How You Can Employ a Deft Tax-Efficient Strategy

Fund distributions can undermine returns for taxable investors.

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KEY INSIGHTS

- A long-term horizon, low portfolio turnover, and tax loss harvesting are essential elements to minimize the impact of taxes on an investment portfolio.
- In-depth research and a growth-oriented investment approach can help to build a portfolio of high-quality companies with durable growth potential.
- An investment strategy that includes appropriate asset allocation and asset location can help minimize an investor's tax bill.

Taxes on dividends and capital gain distributions can pose a significant drag on returns for investors holding funds in taxable accounts. So it's important for taxable investors to be cognizant of the tax implications in managing their portfolio.

Equity fund investors can minimize the tax drag on their portfolio and improve their after-tax return potential by focusing on three key strategies:

1. Asset allocation
2. Asset location
3. Tax-efficient investing

Not employing these strategies can cause a significant drag. An analysis by Morningstar shows that using invested assets to make tax payments on annual distributions trimmed the average annual return for large-cap growth funds by more than two percentage points over the one-, three-, and five-year periods ended December 31, 2018. This can produce an enormous difference in return when compounded over long time periods.

Taxes have taken an increasing bite out of investors' returns over time even though the 2017 tax act lowered income tax rates for many investors. A decade ago, the tax rate on long-term capital gains and qualified dividend income was 15%, and the top marginal rate for ordinary income was 35%. Now the maximum rates are 23.8% and 40.8%, respectively (including the 3.8% net investment income tax).

Also, a significant amount of mutual fund assets is held in taxable accounts. As of the end of 2018, 43% of mutual fund assets under management in the United States, or USD 7.6 trillion, was held in taxable accounts, according to the Investment Company Institute.

Low Turnover Can Improve Tax Efficiency

(Fig. 1) Annual Portfolio Turnover Rates

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
T. Rowe Price Tax-Efficient Equity Fund	60%	41%	27%	30%	20%	18%	11%	18%	17%	11%	26%
Morningstar Large Growth Category Average[1]	110	91	74	73	72	70	69	62	58	43	65

As of December 31, 2019.

Sources: T. Rowe Price and Morningstar (see Additonal Disclosure).

[1] Large-growth funds invest in big companies that are projected to grow faster than other large-cap stocks. Most of these focus on companies in rapidly expanding industries.

> We prefer to let our winners run, rather than realize gains, unless a company's long-term outlook has fundamentally deteriorated.

The Importance of Asset Location

Every investor should focus on asset allocation in building an effective investment portfolio. This includes an assessment of your time horizon, risk tolerance, and other factors to determine a mix of stocks and bonds that maximizes your opportunity to meet your financial goals.

But a thoughtful tax-efficient investment approach doesn't end with asset allocation. Once you've determined an appropriate asset allocation, you should consider asset location. That's defined as the optimal placement of your assets into taxable and tax-advantaged accounts, such as Roth IRAs and other retirement plans. The right asset location strategy could make a portfolio more tax-efficient and potentially improve long-term returns.

Generally, investors should use tax-advantaged accounts for higher-income-oriented assets, such as taxable bonds and bond funds, high-dividend-paying stocks or stock funds focusing on such securities, and real estate investment trusts. Ordinary income is generally taxed at a higher rate than long-term capital gains, so it is better earned in a tax-advantaged account. This may also apply to equity funds with relatively high turnover rates, generating capital gain distributions.

Alternatively, a taxable account is usually best suited for four types of holdings. That is, individual stocks held over long periods of time; tax-advantaged securities such as municipal bonds; certain types of index funds; and actively managed equity mutual funds that tend to have relatively low turnover, low yields, and a growth-oriented investment approach.

A Focus on Tax Efficiency and After-Tax Returns

A third strategy in optimizing an investor's portfolio is to employ tax-efficient investing.

Most equity portfolio managers are measured and compensated based on pretax returns. As a result, they tend to have higher turnover rates. That may generate more capital gain distributions, creating a potentially significant taxable event for shareholders. Over time, this could create a large difference between the pretax performance of a tax-blind investment approach and what an investor actually earns after taxes.

A tax-efficient equity strategy is more focused on after-tax returns than on pretax returns. Tax-efficient funds are managed to minimize annual distributions and tend to have lower turnover rates than traditional actively managed equity funds. The longer investors have to compound the return without paying taxes on large distributions each year, the better off they should be.

One of the primary ways a portfolio manager can employ tax efficiency is to invest for longer time horizons.

For example, the trailing 12-month turnover rate for the T. Rowe Price Tax-Efficient Equity Fund as of December 31, 2019, was 26%, implying almost a four-year ownership period for the average fund holding. The average portfolio turnover rate for actively managed U.S. large-cap growth funds was 65%, according to Morningstar Direct, implying a holding period of just one and a half years. (Some T. Rowe Price equity funds that are not specifically tax managed also tend to have relatively low turnover rates compared with peers in the industry.)

