Allocating Investments: Coordinating Retirement Plans and Taxable Savings

By Maria Crawford Scott

One difficulty facing many investors is coordinating investments in taxable savings with those in retirement plans. This can be a complex undertaking. Ideally, money set aside for retirement will be invested long term, and thus can be committed to investments that may be volatile over the short term but that have long-term growth prospects, such as stocks.

On the other hand, retirement plans more aptly referred to as tax-deferred plans—are one of the few remaining tax shelters, and as such, are a perfect place to shelter your investments that produce large tax liabilities. Included among those are the more conservative investments that generate annual income, are less volatile and therefore tend to be more liquid, and are often found in taxable accounts.

The best approach to coordinating taxable and tax-deferred investments is to aim for tax efficiency. First, determine an asset allocation for your savings as whole, combining both taxable savings and tax-deferred retirement plan savings; then allocate to your taxable savings portfolio any cash and shorter-term investments that will be needed before age 59½ (when tax-deferred savings can be withdrawn without penalty); after liquidity needs are met, allocate your investments either to your taxable or tax-deferred account based on the amount of tax sheltering that is needed.

One way to understand the approach is by looking at an example.

The Fords and Changing Liquidity Needs

George and Nora Ford just paid their last tuition bill, having successfully navigated their two children through college. The Fords were quite fortunate: They had built up considerable savings to help pay for their children's education, which as their children neared college-age they invested in certificates of deposit with staggered maturities. But scholarships and attendance in public rather than private institutions held down the costs, and the Fords now have about $60,000 in CDs that recently matured.

With their children now fully on their own, and the money from the CDs available for investment, George and Nora felt that it was an opportune time to reassess the allocation of their savings.

Currently, both George and Nora are working, with a combined income of about $100,000, putting them in the 31% marginal tax bracket. They are both in their early 50s, and plan to keep working until at least age 65. Until recently, they did not contribute any of their pretax salaries to their employer retirement plans, preferring instead to add to their taxable savings to ensure they had savings for their children's education.

Nonetheless, employer contributions to their plans, as well as their own separate IRAs (rollovers from prior jobs) have allowed the Fords to build up some tax-deferred savings. The Fords' tax-deferred savings are currently invested in stocks, since the investments are long-term and growth-oriented. George enjoys investing in individual stocks, primarily small-caps, and does so through a self-directed IRA; Nora enjoys tennis, and her IRA is invested in a low-cost index fund. For their 401(k) plans, both of their employers offer limited selections from a family of mutual funds, and both George and Nora use roughly the same allocations for their employer contributions to their plans: two-thirds to the large-cap fund in the family, with the remaining split between the small-cap fund and the international fund.

The Fords' current savings is depicted in Table 1, which also provides their asset allocation based on their holdings.

Although the Fords have all of their tax-deferred money invested in the stock market, the large taxable portfolio investment in CDs has tilted their asset allocation more heavily toward fixed-income than they would currently prefer, since they no longer have any immediate spending needs. On the other hand, they do wish to maintain some commitment to fixed-income. For this reason, they decide to keep their current asset allocation as it is, but all future additions to their savings will be

Maria Crawford Scott is editor of the AAII Journal.

invested in stocks.

George and Nora started to examine fixed-income alternatives that would produce a somewhat higher return than their CDs. A long-term corporate bond would provide them with an annual interest payment of roughly 8%, but purchasing individual bonds on their own, they felt, would not provide them with sufficient diversification, and they therefore settled upon a long-term corporate bond fund.

It suddenly occurred to them, however, that from an aftertax standpoint, higher yields in their taxable portfolio would be counterproductive. Although they planned on increasing their pretax salary contributions to their 401(k) plans, which would lower their taxable income, their marginal rate would most likely not drop below 31%. A $60,000 investment in a bond fund that yielded roughly 8% would raise their income by $4,800, of which at least $1,488 would go to taxes, assuming a 31% tax bracket, and even more if state taxes were considered.

George and Nora briefly considered investing the money in municipal securities. However, the aftertax return to the Fords, in a 31% tax bracket, was not particularly appealing.

Their conclusion: From a tax standpoint, their fixed-income holdings would be better off in one of their tax-deferred portfo-

Table 1.
Reshuffling for Tax Efficiency

	Current Portfolio		Rearranged Tax-Efficient Portfolio	
	Holding	**Amount ($)**	**Holding**	**Amount ($)**
Taxable Savings				
	Maturing CDs	60,000	Individual Stocks (Small-Cap)	40,000
	Cash	20,000	Tax-Managed Index Fund	20,000
			Cash	20,000
Tax-Deferred Savings				
George's IRA				
	Individual Stocks (Small-Cap)	40,000	Corporate Bond Fund	40,000
Nora's IRA				
	Large-Cap Index Fund	20,000	Large-Cap Index Fund	20,000
George's 401(k) Plan				
	Large-Cap Stock Fund	33,000	Large-Cap Stock Fund	33,000
	Small-Cap Stock Fund	8,500	Small-Cap Stock Fund	8,500
	International Stock Fund	8,500	International Stock Fund	8,500
Nora's 401(k) Plan				
	Large-Cap Stock Fund	20,000	Corporate Bond Fund	20,000
	Small-Cap Stock Fund	5,000	Small-Cap Stock Fund	5,000
	International Stock Fund	5,000	International Stock Fund	5,000
	Total	**220,000**	**Total**	**220,000**
Asset Allocation		**(%)**		**(%)**
Cash		9		9
Fixed-Income		27		27
Stocks		64		64
	Total	**100**	**Total**	**100**
Stock Portion:				
Large-Cap		52		52
Small-Cap		38		38
International		10		10

