ALTERNATIVE INCOME SOLUTIONS

Asset Location

In investment management, conventional wisdom and research suggest that ***Asset Allocation*** is the single largest contributor to long-term returns. It is important to note that a key factor has been omitted from these analyses: ***taxes***. When considering the effect of taxes, there is another factor of equal or greater importance: ***Asset Location***. We define ***Asset Location*** as selecting which investment vehicle an investor will use for each asset selected within the asset allocation.

At virtually all levels of income, long-term capital gains and qualified dividends enjoy tax advantages over passive income. Investors and their advisors need to look beyond asset allocation and emphasize ***Asset Location*** in determining the construct of an "optimal" investment portfolio.

Taxes have been ignored for a variety of reasons. First and foremost is uncertainty. None of us knows today with certainty what our marginal tax rate will be next year, and we certainly don't know what it may be in twenty years. This uncertainty exists because of potential policy changes and potential changes in the economic environment that may impact our earnings.

There is even less certainty as to what our tax rate will be at retirement. There is also no way for us to know what interest rates will be, what the long-term performance of the stock market will be or what our earnings and savings will be over the long-term. This has resulted in analyses that have been done largely from a pre-tax perspective, or with the assumption that we will have substantially lower tax rates in the future. If we consider taxes as a key factor and assume that we will be successful in accumulating wealth, then we can assume that taxes will likely be consequential.

The typical high net worth investor may have a wide variety of vehicles available for ***Asset Location***. These can include fully taxable accounts and tax-deferred accounts, including 401(k), IRA, rollover IRA, deferred compensation, Insurance, variable annuity, 529 and Keogh accounts. When ignoring or avoiding the impact of taxes, asset allocation is driven by the time frame for the investment. This has traditionally suggested that tax-deferred accounts be invested largely in equities, as the money won't be accessed for a long time and should therefore be invested in the asset that is assumed will provide the highest total return over the long-term, regardless of volatility.

This advice might be quite appropriate for people who save primarily through IRAs and 401(k)s, but if an investor has a larger and more diverse portfolio, then ***Asset Location*** becomes increasingly important.

Under the current tax code, the top marginal income tax rate is 37%. The top tax rate for capital gains and dividends is 20%. There is also a federal tax on investment income of 3.8% for high earners (the ACA Tax), so the net top marginal federal tax rate on coupon income is 40.8% and the net top marginal federal tax rate on long-term capital gains is 23.8% (excluding state and local tax rates, which differ substantially by state. But note, these rates would be roughly 54% and 37%, respectively if you are a high earner in California or New York City.)

These federal rates provide a distinct tax advantage for equities if they are held for more than 12 months or longer in a taxable account. If equities are held in a tax-deferred account, the investor will effectively achieve the conversion of tax advantaged returns into fully taxable returns (qualified distributions are taxed as ordinary income at your top marginal rate) at an uncertain future tax rate and date. An investor with means should seek to hold these tax-advantaged investments in a taxable account and hold primarily (if not exclusively) fully taxable securities in tax-deferred accounts.

Let's assume that an investor implemented a successful investment program in their twenties/thirties and has done sufficiently well that they will remain in one of the higher tax brackets at retirement. A focus on ***Asset Location*** would have resulted in investing tax-deferred monies in income-generating assets and investing taxable monies in equities and other tax advantaged investments including municipal bonds and real estate.

The taxation of equities is complex relative to income, but generally lower. Capital gains are only taxable when a stock is sold and then they are taxed preferentially if held for the long-term (greater than 12 months). If this investor had acquired a portfolio of high-quality stocks, it is conceivable that sales would have been minimal over the years and capital gains taxes could have been deferred or even avoided entirely, if held until death.

