Tax Cost Ratio | White paper

Creating Alpha through asset location

Tax Cost Ratio[1]

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% returns lost

The value of an investment advisor's advice is often diluted by taxes. Over the past two decades Morningstar has quantified this effect, providing a Tax Cost Ratio[1] that measures how much a fund's annualized return is reduced by the taxes investors must pay on the fund's distributions.

For example, according to Morningstar Direct, between November of 2018 and October of 2023, the Fidelity® Contrafund® provided an average annual return of 9.99% (after factoring investment management fees). During that same period, the average annual Tax Cost Ratio for the Fidelity Contrafund was 1.95%. In essence, investors lost 1.95% of their return to taxes each year, reducing the fund's average annual after tax return to 8.04%.

If you could eliminate or reduce the tax cost, you could create immediate Tax Alpha[2] for your clients.

[1] **Tax Cost Ratio:** Like an expense ratio, the Tax Cost Ratio is a measure of how one factor can have a negative impact on performance. Also like an expense ratio, it is usually concentrated in the range of 0-5%, with 0% indicating that the fund had no taxable distributions and 5% indicating that the fund was less tax efficient.

The Tax Cost Ratio provides information that is not available from after-tax returns alone.

- Based on SEC's guidance, after-tax returns reflect both tax effects and sales loads. The tax cost ratio isolates the effects of just taxes.
- Different categories of funds and different time periods will have varying levels of pre- and after-tax returns. The tax cost ratio is independent of the level of the return and is always expressed on an annualized basis. That's why it can be used to compare different funds, categories, managers, and time periods. For example, you can compare the 3-year and 10-year Tax Cost Ratios for the same fund to see if the manager has become more adept at managing tax issues in recent years.

Note: The Tax Cost Ratio does not take into account taxes on unrealized gains when the shares are sold.

[2] **Tax Alpha:** The potential value created by the effective tax management of investments. For example, reducing the amount of tax drag, thereby potentially increasing the ultimate ending value of a portfolio.

Managing taxes through qualified plan investment

You could defer or eliminate your client's taxes through qualified plan investing. However, the amount that can be invested in qualified plans is limited.

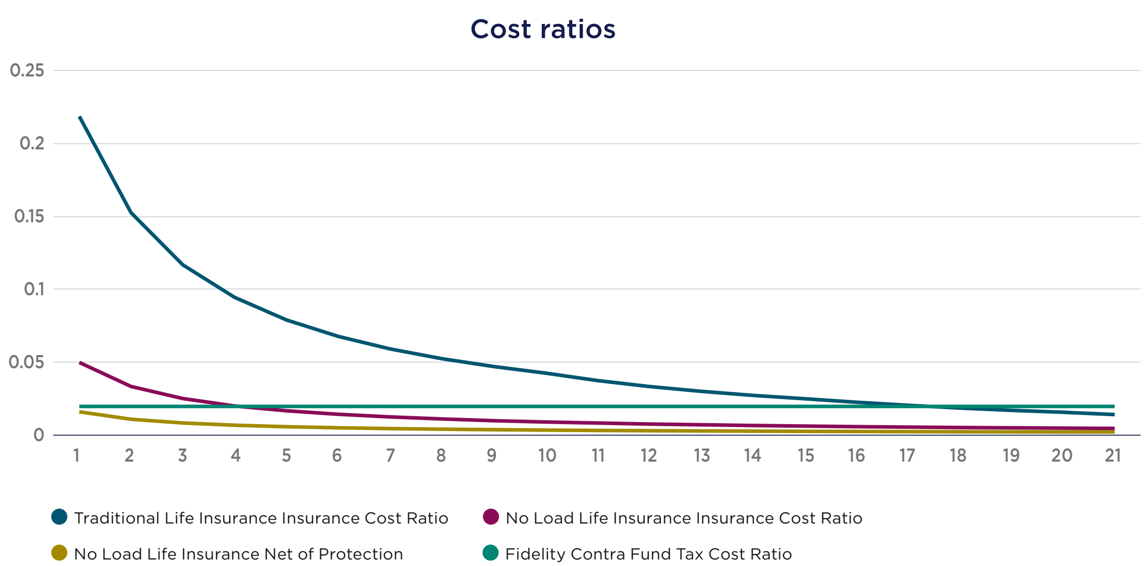
Managing taxes through insurance solutions

A properly designed life insurance policy could give your client control of their tax liability. Of course, there is a cost associated with insurance solutions. To generate Alpha, the Insurance Cost Ratio[3] would have to be less than the Tax Cost Ratio.