lios. When they were saving for their children's education, this was not an option, since they needed access to their fixed-income assets. However, they no longer face that situation, and can easily put their taxable savings into a more tax-friendly investment. Their current cash holdings, they felt, would provide them with enough liquidity to meet any emergencies.

The Fords decided some reshuffling would be in order: They would shift $60,000 of their tax-deferred investments into a long-term corporate bond fund, and invest their maturing CDs in stocks that paid little or no dividends and that would be held long term, which would defer capital gains taxes.

George's $40,000 IRA is a prime candidate for reshuffling part of the $60,000 in taxable savings. First, none of his small-cap selections pay any dividends; second, George tends to hang on to his stocks long term, so capital gains taxes can be deferred; third, George has control over the timing of any sale, and can choose to offset gains with any losses.

Selling the stocks in George's IRA would not result in any taxes due, since it is a tax-deferred account. It would, however, incur transaction costs, as would the purchase of the stocks in the Fords' taxable portfolio. George calculates that the transaction costs would be roughly $800 ($40,000 × 2%—1% for the sale and 1% for the repurchase). On the other hand, if the Fords kept $40,000 of their taxable savings in a fixed-income fund, the annual tax bill would be $992; by reshuffling the $40,000, the first-year tax savings would pay for the transaction costs.

Reshuffling George's IRA, though, still leaves $20,000 of their taxable savings "unshuffled." George would prefer not to add to his individual stock holdings at this time, particularly since doing so would increase their current commitment to small-cap stocks, which already account for close to 40% of their stock portfolio. For the remaining $20,000, they would prefer to invest in a large-cap stock fund that produces low annual taxable income. They must be careful in their selection of a fund, however, since they do not want one that invests in high dividend-yielding stocks, nor do they want one that tends to buy and sell shares frequently and that could have high annual capital gains distributions. One option they are drawn to is an index fund, which has very little portfolio turnover; the primary annual distribution of such a fund would be dividends paid out by the larger cap holdings. George and Nora decide to take a closer look at several tax-managed index funds, which invest in larger companies but attempt to do so in such a way as to hold down taxable income. And the transaction cost of the shuffle, they feel, will be more than offset by the tax savings.

Which tax-deferred account should they shuffle around to accommodate this investment?

Nora has recently become a little concerned with the stock fund offered by her 401(k) plan; it hasn't had bad performance, but the fund recently changed objectives, and it doesn't fit quite as closely to their needs. The 401(k) plan does, however, have a corporate bond fund that she and George like quite well. For that reason, the Fords decide to shuffle Nora's 401(k) plan assets, investing in the corporate bond fund alternative.

The result of all this reshuffling is that Nora and George have retained the asset allocation of their savings portfolio, but by putting the investments with higher annual tax liabilities into their tax-deferred accounts, and investing taxable savings in investments with lower tax liabilities, they have increased their portfolio's tax efficiency.

And that will boost their aftertax return.

Tax Efficiency: The Bottom Line

The Fords' decision was made easier because they did not have to realize any taxable gains to reshuffle. As with any investment, the cost of any reshuffling must be balanced against the gains produced by reducing your tax bill. And, of course, liquidity needs can be difficult to predict, as the Fords discovered when they were setting aside taxable savings for their children's education.

Nonetheless, coordinating your tax-deferred accounts with your taxable savings is essentially a tax-planning decision that allocates holdings by taking tax exposure into consideration. Here are some points to keep in mind:

- Your first decision is your overall asset allocation for your entire savings portfolio.
- Next, your taxable savings must include all assets that are needed for liquidity, whether it be cash for short-term emergencies or for intermediate-term needs, as in the case of the Fords saving for their children's education.
- After liquidity needs are met, assets can be divided according to tax exposure, with high tax exposure investments allocated to the tax-deferred accounts, and low tax exposure investments allocated to the taxable accounts. If investments are re-allocated, make sure that you balance the costs, such as taxable gains or transaction costs, against future tax savings.
- Low tax exposure investments include: investments with low income and dividends, such as small-cap stocks or low dividend-paying medium and larger-cap stocks; investments where you can control the tax decision, such as the direct purchase of individual stocks and mutual funds with a history of low distributions and low portfolio turnover; and investments with built-in tax shelter advantages, such as municipal bonds.
- High tax-exposure investments include: investments with high income and dividend payments such as high dividend-paying stocks, fixed-income investments and fixed-income mutual funds, equity-income funds and balanced funds; investments where you cannot control the tax decision, such as high turnover stock funds; and investments with tax liabilities but no income, such as zero-coupon bonds.