Efficient Tax Management in Taxable VEBA Portfolios

Introduction

Reducing tax consequences in equity portfolios offers tangible benefits in the current tax environment. Three key decisions that directly influence the after-tax performance of such portfolios include:

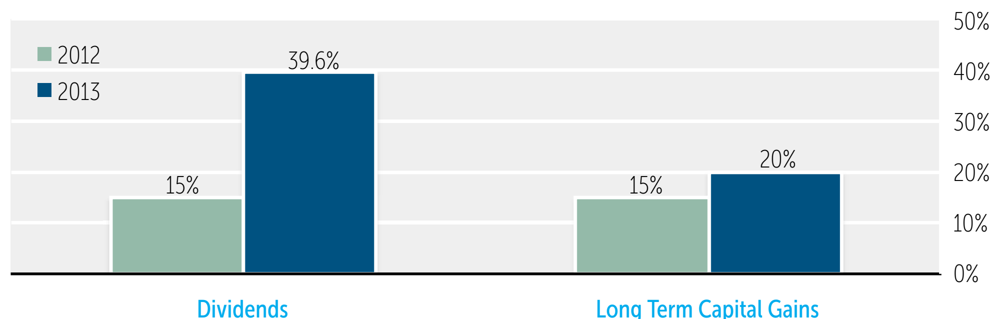
- Portfolio Dividend Tilt
- Portfolio Turnover
- Capital Gain/Loss Realization

These decisions take on even greater importance under the tax code changes which take effect at the end of 2012 absent congressional action. Therefore, an evaluation of existing tax-management practices is very timely. The current uncertainties in the tax code make being prepared to react to a (potentially) quickly changing tax environment particularly useful.

Each of these decisions should be evaluated in the context of tracking error versus the desired benchmark and could ultimately affect the benchmark selection.

Taxes[1,2]

Income, dividend, and capital gains tax rates are set to increase in 2013 when the current rates expire. Our focus in this paper is on two key tax changes scheduled to occur in 2013: dividends will be taxed as ordinary income, and long term capital gain tax rates will increase from 15% to 20%. The chart below compares the 2012 and 2013 tax rates:



Shifting the Dividend Return

When 2013 tax rates take effect, the dividend tax rate will more than double for taxable VEBA portfolios. When this occurs investors may be able to increase after-tax performance by reducing the portfolio's dividend yield. This change in tax rates creates a powerful incentive for taxable VEBA equity portfolios to receive more of the equity total return in the form of capital gains as opposed to dividends. A key assumption in this is that the same long-term equity risk premium is available with a low dividend yield portfolio. If true, shifting portfolio return away from dividends will lower the overall effective tax rate as dividends are taxed at a higher rate.

[1] *For purposes of this analysis, additional taxes resulting from the Patient Protection and Affordable Care Act have been ignored.*
[2] *NISA Investment Advisors, L.L.C. does not purport to be experts in, and does not provide, tax, legal, accounting or any related services or advice.*

NISA Investment Advisors, L.L.C.
101 South Hanley Road, Suite 1700
St. Louis, MO 63105-3487
P: 314.721.1900
www.nisa.com

November 2012
© 2012 NISA Investment Advisors, L.L.C.

In the analysis presented below, a series of portfolios were modeled with varying degrees of dividend tilt to a stated benchmark. All portfolios have an assumed illustrative before-tax annual total return of 7.0%, with the benchmark receiving 2.5% of its total return from dividends. The 'tax-enhanced' portfolios' dividend yield was reduced as shown in the tables below (i.e. a portfolio with a -1% dividend tilt will have an annual price return of 5.5% and an annual dividend return of 1.5%). Current (2012) tax rates were applied in table A while the 2013 tax rates of 39.6% on dividends and 20% on capital gains were applied in table B. For simplicity, zero turnover was assumed for all portfolios. For conservatism, US Treasury rates as of 10/31/2012 were used to quantify the present value of different tax liabilities. If there is an opportunity cost to forgoing equity market (or other) investments due to tax obligations, the numbers presented below would be even larger as there is a greater benefit to tax deferral.

