WIAD Newsletter

August 2001, Vol. 1, No. 3

In This Issue

- August Investment Results
- What I Am Thinking - Big Picture
- Tax Loss Harvesting: What is it? Why is it so important?
- Tax-deferred saving: How much is too much?

August Investment Results:	**August**	**YTD**
NJL Equity/Income Aggregate:	-3.62%	- 8.12%
S&P 500 (including dividends):	-6.26%	-13.40%
Russell 3000 (including dividends):	-5.90%	-13.11%
MSCI World (in US $, price only):	-4.95%	-16.75%

What I Am Thinking - Big Picture

Another bad month for the equity markets. I think the reason there are more sellers than buyers in this market is that there are currently many more reasons to sell than to buy. Despite seven Fed interest rate cuts, the economy remains weak and has shown few signs of near-term improvement. With Fed Funds now at 3.50%, the Fed has few bullets left to stimulate the economy, and as a result, investor confidence is low. For the near-term, I am not constructive on the markets as unemployment is rising, the Bush Administration appears to be fumbling the budget surplus, and perhaps most importantly: tax-loss harvesting season for the US equity market has begun.

Coming this “Fall”:

October: Mutual fund year end: massive tax loss selling, especially in the “TnT” sector.

November: 3rd quarter corporate earnings releases: more than likely to be disappointing.

December: Individual/retail tax loss selling: these “late Larry’s” will provide a buying opportunity.

In my opinion, it’s going to get uglier before it gets prettier. Let’s hope I am wrong.

Tax Loss Harvesting: (what is it? why is it so important?)

In 2000, mutual fund managers (especially technology-oriented growth funds) gave their taxable investors a double whammy: substantially lower NAVs and huge taxable distributions at year-end.

When you think about it, this shouldn’t have been a big surprise: the market goes down when there are more sellers than buyers, and when you sell stocks you have owned for a long time, chances are good you will have realized a taxable gain. In an extreme year like 2000, the distributions from many mutual funds were large and taxable (if held in taxable accounts). A lot of investors were caught off guard when their taxes were due the following April. This was a painful time for many people.

From a tax perspective, year-end for most mutual funds is at the end of October while for individuals it is at the end of the calendar year. Tax-loss selling can be a major source of volatility for the equity markets; especially in years when the market is down substantially.

"when the markets give you lemons, make lemonade"

As you may know, mutual funds cannot distribute realized losses to its shareholders; they can only distribute net gains (if any). When a mutual fund sells a stock that is at a loss, it can only use that realized loss to offset a realized gain elsewhere in the fund.

In contrast, an individual investor can realize losses when selling individual stocks, bonds, and/or mutual and index funds that are at lower values than their cost basis. Realized investment losses can be valuable, especially in years you have capital gains in your portfolio. Taxable investors should always try to harvest their tax losses in year's that they have them. These losses can be on individual stock or bond positions, and on mutual and index funds.

- If you have capital gains that have been realized, then realizing investment losses can be used to offset these gains and minimize your capital gains tax for a given year.

- If you have capital gains that are not realized, you may want to realize the capital gains on winning positions up to the amount of your realized losses and then buy the winners back, effectively "raising the basis" of your winning position(s) for tax purposes. I believe the 30-day wash sale rule only pertains to investment losses; you can buy a position sold at gain immediately. Consult a tax accountant or lawyer to be sure.

Even if you have no realized or unrealized capital gains to offset losses in your portfolio, you can use up to $3,000 in capital losses annually against ordinary income for tax purposes. To the degree you realized more losses than you can use in a given year, these realized losses can also be carried forward to be used against future ordinary income (up to $3,000 annually) or future year's capital gains. ***Holding investments at a loss (against your cost basis) when you have realized capital gains in your portfolio is a missed opportunity to limit your tax bill.***

A caveat: when you sell a losing position and claim the loss for tax purposes, you can't buy the position (or a position that is substantially the same) back for 30 days. This is called the 30-day "wash sale" rule. Obviously, a negative aspect of selling any position is the risk of being out of the market.

It is because of the 30-day wash sale rule that many investors do not realize losses. "What if the stock or fund goes up after I sell it? I don't want to miss it!" There is a way to effectively side step the 30-day wash sale rule and maintain a sector exposure when selling a losing position such as a technology stock or mutual fund: Buy an (similar, but not substantially the same) Exchange Traded Fund (ETF) when you harvest your tax loss that has a high performance correlation to the position that you are selling. ETFs are sector index funds that trade like a stocks and are similar to index funds in that they have low expense ratios and replicate ownership in all the stocks in a given sector. ETFs are great asset allocation vehicles and I will write about them in greater detail in a future WIAD issue.

