I May Be Dumb, But I'm Not Stupid

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To football fans he is a Super Bowl MVP quarterback, but to my daughter he will always be the 'little brat' that she babysat. While Anna has never played football, she has been on the receiving end of a number of our signal caller's tosses. But it wasn't footballs he was throwing and it wasn't pass routes she was running. He was throwing water balloons, and she was running for cover. It was New Year's Eve and the little brat along with his brothers had locked Anna out of the house. As she banged on the front door, alternately begging for mercy and spewing threats, the little gang of juvenile delinquents was stealthily sneaking out the back door. After retrieving their stash of water balloons they continued on their well-planned but ill-advised adventure.

I called their plan ill-advised because they never considered the consequences of their actions. They caught Anna completely by surprise, but they should not have been surprised by the hell they caught when their parents returned home. Being a good parent requires knowing when to extend mercy and when to impose consequences. Our future field general and his band of brothers found out real quick that this was not going to be a time for mercy.

Like parents, the IRS imposes consequences for stupid decisions. But, unlike good parents, they rarely show any mercy. So it surprises me how often tax consequences are ignored when investors purchase mutual funds. While the income tax implications of a particular fund's strategy is not a consideration when selecting investments for an IRAs or a 401(k), it should be one of the most important considerations when selecting investments for taxable accounts.

Most mutual funds have an active investment strategy that attempts to increase returns by trying to unload poor performing stocks and replace them with winning ones. The result is that the typical US stock fund turns over about 95% of their assets each year. These transactions not only generate costs, but they also increase taxes because of the pass-through of the capital gains. The fact that many of these gains are taxed at higher short term rates makes things even worse.

To significantly reduce costs and taxes, smart investors choose indexed mutual funds which have turnover ratios in the 10% range, or less. According to ten-year statistics from the Summer 2006 issue of *The Journal of Wealth Management*, switching to an index fund would increase after-tax returns by 1.2 percentage points per year. And this number doesn't include the cost advantage index funds have over active funds (but that is an issue for another time). Extrapolate only that tax savings over 20 years and the result is a 27% increase in value for the index funds.

This is good, but you can do better. While an active investment strategy is pretty much a guaranteed loser, active management of taxes (and costs) has just the opposite effect. By combining passive index investment strategies with active tax strategies, mutual fund companies have been able to significantly enhance the tax savings. Using our 20-year numbers, the tax savings could increase values by an additional 8%, on top of the original 27% increase.

Our little water balloon tossing quarterback grew up and learned to consider the consequences of his actions. Investors also need to grow up. Terry Bradshaw, a former quarterback turned announcer, described the maturing process in a unique way, "I may be dumb, but I'm not stupid." In other words, learning from dumb mistakes is part of maturing. So mature investors consider the tax consequences of their actions because paying too much in taxes is just stupid.

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