Although tax savings occur at the 2012 tax rates, the savings become much more pronounced at the higher 2013 tax rates due to the difference in tax rates.

Return Assumptions in Tables A and B

	Degree of Dividend Tilt				
	-0.5%	-1.0%	-1.5%	-2.0%	-2.5%
Price Return	5.00%	5.50%	6.00%	6.50%	7.00%
Dividend Return	2.00%	1.50%	1.00%	0.50%	0.00%
Total Return	7.00%	7.00%	7.00%	7.00%	7.00%

Table A: Annualized after-tax return benefit (2012 Tax Rates)

	Degree of Dividend Tilt				
Investment Horizon	-0.5%	-1.0%	-1.5%	-2.0%	-2.5%
1	0.00%	0.00%	0.00%	0.00%	0.00%
5	0.00%	0.00%	0.00%	0.00%	0.00%
10	0.00%	0.01%	0.01%	0.02%	0.02%
15	0.01%	0.01%	0.02%	0.03%	0.04%
20	0.01%	0.02%	0.03%	0.04%	0.04%
30	0.01%	0.02%	0.03%	0.04%	0.05%

Table B: Annualized after-tax return benefit (2013 Tax Rates)

	Degree of Dividend Tilt				
Investment Horizon	-0.5%	-1.0%	-1.5%	-2.0%	-2.5%
1	0.10%	0.20%	0.29%	0.39%	0.49%
5	0.09%	0.19%	0.28%	0.37%	0.47%
10	0.09%	0.19%	0.28%	0.37%	0.47%
15	0.10%	0.19%	0.28%	0.38%	0.47%
20	0.09%	0.19%	0.28%	0.37%	0.45%
30	0.09%	0.17%	0.26%	0.34%	0.42%

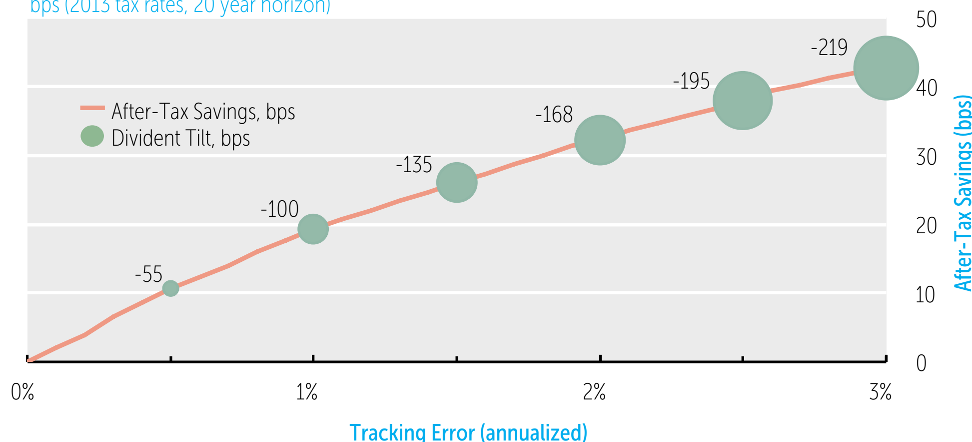
A portfolio with a 100bp reduction in dividend yield will realize 1bp of annualized after-tax return benefits at 2012 tax rates while the same portfolio will realize 19bps of annualized tax benefits at 2013 tax rates, assuming pre-tax total returns are unchanged.

By reducing the dividend yield of a portfolio under these scenarios, a larger portion of the total return will come from capital gains. This allows a lower tax to be paid since dividends will be taxed at a higher rate than capital gains. Additionally, (and regardless of tax rates above) shifting to a lower dividend portfolio allows taxes to be deferred, enhancing after-tax returns.

 © 2012 NISA Investment Advisors, L.L.C.