For example, anyone who bought the actively-managed Fidelity Aggressive Growth Fund (FDEGX) in a taxable account in the spring of 2000 now holds that fund at a substantial loss. This fund was one of the best performing technology-oriented growth mutual funds in the 90s. If an investor wants to take the tax loss that will be generated by selling that fund, but feels technology has bottomed and doesn't want to lose his exposure to the sector, he can sell this fund and buy a technology-oriented ETF such as the QQQ (Nasdaq 100) or XLK (S&P Technology). After taking the tax loss, the investor can either reverse the "swap" in 31 days or just continue to hold the new ETF position.

While the correlation between the FDEGX fund and these particular ETFs is not perfect, if you look at the 12-month price performance graphs of FDEGX vs. the QQQ or the XLK, it is pretty close. These tax-driven "swaps" serve a purpose as they effectively allow an investor to realize losses and maintain exposure to a given sector while sidestepping the 30-day wash sale rule.

Psychologically, selling at a loss is never easy. While tax-loss harvesting can be a painful and emotional process; it is necessary to optimize an investment portfolio's performance. I am trying to harvesting my

tax losses early (before the end of the 3rd quarter) as I believe mutual fund and individual investor selling going into year-end will be heavy.

Tax-deferred Saving (how much is too much?)

"Should you always put as much of your assets in tax-deferred accounts as you can?"

The short answer is no; the long answer is yes, to a point, then no. While pre-tax contributions and tax-deferred compounded growth are the obvious benefits of tax-deferred investing, the unavoidable and more important issue here is*: If you die with substantial assets in your tax-deferred account, most of funds that remain undistributed in the account will go to pay income and estate taxes before your non-spousal beneficiaries or heirs see a dime.* For these remaining funds, Uncle Sam effectively becomes your closest living relative (aside from your spouse). ***To prevent this posthumous robbery, at a certain level of tax-deferred assets, it makes sense to either stop putting assets in a tax-deferred account, or change the type of assets allocated to the tax-deferred sector of your portfolio.***

Perhaps the reason the US Government is not as hard on the alcohol and tobacco industries as they might be is because of estate taxes. Without some basic estate planning, the IRS is often able to take more of your assets when you die than when you are living and generating income. While many of you have probably heard that the estate tax has recently been repealed***, the death of the estate tax has greatly been exaggerated****; its repeal can be repealed at any time.* I believe it is unrealistic and naïve to believe that some kind of estate tax will not be in force after 2010. While it is hard to predict that the form and magnitude of this tax will be, I think it is safe to assume if you have significant assets at death, your estate will be taxed. That being said, if the current repeal of estate tax survives as it is written, I believe that doctor-assisted suicide will thrive in 2010…

As you know, accounts such as regular IRAs, 401Ks, Keogh's etc. allow investors to save for retirement on a tax-deferred basis. In most cases, money put into these accounts is pretax, meaning the investor has not yet paid any tax on the money that is being invested*.* ***It is important to make the distinction that tax-deferred accounts are not tax-exempt; eventually, you will have to pay income tax, and perhaps estate tax on this money****.* Tax-deferred means that the investment growth on this money is only taxed when the money is taken out and/or distributed from the account at retirement, allowing the capital to compound without paying annual taxes. The theory is that this capital will be able to use the power of compounding, free of annual income taxes until distributions are made at retirement, and that the income tax rate the investor will be subject to at retirement will be lower than the income tax rate the investor is subject to before retirement.

If we stop there, everything about tax-deferred accounts are great. Pre-tax contributions are great, company 401K matching plans are great, and the power of compounding pre-tax is really great. *That being said, having too much money in your tax-deferred account is not great.*

At a point, the IRS says you must start taking out money and paying taxes on the distributions; I believe it is 59 ½ when you ***can*** start taking distributions without penalty and 70 ½ when you ***must*** start taking minimum distributions. Depending upon on how much you take out, the federal income tax rate on distributions will range from 27.5% to 39.1% (using the new Bush tax rates for 2001). Obviously, the more you take out at one time, the higher marginal income tax rate you pay.

More importantly, if you have any capital left in a tax-deferred account when you die, the remaining balance is subject to federal income tax, and more than likely, estate tax (which even under the new Bush plan can be as high as 50% unless you die in 2010). As a result of holding too much money in a tax-deferred account, on your death, Uncle Sam, rather than your chosen non-spousal heirs, will more than likely get a large percentage of the remainder of your tax-deferred account.