Dividends would have been taxed at a preferred rate that is generally lower than the rate for passive income (this preferred tax rate for dividends has come and gone over the years but is currently in place: 20% for high earners plus the ACA tax for a total tax of 23.8%). If this same investor had focused on ***Asset Location*** and used tax deferred accounts to buy bonds (and other fully taxable, income-oriented investments) across the risk spectrum over the entirety of their working life, they could have better optimized their investment program to minimize taxation and enhance wealth.

	Fully Taxable	Tax-Deferred
Bonds		
Income	40.8%	37.0%
Gains	23.8%	37.0%
Stocks		
Dividends	23.8%	37.0%
Capital Gains	23.8%	37.0%

The simple conclusion is that most investment earnings are taxed at lower rates than earned income. The one exception is coupon or investment income, which is taxed at a higher rate when earned in a taxable account.

The conclusion?

Income oriented investment should be the investment of choice in tax-deferred vehicles.

The Default Option

Target date funds or similarly constructed portfolios are increasingly becoming the default investment vehicle for 401(k) and IRA plans. Even more sophisticated approaches seek to achieve the same objective: de-risking with time. To accomplish this goal, these products tend to be heavily weighted toward equities in the early years and increasingly balanced as the target date approaches. This reflects the equity bias inherent in these strategies. When liquidated, the cumulative contributions, income, gains and dividends are all taxed at the investor's top marginal tax rate at the time of distribution. It is impossible to know in advance what rate this will be.

What we *do know* is that all distributions will be taxed as ordinary income at the time of distribution and the investor will have effectively eliminated the tax advantages associated with long-term capital gains and dividends.

Sample Asset Allocation of Target Date Funds

Age	25	45	60
Years to Retirement	40	20	5
Stocks	90%	80%	65%
Bonds	10%	20%	35%

If clients can save outside of these vehicles in fully taxable accounts, then financial professionals might propose a dramatically different construct for a tax-deferred portfolio. Within a tax-deferred vehicle allocations should seek to minimize equities and maximize assets that generate income and short-term capital gains.

These vehicles might be largely populated with diversified portfolios of bonds, equity securities that pay non-qualified dividends, private debt and alpha generating strategies that rely on active trading and high turnover which can generate a substantial portion of the return through short-term capital gains. Other than bonds, few of these strategies are typically found in corporations 401(k) offerings and few advisors recommend these strategies in other tax-deferred accounts.

Likewise, these strategies should also be the go-to asset in variable annuity and insurance contracts as they typically have substantially lower volatility and can provide a reliable source of accretive income.

Asset Location

At all levels of income, long-term capital gains and qualified dividends enjoy a substantial tax advantage over earned income. As we would rarely recommend that municipal bonds be used in a tax-deferred account, we suggest that fully taxable assets should be held in tax-deferred vehicles. Other assets that enjoy some degree of preferential tax treatment should be held in taxable accounts to derive the greatest benefit and achieve the highest long-term after-tax return.

Investors and their advisors should look beyond asset allocation and emphasize ***Asset Location*** in determining the construct of an investment portfolio. Tax-deferred vehicles are a great tool for savings. Optimizing ***Asset Location*** can greatly enhance tax efficiency and enhance long-term wealth accumulation.

About Alternative Income Solutions, LLC (AIS)

AIS engineers and delivers diversified portfolios of specialty finance and income producing opportunities. Our strategies provide solutions and meaningful income for accredited investors and their financial advisors. We seek to achieve this through targeted portfolios of investment strategies and opportunities with three common characteristics:

- ***Significant income***
- ***Low correlation to major market indices***
- ***Low risk of permanent loss of capital***

The founding partners **Don Plotsky and Andrew Saunders** have spent careers, respectively, in fixed income and alternative investments covering specialty finance and alternative income strategies. Our experience allows us to access opportunities typically reserved for large institutions, often at a lower fee structure, creating opportunities for AIS to improve client outcomes by reorienting a portion of the portfolio to income producing opportunities.

Further information including additional thought pieces and video interviews can be found at www.alt-incomesolutions.com.

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