

ABOVE THE FRAY

Barking Up the Wrong Tax Tree

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My dad used to remind me occasionally that the easiest (legal) way to avoid paying taxes is to not make any money. I don't think he was recommending unemployment, but instead was suggesting I relate the taxes I pay to the earnings that trigger them.

Similarly, portfolios targeting sources of higher expected returns, such as size, value, and profitability premiums, may drive up an investor's tax bill through higher growth of wealth more than a broad market investment would. But if the net result is higher after-tax wealth, that's a tradeoff many investors would find satisfactory.

It is better, then, to avoid letting the tax tail wag the expected returns dog, and focus on maximizing after-tax returns rather than on minimizing taxes.

*Glossary*

Expected return: *Expected payoff of a security (price appreciation + interest/dividend payments) over a given period, divided by the current market price.*

Size, value, and profitability premiums: *The size premium refers to the tendency of stocks from issuers with a small market capitalization to outperform those of issuers with a large market capitalization. The value premium refers to the tendency of stocks with low relative prices (stock price divided by an accounting metric such as book value) to outperform. The profitability premium refers to the tendency of stocks of issuers with high relative operating profits (operating profits divided by an accounting metric such as book equity) to outperform.*

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