



CESTNICK

TAX MATTERS

Guaranteed returns easy as finding 'tax alpha'

I had lunch with my good friend Rob this week. We were talking about his work, and then the conversation turned to his investments. “Tim, I’m beginning to think that the firm managing my money is a lot like my employer.”

“In what way?” I asked.

“Well, at the office, any connection between my salary and my hours of work is purely coincidental,” he said with a laugh. “And with my money manager, any connection between my investment performance and my portfolio is also purely coincidental.”

Alpha and beta

As it turns out, Rob has not been convinced that the firm managing his money is adding any value. “Tim, any increase in my portfolio is an increase I probably could have achieved by simply investing passively in an exchange traded fund (ETF) or index fund,” he explained.

“You’re talking about alpha and beta,” I replied.

“I’m not sure I understand,” Rob said.

“Well, without boring you with the technical details of the capital asset pricing model – which I guarantee will put you to sleep – let me over-simplify it by saying this: Beta is the return you can expect simply from being invested in the stock market. Owning ETFs is a low-cost way to achieve those returns – that is, to ‘get beta.’ Alpha is the return a money manager provides over and above what the market itself provides. It’s what you pay the money manager for. If the manager isn’t going to add value, or ‘alpha,’ you’d be better off simply investing passively using ETFs or index funds.”

I continued, “Rob, there are three things you should recognize. First, there’s no single money manager that is

best at everything. One of your problems is that you’re using a single money manager. A portfolio built with multiple managers makes more sense, as long as you know how to knit those managers together. You don’t want the managers to be too correlated with each other so that their portfolios all look the same and behave the same; that’s not diversification.

“Second, you have to be able to judge which managers are truly adding value – that is, alpha. This is partly number crunching, and partly qualitative research. It’s an art as much as it is a science. But doing this research, or finding someone to do it for you is very important. This is your financial well-being we’re talking about – don’t leave it to chance.

“Now, one last point. You should take advantage of something that is going to provide you with guaranteed alpha,” I said.

“Is there such thing as ‘guaranteed’ alpha?” Rob asked.

“I’m talking about a different type of alpha than what your money manager might provide by his good stock picks,” I replied. “I’m talking about ‘tax alpha.’”

I then spent the next hour talking with Rob about “tax alpha”. Let me share the highlights with you as well.

Tax Alpha

You see, tax alpha is the additional after-tax return you can add to your portfolio by taking steps to minimize the tax burden on your portfolio. Unlike traditional alpha which is added by a manager’s skill at selecting the right securities, tax alpha can be added by structuring your investments to take advantage of our tax law. If the law says you’ll pay less tax on portfolio “A” than portfolio “B”, then portfolio “A” will have a higher after-tax rate of return. That additional return is known as tax alpha. And it’s as guaranteed as you can get. Unless the tax law changes in the short term to cause more tax on your portfolio, you can count on those additional returns to be there. Unlike traditional alpha that can be measured only after the fact, you can actually quantify tax alpha – that is, the expected higher after-tax returns – ahead of time. And let’s face it, after-tax returns are the only returns you can spend or reinvest.

The questions

All of this raises a few questions. How much value can be added to your returns annually? Is it really worth the time and effort? Is it worth paying someone to help with this? And more importantly, what strategies can be utilized to actually create this tax alpha we've been talking about? I'll discuss this next week.

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