Traditional life insurance has frequently been presented as an accumulation alternative to taxable investing. Unfortunately, the sales loads and surrender charges associated with traditional life insurance leave these products with an Insurance Cost Ratio that may not outperform a mutual fund's Tax Cost Ratio for 20 years or more.

No-load insurance products are currently offered with an Insurance Cost Ratio that may fall below a mutual fund's Tax Cost Ratio within 5 years, accompanied with additional material advantages thereafter. This could mean significant tax savings and a dramatic increase in the assets managed by the advisor.

For example, using the Nationwide Advisory Variable Universal Life product could yield an average annual Insurance Cost Ratio of less than .4% in contrast to the 1.95% Tax Cut Ratio of the Fidelity Contrafund. If a client has a protection need, life insurance could provide even more immediate benefits. Basically, the cost of the term insurance should be viewed as a sunk cost that reduces the client's available investment funds. By redirecting that sunk cost toward options such as a Nationwide Advisory VUL, the Insurance Cost Ratio could be less than the Tax Cost Ratio in year 1.



[3] **Insurance Cost Ratio:** The rate of return of the funds inside the life insurance policy, after investment management fees and before any M & E or low-cost fund fees, minus the IRR on the CSV of the life insurance policy.

Henry: A Case Study

Let's translate those strategies into real dollars for a representative client. Take Henry. He is 45 years old, makes over $500,000 a year, and is in reasonably good health. He would like to invest $50,000 a year for his retirement. He also has about $1,000,000 of life insurance through his employer that costs him about $1,500 a year.

Scenario 1

Henry could take the net amount ($48,500) and invest it in a taxable brokerage account. In the early years, the taxes would be relatively insignificant (about $950[4] in year 1 using Fidelity Contrafund's historical averages as an example). Assuming he pays for those taxes out of pocket, instead of withdrawing from the taxable account, the amount Henry would have to invest the following year would be noticeably reduced. At age 65, he would have paid over $40,000 in taxes and would only have around $9,000 to invest for his retirement.

After retirement:

In a taxable account, when securities are sold, unrealized gains are realized — and may be subject to capital gains taxes. If Henry sells shares to supplement his retirement, the taxes from that liquidation would not have been factored into the fund's Tax Cost Ratio. To pay those taxes, Henry will have to "gross up" the withdrawals from his taxable account. Those larger withdrawals will accelerate the depletion of his account.

[4] **Taxes in Year 1:** 1.95% x $48,500 = $945.75

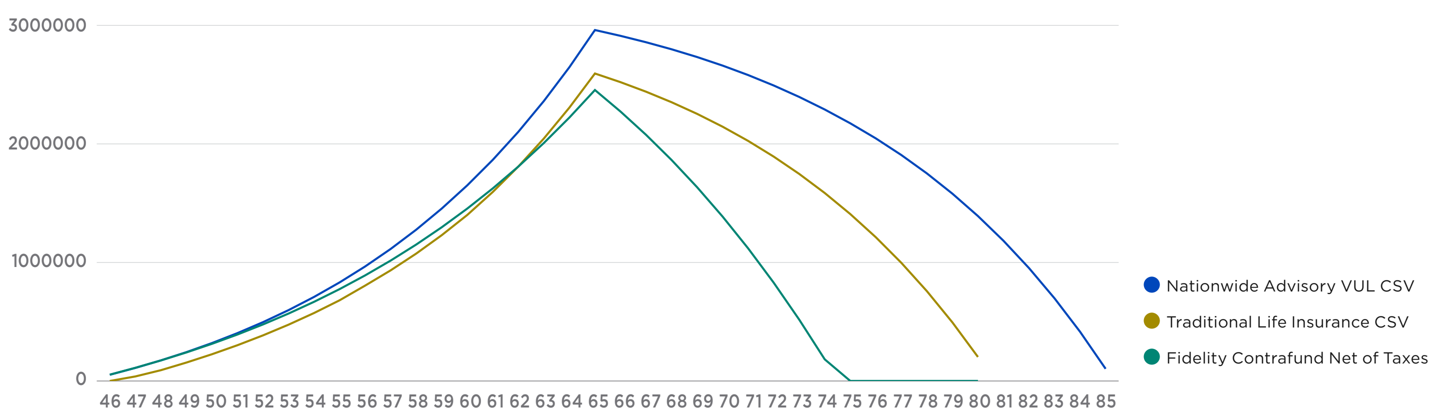
Scenario 2

If Henry replaced the group term life insurance from his employer with the Nationwide Advisory VUL product, Henry could invest the full amount he intended (after paying for the protection cost and state premium taxes) in a Fidelity Contrafund inside the life insurance. According to Morningstar Direct, Fidelity VIP Contrafund Service 2 had an average annual return, after investment management fees, of 9.94% between November 2018 and October 2023. This means that Henry could eliminate the tax bill on the Fidelity Contrafund and have more assets to put under the advisor's management. In fact, by age 65, Henry would have an additional $400,000 inside the insurance.