We prefer to let our winners run, rather than realize gains, unless a company's long-term outlook has fundamentally deteriorated. Indeed, our fund's 26% turnover rate in 2019 was low for any actively managed fund. It is notable that this rate also includes extra trading for loss recognition, which is done to reduce the capital gains that are distributed to shareholders. It's very

Tax Efficiency Can Improve After-Tax Returns

(Fig. 2) Tax Efficiency Rates for Various Types of Funds

Annualized Returns, Five Years Ended January 31, 2020

	Pretax Return	After-Tax Return Pre-liquidation[1]	After-Tax Return Post-liquidation[2]	Tax Efficiency[3]
T. Rowe Price Tax-Efficient Equity Fund	14.30%	13.99%	11.44%	98%
U.S. Large-Cap Growth Funds	12.92	10.72	9.70	83
U.S. Mid-Cap Growth Funds	11.11	9.05	8.29	81
U.S. Small-Cap Growth Funds	10.55	8.20	7.75	78

Average Annual Total Returns as of December 31, 2019

	One Year	Five Years	10 Years
T. Rowe Price Tax-Efficient Equity Fund Pretax Annualized Returns	36.04%	13.75%	14.64%
T. Rowe Price Tax-Efficient Equity Fund After-Tax Returns Pre-liquidation	35.82	13.44	14.29
T. Rowe Price Tax-Efficient Equity Fund After-Tax Returns Post-liquidation	21.42	10.98	12.30

Current performance may be higher or lower than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or loss when you sell your shares. To obtain the most recent month-end performance, go to troweprice.com/tmc.

The fund's gross expense ratio was 0.81% and the net expense ratio was 0.77% as stated in the most recent prospectus. The Fund operates under a contractual expense limitation that expires on June 30, 2021. As a result of class-specific expense limitations, T. Rowe Price Associates, Inc. waived fund-level expenses ratably across all classes.

Sources: T. Rowe Price and Morningstar.

1 These returns reflect payment of taxes on annual dividend and capital gain distributions but assume that investors did not sell their shares at the end of this 5-year period.

2 These returns reflect taxes paid on annual dividend and capital gain distributions and any capital gains tax due on the sale of all fund shares at the end of this 5-year period.

3 Tax efficiency measures how much of a fund's annual return is earned after taxes, so the higher the number the better. These data reflect taxes paid on annual dividend and capital gain distributions but assume investors did not sell their shares at the end of this 5-year period.

The returns presented reflect the return before taxes, the return after taxes on dividends and capital gain distributions, and the return after taxes on dividends, capital gain distributions, and gains (or losses) from the redemption of shares held for the periods shown. The after-tax returns reflect the highest long-term capital gains and qualified dividend rate (23.8%) and highest applicable rate to ordinary income (40.8.%) currently in effect. State and local taxes are excluded. During periods when the fund incurs a loss, the post-liquidation after-tax return may exceed the fund's other returns because the loss generates a tax benefit that is factored into the result. An investor's actual after-tax return will likely differ from those shown and depend on his or her tax situation. Past before- and after-tax returns do not necessarily indicate future performance. Average annual total return figures include changes in principal value, reinvested dividends, and capital gain distributions.

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97.9%

Tax-Efficient Equity Fund tax efficiency ratio since 2000

unusual for a fund that focuses on pretax returns to steadily harvest losses to minimize distributions.

In down markets, however, the turnover rate of a tax-efficient fund, as well as other equity funds, can be higher than normal as more losses will exist in the portfolio. This process of tax loss harvesting is critical because it can improve after-tax returns over time since accumulated losses can be used to offset gains that are later realized in the portfolio.

The strategy is not risk-free. If the stock you sell outperforms the stock you replaced it with, then you created a poor tax shield. That's probably a losing trade. The process of tax loss harvesting is not easy for individual investors to implement.

A longer investment time horizon and a low portfolio turnover rate are keys to maintaining a high tax efficiency ratio, which is calculated by dividing a portfolio's after-tax return by its pretax return. The 97.9% tax efficiency ratio of the Tax-Efficient Equity Fund, for example, indicates that the fund has made minimal taxable distributions from its inception on December 29, 2000, through December 31, 2019.

Taxes are a constant consideration for investors pursuing long-term financial goals. While avoiding all taxes is virtually impossible, investors can make some important portfolio decisions and adjustments to adopt a more tax-efficient investing strategy. A successful strategy includes an appropriate asset allocation and asset location with a focus on after-tax returns for assets in taxable accounts. This should help an investor reduce his or her tax bill.

Additional Disclosure

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