New York Times,
STRATEGIES
December 17, 2000

In Asset Allocation, Think Location, Location, Location

By MARK HULBERT

VIRTUALLY all financial planners say asset allocation is the most important determinant of wealth in retirement. It is far more important, they say, how you divide your portfolio among stocks, bonds and other categories than how you invest within them. But new research points to an additional decision that also greatly effects retirement wealth, even if it attracts little interest from planners. It is called "asset location": choosing the asset classes that should be in tax-deferred accounts and those that should be in taxable ones.

Financial planners tend to ignore asset location for two reasons. First, until recently, few investors had much money in both taxable and tax-deferred accounts. But with an estimated 30 million investors now having 401(k) plans and millions more in I.R.A.'s, many people now have substantial assets in both categories.

Second, many planners have been taught that if you must choose assets for a tax-deferred account, you should favor bonds. Bonds pay taxable interest that a retirement account can shield, the logic goes, while most of the gains from stocks are not taxable until they are sold.

But a new study has found that this conventional wisdom, known as "defer bonds first," is rarely good advice. The research was conducted by three economics professors — James Poterba of the Massachusetts Institute of Technology and John B. Shoven and Clemens Sialm of Stanford. A summary is available free at http://papers.nber.org/papers/w7991; the full study costs $5. The study says the conventional advice ignores the high taxes generated by the typical stock fund and the availability of tax-exempt municipal bonds for the fixed-income part of a portfolio.

Most investors in tax-deferred accounts buy stocks through mutual funds, not individually. The typical stock fund pays enough in dividends and, more important, trades so often that the after-tax return of the average domestic stock fund is nearly 20 percent below its pretax return, according to Mr. Poterba. So favoring stock funds in a retirement account can pay off in tax savings. Moreover, municipal bonds allow investors to avoid taxes on the fixed-income portion of their portfolios, even in their taxable accounts. Most investors can earn just as much from municipal bonds as they do after paying taxes on their taxable bonds. Consider the Vanguard Long-Term Bond Index fund. It now yields 6.66 percent — the equivalent of 4.60 percent after taxes, assuming a federal rate of 31 percent. By contrast, the Vanguard Long-Term Tax-Exempt fund carries a yield of 5.04 percent.

For many investors, then, the rational course is to favor equities in tax-deferred accounts — to defer stocks first. That means, for example, putting one's annual 401(k) contribution into a stock fund, and saving any bond investments for taxable accounts. And to the extent that investment ceilings on retirement accounts keep some bonds or bond funds out of tax-deferred accounts and in taxable ones, investors should buy tax-exempt bonds instead.

What price have investors paid over the years by putting bonds into their retirement accounts? Mr. Poterba and his colleagues calculated an answer by following two imaginary investors over 37 years — 1962 through 1998. Both divided their assets equally between equities and bonds, both invested their equity portion in the average stock fund, and both invested $1,000 annually, in 1998 dollars. But one investor first deferred bonds, while the other first deferred stocks. By the end of 1998, the investor who favored bonds was worth $83,010, after taxes, while the one who favored stocks was worth $90,290 — or 8.8 percent more. The only exception occurred when their equity money was invested in stock index funds, which incur relatively few taxes because they seldom trade. But even then, the strategy of emphasizing stocks in retirement accounts fared about as well as the conventional, reverse approach. By deferring stocks first, then, you should be no worse off at retirement than if you defer bonds first, and you are likely to be much wealthier. That is a bet worth taking.