After retirement:

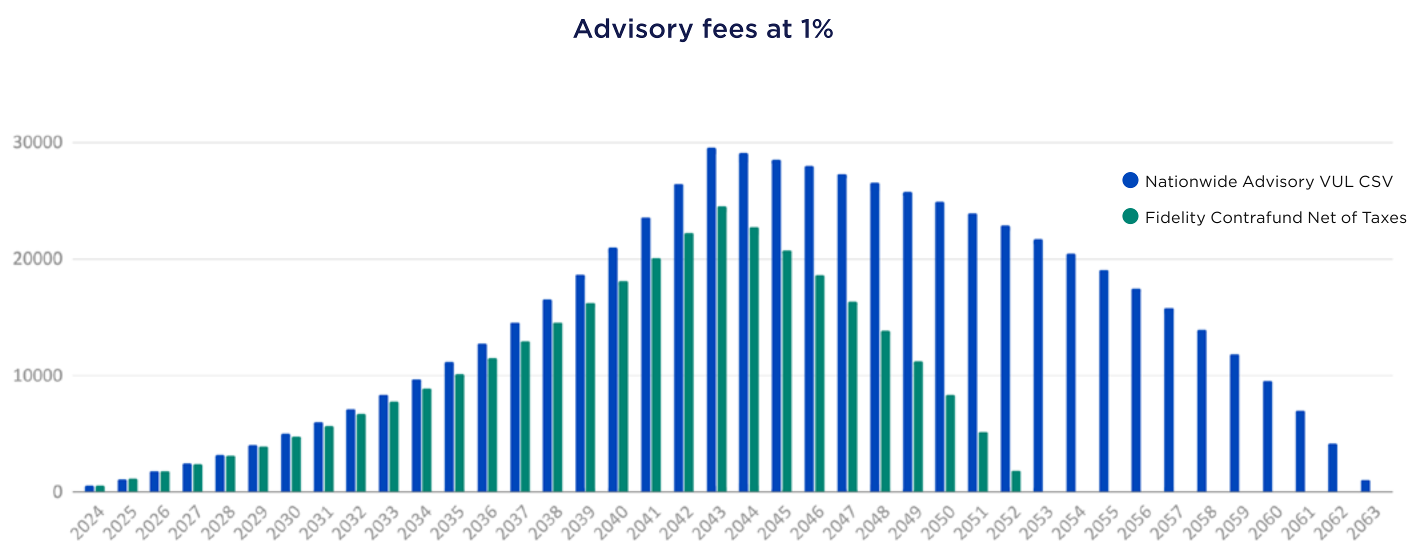
With a properly structured life insurance policy, Henry could withdraw basis and then borrow against any gains tax-free. By relocating his Fidelity Contrafund investment into a Nationwide Advisory VUL, his money could last 11 years longer after he starts tapping into it to supplement his retirement. In fact, Henry could get over $3,200,000 ($6,150,000 vs. $2,950,000) more out of the insurance than he would from having invested in a taxable account. The total insurance cost would be just over $100,000 while the taxes on realized gains would have amounted to over $550,000.

Account value



What's that additional alpha/value worth?

With a 1% advisor fee, about $285,000.



Key takeaways

Be aware of mutual funds and ETF's Tax Cost Ratio.

If the cost of an alternative location is less than the Tax Cost Ratio, explore the alternative location for that part of the asset allocation.

To learn more about generating after-tax Alpha for your clients, contact your Nationwide wholesaler or visit **nationwideadvisory.com**

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Morningstar calculates the Tax Cost Ratio on a monthly basis, using load-adjusted and tax-adjusted returns for different time periods. Morningstar uses the tax-adjusted return that is called "pre-liquidation after-tax return," which is also known as "return after taxes on distributions." Morningstar calculates this statistic for open-end mutual funds, exchange-traded funds, and variable annuity underlying funds based in the United States.

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