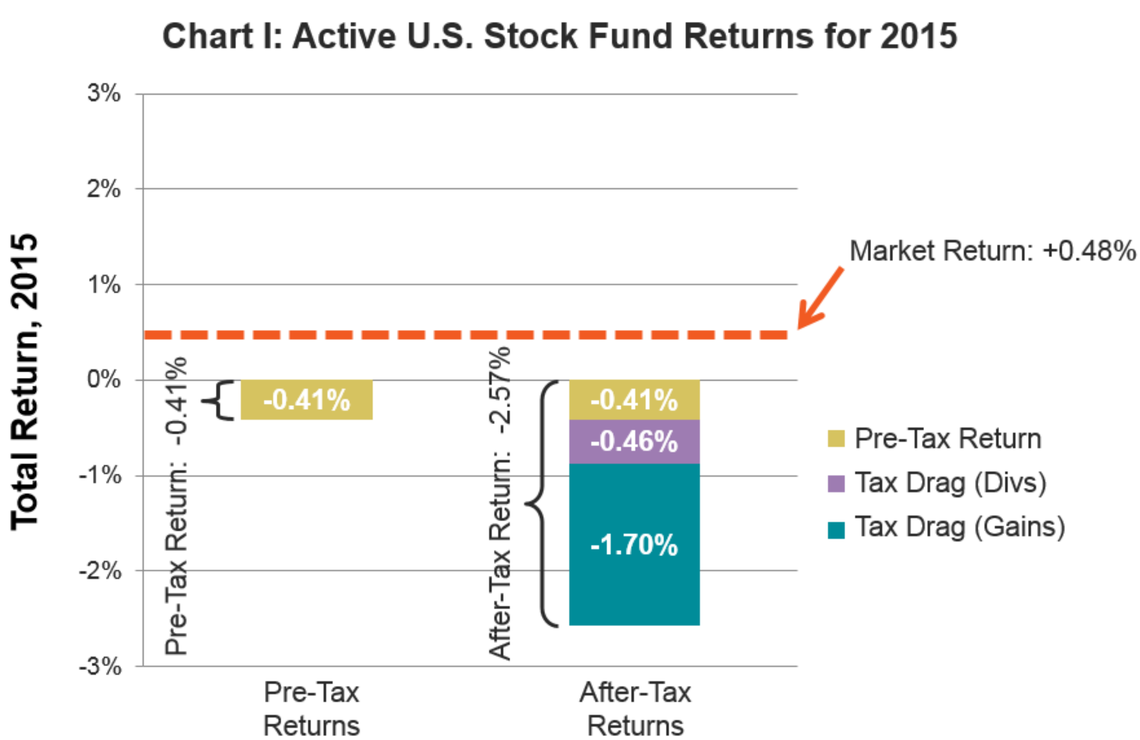
Adding Insult to Injury: The 2015 Tax Penalty for Active Management

KEY TAKE-AWAYS

- In 2015, the average active US equity mutual fund lost money, yet high-income taxable investors still had to pay a lot of capital gains tax, i.e., though investors suffered losses, they still paid taxes as though they'd earned gains.
- Because investors may treat their taxes and investing separately, they may not realize how much high-turnover active strategies can harm their pocketbooks.
- Taxable investors can avoid a lot of unnecessary tax damage by taking control of the timing of their tax payments rather than surrendering that control to their active managers.

We all understand from playground morality that it's shameful to kick someone when they're down. Unfortunately, that's exactly what many active equity fund managers did to taxable investors in 2015 in terms of tax burden. In 2016, investors are being forced to pay a lot of capital gains tax on 2015 fund distributions even though their investments generally lost money last year. Morningstar data shows that, on average, actively managed US stock mutual funds earned a negative return, but they distributed sizable capital gains anyway, which left investors worse off by about $14 billion.[1]

Many students of behavioral finance know that in terms of emotional impact, investors abhor losing money about two to three times more than they enjoy winning the same amount. It's also common knowledge that wherever one may sit on the political spectrum, most people feel rather unhappy about the painful reality of having to pay taxes. As the chart below shows, a major insult from taxes worsened the more minor injury of a slight down year in active US equity mutual fund returns.



Source: Morningstar, Russell Investments, and Aperio Group. See disclosure for details.