While it is true that at death, after income taxes are paid, the remaining funds in tax-deferred accounts

are available to be included in one's lifetime estate "unified credit" exclusion of $675K in 2001 (it will gradually be raised to $1MM by 2003 and ultimately to $3.5MM in 2009) to avoid estate taxes; for the purposes of argument, the assumption has been made that at death, the investor has already fully utilized this credit from the estate's taxable assets.

The theory behind tax-deferred accounts includes pre-tax contributions while your marginal tax rate is high, tax-deferred compounding until retirement and distributions at retirement when your marginal tax rate will allegedly be lower. When this theory is considered under a ***contribution to retirement*** investment horizon, the theory seems to work (in fact, work well). However, when you look at the theory of tax-deferred investing over a ***contribution to death*** investment horizon, the benefits of pretax contributions and tax-deferred compounding may be outweighed by the inevitability of estate taxes.

A lot of readers might say that it is unlikely that they will ever have enough where the problem of too much money in their tax-deferred accounts will ever be a reality. *Remember the power of pre-tax savings and compounding:* consider an employee who has contributed the maximum allowable pretax contributions to a corporate 401K tax-deferred account since these accounts were invented in 1987. If this investor simply put all these contributions into a broad domestic equity index like the S&P 500 (w/dividends reinvested) each year, he would have almost $400K by the end of 2000. This amount could be substantially more if his/her company had a 401K matching plan, if he also contributed annually to an IRA account, and/or if he successfully invested in more aggressive equity sectors over the 1987 - 2000 bull market period. Additionally, business owners and employees of closely-held companies can put as much as 25% of pre-tax income up to a maximum of $30K annually in tax-deferred accounts such as a Keogh plan. If you are not careful, tax-deferred assets can really add up over a lifetime.

A real life example: a 70 year-old investor and WIAD reader who i) contributed the maximum allowable pretax contribution annually since 401Ks were invented, ii) was fortunate to have an employer that matched his contributions, and iii) annually contributed post-tax funds to his IRA, finds himself with almost $2MM in total tax-deferred assets at retirement. His investment allocation for this account had been a diversified but growth-oriented domestic equity fund, so for the most part, the past 20 years have been kind. It is alarming yet inspiring how many people are in this position.

At 70 ½, the IRS requires tax-deferred investors to begin withdrawing money (at a rate of at least 3%-5% per year) and paying income taxes on the distributions. Depending upon how much this investor takes out per year, he will pay federal income taxes on the distributions ranging from 27.5% to 39.1% (in 2001). In this example, if he only takes out 5 % a year (~$100,000) and his tax-deferred portfolio grows at a faster rate than 5% annually (which it has historically), this investor will never deplete the capital in this account regardless of how long he lives. At his death, after income tax and estate tax, very little of the $2MM will be left for his living non-spousal heirs.

If this investor takes larger distributions to deplete the capital in his tax-deferred account during his lifetime, his distributions will be taxed at the higher-end of the income tax rate schedule. With such a large amount of money in a tax-deferred account at retirement, this investor will find distributing all the funds during his remaining lifetime to be a highly taxing challenge.

A good guideline is to only put as much in your tax-deferred account as you feel you can fully deplete during your retirement lifetime. Obviously, to do this requires a lot of planning well in advance of retirement as well as making assumptions on asset sector growth rates for investment allocation purposes. If you put too little in, hopefully you will have sufficient taxable assets to fund your life in retirement, if you put too much in, it is expensive (but not impossible), to keep out of the taxman's hands.

An altruistic alternative if you have too much in tax-deferred assets near the end is to instruct your estate to give the remainder of your tax-deferred account to charity upon your death. Your estate will receive a useful tax deduction and perhaps empower your heirs to greater involvement in charitable endeavors.

Summary

"Failing to plan is planning to fail"

In this issue of WIAD, we discussed the rationale for tax-loss harvesting and the potential pitfalls of tax-deferred saving. Obviously, a significant amount of thought from an investment strategy and estate-planning standpoint is required. For issues as important as these, it is important to have the support and expertise of a financial advisor you trust.

For the past, 18 months, we have suffered through a very difficult market environment. I have heard from many readers who had concentrated positions in technology, internet, or international/Japan sectors, who have had devastating investment results. Times like this can be very humbling, but they offer an opportunity to harvest investment losses, rethink the concept of diversification, and fine-tune our portfolio asset allocation plans.

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September 5, 2001

Next Month:

- 3rd Quarter 2001 Review
- Lucent Bonds: Is it too late?

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