Tracking Error from Dividend Tilt

As a portfolio's dividend yield moves away from a stated benchmark, the tracking error of the portfolio quite likely increases. The graph below illustrates the relationship between annual after-tax savings and tracking error vs. the S&P 500 as well as the associated yield tilts. Although dividend tilt will increase the predicted after-tax tracking error of a portfolio, the primary risk factors in each portfolio remain relatively unchanged and the resultant portfolios have a predicted beta of 1.0 to the benchmark, suggesting an equivalent expected return and overall level of risk as the benchmark. The tradeoff between tracking error and after-tax savings is approximately a 0.2 information ratio.



Source: Calculated by NISA using Barra[3]

When using a large cap benchmark such as the S&P 500, as the dividend tilt increases, market capitalization differences become a greater contributor to tracking error.

A full capitalization benchmark such as the Russell 3000®, the S&P 1500, or a custom benchmark may allow for a dividend tilt with less tracking error since the market capitalization is less concentrated in large capitalization stocks.

Therefore, in a portfolio with a broad-based benchmark, a greater degree of dividend tilt can be achieved while maintaining the same tracking error as a comparable large cap portfolio. If selecting a different benchmark, it is important to understand any expected return and volatility differences that may occur.

Turnover

Turnover is a factor in after-tax performance. Reducing the turnover in a portfolio allows capital gains taxes to be delayed. It is the present value of this tax deferment that allows low turnover portfolios to realize a greater after-tax savings than higher turnover portfolios. For our analysis the Treasury yield curve as of 10/31/2012 is used. Ignoring transaction costs and assuming gains are taxed at 20%, an active portfolio manager with 50% turnover is expected to have 8bps of lower annual after-tax return over a 15-year horizon relative to a portfolio with no turnover due to the timing of taxes. On a $100 million dollar portfolio, this results in ~1.2 million of present valued tax savings over 15 years. This analysis assumes a pre-tax total return of 7% (2.5% dividend return, 4.5% price return). For reference, NISA estimates from historical data over the prior thirty years, the annual turnover of the S&P 500 and Russell 3000® indices are 4.5% and 5.5%, respectively.

The tables below show the impact of current and 2013 tax rates with varying degrees of turnover on a taxable equity portfolio. For this analysis any impact of short term capital

[3] *Barra, Inc.'s analytics and data (www.barra.com) were used in the preparation of this report. Copyright 2012 BARRA, INC. All Rights Reserved.*

 © 2012 NISA Investment Advisors, L.L.C.

gains on the portfolio have been ignored. Additionally, it is important to keep in mind that all turnover is not created equal. This analysis makes no assumptions for harvesting losses, and assumes equal gains across all positions. Therefore, the numbers presented in the tables below are conservative and having a manager focused on tax-sensitive investing could increase after-tax savings.

Table C: The Cost of Portfolio Turnover (2012 Tax Rates)

	Annual Capital Gain Realization Rate			
Investment Horizon	5%	15%	25%	50%
1	0.00%	0.00%	0.00%	0.00%
5	0.00%	0.00%	0.00%	0.01%
10	0.01%	0.02%	0.02%	0.03%
15	0.01%	0.03%	0.05%	0.06%
20	0.02%	0.05%	0.06%	0.07%
30	0.03%	0.06%	0.08%	0.09%

Table D: The Cost of Portfolio Turnover (2013 Tax Rates)

	Annual Capital Gain Realization Rate			
Investment Horizon	5%	15%	25%	50%
1	0.00%	0.00%	0.00%	0.00%
5	0.00%	0.00%	0.00%	0.01%
10	0.01%	0.02%	0.03%	0.04%
15	0.02%	0.05%	0.06%	0.08%
20	0.03%	0.06%	0.08%	0.10%
30	0.05%	0.09%	0.11%	0.13%

Even at the lower 2012 tax rates the benefits of a low turnover portfolio are apparent. When the 2013 long-term rates are assumed, the tax cost of turnover increases by over 30% for 10-year and longer horizons. Accordingly, pending tax changes may merit the re-evaluations of active management styles that encompass higher portfolio turnover. Additionally, in high rate environments the importance of delaying tax payments is magnified.