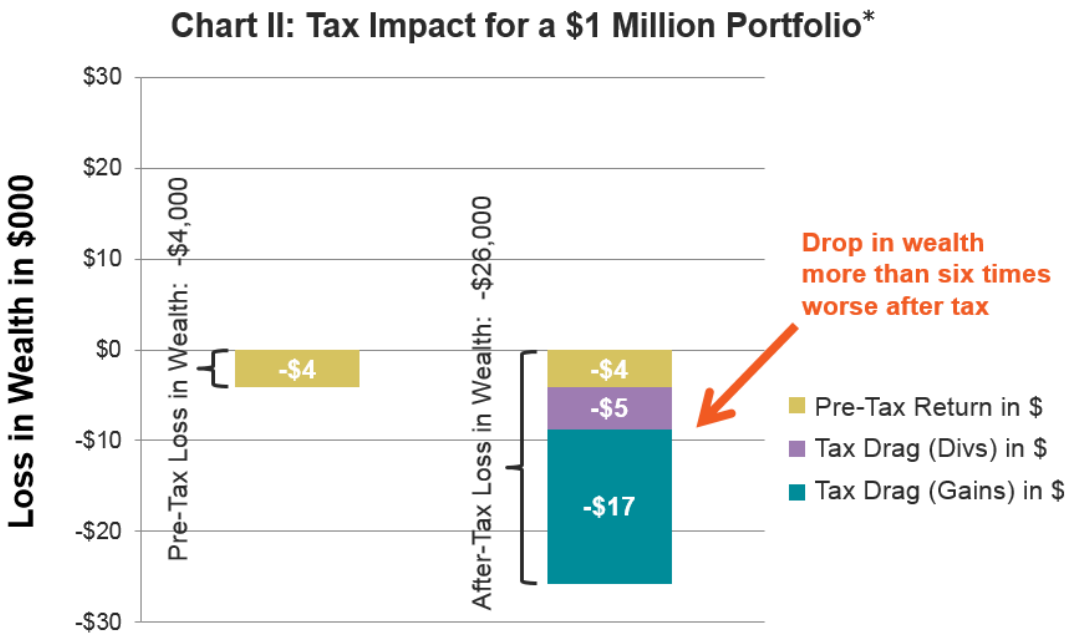
As seen on the left side of Chart I, in 2015 the weighted average pre-tax return for all active US stock funds was -0.41%. That's not such an emotionally devastating outcome, although the active funds did lag the US stock market as measured by the Russell 3000 Index (shown by the dashed blue line), which was up slightly at +0.48%.[2] The real pain kicks in when taxes are included, since the average after-tax return for a high-income taxable investor was -2.57%, or 2.16% worse than the pre-tax number. Could this significantly greater pain for taxable investors have been avoided, or is this insult something out of our control?

Control Freaks

Unfortunately, investing by its nature means there are a lot of things we can't control, like when the market will go up or down. However, as human beings we may not acknowledge that we don't have as much control over the results of our portfolios as we think we do. In fact, research in behavioral finance has identified a well-documented bias known as the "illusion of control,"[3] which refers to situations in which investors believe, erroneously, that they control outcomes that are in fact more random.

When taxable investors choose traditional active stock-picking strategies over passive ones like indexing, in addition to trying to beat the market, they are also implicitly turning over control of their tax payments to their managers. The turnover for those active strategies is generally much higher than for passive portfolios benchmarked against broad market indexes, where low turnover means that capital gains can often be driven down to zero. By virtually eliminating their realized gains, taxable investors can thus control the timing of their own tax payments rather than ceding that control to their managers. The dividend tax drag, of course, applies equally to most broadly diversified long-only strategies, whether active or passive. In Chart I, that means only the red section of the tax drag (the one caused by realized capital gains) can be controlled, since the green section (the tax drag from dividends) generally applies to both active and passive strategies. Still, that 1.70% return penalty for capital gains[4] in the form of lower after-tax returns significantly worsens a taxable investor's net spendable wealth, especially in a year like 2015, when the average active mutual fund return was already negative.

Ironically, the insult of paying a lot of capital gains can be rather easily controlled by avoiding the turnover inherent in most active strategies, where managers may not focus on after-tax results. That lack of focus reflects the fact that it's the investors, not the managers, who pay the painful tax penalties. For taxable investors, the decision to allow someone else to determine their tax bill could be labeled in behavioral terms as the "illusion of a lack of control" because many investors may not realize the magnitude of the harm from taxes or how simple it can be to reduce it. From the behavioral standpoint, this belief that taxes may not be controlled arises from a condition known as "mental accounting," where we think of our investment accounts separately from the bank accounts from which we pay our taxes.



*Assumes a portfolio of $1 million held in the weighted-average active fund for 2015.

Source: Morningstar and Aperio Group. See disclosure for details.

To illustrate the problem of mental accounting, we'll convert the percentage return penalties into dollars lost, as shown on Chart II for a hypothetical $1 million portfolio. Since we probably pay that extra $17,000 tax on capital gains from a different account, we don't associate that part of the drop in our after-tax wealth with our investment choices, maybe because we discuss our portfolio with our investment advisor but our taxes only with our accountant. In this example, the avoidable tax burden of $17,000 represents a pretty sizable and concrete cost from mental accounting, which is usually viewed as an abstract concept.

Conclusion

As we've seen from the Morningstar data, the year 2015 brought some painful and counterintuitive capital gains to taxable investors even though it was a slightly down year for active mutual funds. Big gain distributions in a down year are not so surprising when put in the context of the long bull market that has been running since the low point in March 2009, during the financial crisis. Those funds had built up a lot of gain that then was triggered because the high turnover from active management tends to occur whether the market is up or down.