Realizing Gains/Losses

Regardless of the level of taxes, circumstances can exist that make it advantageous to realize or defer capital gains/losses. With capital gains scheduled to increase from 15% to 20% in 2013, depending on a plan's investment horizon it may be beneficial to realize taxable gains in 2012. For a plan with a $100,000 gain on a position, if the gain is realized in 2012, $15,000 of tax is paid; in 2013 and beyond $20,000. However, depending on the investment horizon the potential earnings on leaving $15,000 invested in the market may overwhelm the $5,000 in tax savings. Given the current interest rate environment, we estimate that it would take an investor 18 years to break-even on the decision to defer the tax, assuming the 2013 tax rates remain unchanged in the future.

© 2012 NISA Investment Advisors, L.L.C.

Conclusion

A tax-focused equity manager can seek to improve a VEBA plan's after-tax performance by lowering dividend yield, decreasing portfolio taxable turnover, and timing the realization of capital gains/losses. Given the tax increases scheduled to occur in 2013, the impact of these tax management strategies on after-tax performance is increasingly important. Even if the 2013 tax increases do not occur, the benefits of a low dividend tilt and low turnover portfolio exist in the current tax environment. Although it is unclear how tax rates will change going forward, being prepared to navigate a changing tax code is an important step which can provide significant value in the future.

 © 2012 NISA Investment Advisors, L.L.C.

Selected NISA Papers

Our papers can be found on the Library section of our website at www.nisa.com/library.

- *Funding Relief and Implications for Pension Investing* (October 2012)
- *PSRX Overview* and *PSRX Guide* (September 2012)
- *Corporate Bond Scarcity? The Case for Separating Interest Rate and Spread Risks* (August 2012)
- *Prospective Funded Status Volatility* (October 2011)
- *Break-even Yield Curve* (August 2011)
- *Dynamic Liability Driven Investing* (July 2011)
- *Interest Rate Hedges* (May 2009)
- *Considerations Surrounding Corporate Bonds in Pensions* (December 2008)

About NISA Investment Advisors, L.L.C.

NISA Investment Advisors, L.L.C., is an independent investment manager focused on risk-controlled asset management. We manage assets for large institutional investors. Client portfolios include investment-grade fixed income, derivative overlays and indexed equity. NISA is 100% employee-owned and is based in Saint Louis, Missouri.

Disclaimer

This material has been prepared by NISA Investment Advisors, L.L.C. This document is for information and illustrative purposes only and does not purport to show actual results. It is not, and should not be regarded as investment advice or as a recommendation regarding any particular security or course of action. Opinions expressed herein are current opinions as of the date appearing in this material only and are subject to change without notice. Reasonable people may disagree about the opinions expressed herein. In the event any of the assumptions used herein do not prove to be true, results are likely to vary substantially. All investments entail risks. There is no guarantee that investment strategies will achieve the desired results under all market conditions and each investor should evaluate its ability to invest for a long term especially during periods of a market downturn. No representation is being made that any account, product, or strategy will or is likely to achieve profits, losses, or results similar to those discussed, if any. No part of this document may be reproduced in any manner, in whole or in part, without the prior written permission of NISA Investment Advisors, L.L.C., other than to your employees. This information is provided with the understanding that with respect to the material provided herein, that you will make your own independent decision with respect to any course of action in connection herewith and as to whether such course of action is appropriate or proper based on your own judgment, and that you are capable of understanding and assessing the merits of a course of action. NISA Investment Advisors, L.L.C. does not purport to be experts in, and does not provide, tax, legal, accounting or any related services or advice. Tax, legal or accounting related statements contained herein are made for analysis purposes only and are based upon limited knowledge and understanding of these topics. You may not rely on the statements contained herein. NISA Investment Advisors, L.L.C. shall not have any liability for any damages of any kind whatsoever relating to this material. You should consult your advisors with respect to these areas. By accepting this material, you acknowledge, understand and accept the foregoing.

 © 2012 NISA Investment Advisors, L.L.C.