From a behavioral perspective, losing money to the stock market and losing money to the government both hurt, but the penalty of the former is much more easily understood. The more confusing tax drag usually remains unaddressed by an industry not always keen to have investors figure out how expensive active management can be when measured on an after-tax basis. The good news for taxable investors is that they hold much more control over their after-tax wealth than they might think. By taking steps to avoid the large tax drag that often accompanies traditional active management, those investors can save themselves a lot of money by opting for passive strategies (or the rare tax-efficient versions of active strategies). That proactive step means that the next time investors suffer the pain of a down market, they'll still experience market losses, but at least by taking control of their own tax liability they might not have to endure the extra insult of writing large checks to the government even when they've been losing money.

Author: Patrick Geddes, Chief Tax Economist & CEO

Endnotes

[1] Actual assets in active US funds at year-end 2015 were $1,955,553,000,000. Assuming that 58% are held in qualified tax-exempt accounts like 401(k)s or IRAs, that leaves $821,332,000,000 in taxable assets. Morningstar's total tax drag on average for US stock funds classified as actively managed was 2.16% (the difference between pre-tax and after-tax returns for 2015), weighted by fund assets. The dividend yield was assumed to be 1.95% (from the difference for 2015 Russell 3000 Index returns between the total-return series and the price-return series, see endnote 2 for source). Using a dividend tax rate assuming qualified dividends of 23.8%, the tax drag from dividends would be 0.46% (23.8% * 1.95%), leaving a net of 1.70% as the tax drag for distributed capital gains (2.16% total tax drag less 0.46% dividend tax drag). Applying a total capital gains tax drag of 1.70% to $821,332,000,000 in taxable assets at year-end results in total tax liability of $13,950,000,000. This calculation assumes that 1) all the gains are long-term (a conservative assumption given that some of those gains are taxed at higher short-term rates); 2) investors pay no state income tax (again a conservative assumption); and 3) all taxpayers pay the highest tax rate (not a conservative assumption given that some investors will pay at lower rates or none at all). Furthermore, the tax drag is applied to year-end numbers, which represents only a rough approximation of the value throughout the year. The estimate of 58% of mutual fund assets in qualified plans is as of December 31, 2014, from the ICI Fact Book, published by the Investment Company Institute, http://www.icifactbook.org/fb_appa.html#tax. The 58% portion applies to all types of funds, and here we apply that as a proxy for active US equity funds in particular.

[2] Source: http://www.ftse.com/products/russell-index-values, Russell 3000 Index historical data.

[3] Michael M. Pompian. Behavioral Finance and Wealth Management. Hoboken: John Wiley & Sons, Inc., 2006, 111–118. For further details, see the published articles on the illusion of control cited by Pompian.

[4] Technically this penalty could be viewed as simply a timing difference, since in theory a taxable investor may have to pay the capital gains tax eventually. Taxable investors who eventually liquidate their assets would face a smaller tax penalty than the Morningstar data suggest. However, even just a timing difference provides significant ongoing value due to deferral because tax savings can be compounded at market rates of return. Furthermore, assets that pass through an estate or are donated to charities may never have to face taxation of unrealized capital gains.

Disclosure

The information contained within this presentation was carefully compiled from sources Aperio believes to be reliable, but we cannot guarantee accuracy. We provide this information with the understanding that we are not engaged in rendering legal, accounting, or tax services. In particular, none of the examples should be considered advice tailored to the needs of any specific investor. We recommend that all investors seek out the services of competent professionals in any of the aforementioned areas.

With respect to the description of any investment strategies, simulations, or investment recommendations, we cannot provide any assurances that they will perform as expected and as described in our materials. Past performance is not indicative of future results. Every investment program has the potential for loss as well as gain.

Data for tax distributions are from Morningstar. The tax drag was calculated as the difference between the average pre-tax return for all actively managed US equity funds for 2015 less the average after-tax return excluding liquidation, weighted by assets in each fund. Morningstar uses the highest federal tax rates of 23.8% for long-term gains and dividends and 43.4% for short-term gains. The dividend impact was based on the yield for the Russell 3000 Index for 2015 (source Russell web site).

The Russell 3000 Index measures the performance of the largest 3,000 US companies representing approximately 98% of the investable US equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased, and stable barometer of the broad market and is completely reconstituted annually to ensure that new and growing equities are reflected.

Due to the complexity of tax law, not every single taxpayer will face the situations described herein exactly as calculated or stated, i.e., the examples and calculations are intended to be representative of some but not all taxpayers. Since each investor's situation may be different in terms of income tax, estate tax and asset allocation, there may be situations in which the data presented would not apply. Please discuss any individual situation with tax and investment advisors first before proceeding. Taxpayers paying lower tax rates than those assumed or without taxable income would suffer smaller tax harm or even none at all compared to those described.

Aperio Group LLC | 415.339.4300 | www.aperiogroup.com