Don't Let the Tax Tail Wag the Dog

When Avoiding a Tax Bill Becomes the Most Expensive Decision in the Portfolio

Strategic Planning Series
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*With this letter we are launching the Strategic Planning Series, a companion to our Market Updates. This series examines topics and questions that cut across nearly every household we serve, regardless of portfolio size or strategy. We begin with one of the most commonly misunderstood topics we encounter: **taxes**.*

What Wall Street Gets Right

Ask almost any advisor about taxes and you will hear a well-rehearsed and largely correct answer. Taxes are the single largest recurring drag on the returns of a taxable account, larger than fees for most investors, and unlike market returns they are partially within our control. So, the industry has built an entire discipline around minimizing them.

The playbook is familiar:

Defer Until Gains are Long Term: Hold positions longer than a year so that gains are taxed at long-term rather than ordinary income rates.

Tax Loss Harvesting: Harvest losses when markets fall, using realized losses to offset realized gains elsewhere in the portfolio and, within limits, ordinary income.

Asset Location: Put tax-inefficient assets like corporate bonds, REITs, and high-turnover strategies inside IRAs and 401(k)s, and hold tax-efficient assets in taxable accounts.

Use Tax Efficient Tools: Favor exchange-traded funds and separately managed accounts over traditional mutual funds, which can distribute capital gains to shareholders who never sold a share.

Tax Efficient Gifting: Give appreciated shares rather than cash to charity or to a donor-advised fund and let the embedded gain disappear rather than be paid. Where appropriate, let low-basis positions pass through an estate and receive a step-up in basis.

All of this is sound. Done consistently, these techniques can add a meaningful increment to after-tax returns over a lifetime, and we incorporate these techniques where appropriate based on individual client circumstances. Tax-loss harvesting and tax-aware rebalancing are standing protocols for our investment process throughout the year, not an afterthought in December.

But notice what the playbook quietly assumes...

The Hidden Assumption

Every one of those techniques assumes the portfolio you own today is the portfolio you should own tomorrow.

Deferral is the animating principle. Defer the gain, compound the deferred tax, and let time do the rest. The math works beautifully, but only on the condition that the assets you are deferring on remain the right assets to own going forward.

That is not a small assumption.

Tax-efficiency advice is, in effect, advice about *how* to hold a portfolio. It has almost nothing to say about *whether* you should still be holding it.

And markets do not oblige us by staying the same forever. Yesterday's winning strategy is not always right for the world of tomorrow.

When the Map Changes

Most of what happens in markets is noise. Our process is deliberately methodical as markets remain in the same secular regime for long stretches of time, but, on occasion, something more fundamental changes: the market leadership changes, economic policy shifts, monetary policy shifts, market behavior changes, etc.

When the markets change materially, it may be appropriate to reassess your portfolio as well.

Consider these examples:

The Secular Bond Bull Market, 1981-2020. In September 1981, the yield on the 10-year U.S. Treasury reached 15.74%. Over the next thirty-nine years it fell to 0.53% by July 2020. Because bond prices rise as yields fall, that four-decade descent handed bondholders a tailwind that no bondholder had ever enjoyed before: a generation of investors watched high-quality bonds deliver something close to equity-like returns with a fraction of the volatility.

This was part of the empirical bedrock beneath traditional asset allocation advice suggesting holding stocks and bonds to improve risk and returns. That bedrock has been eroding for years.

The arithmetic is unforgiving. Vanguard's Total Bond Market Index Fund (VBMFX), a reasonable proxy for the core bond allocation in a diversified portfolio, compounded at roughly 7.6% annually from its December 1986 inception through the end of 2003. From January 2010 through today, that same fund has compounded at roughly 2.4% annually, and since the start of 2021 it has returned slightly *less than zero*. Same fund. Same strategy. Same theory. A different world. A different secular regime.

Source: FRED (10-year Treasury constant maturity); VBMFX total returns via adjusted closing prices. Data through July 2026.

The Nifty Fifty, 1972. In the late 1960s and early 1970s, institutional investors converged on a group of roughly fifty large-cap growth companies - IBM, Xerox, Polaroid, Coca-Cola, Disney, McDonald's, Merck, Johnson & Johnson - known as the Nifty Fifty. They were called "one-decision" stocks, because the only decision required was to buy them; you were never supposed to sell. They were the best businesses in America, with genuine earnings growth and dominant competitive positions. The bubble was not in the companies; it was in the price.

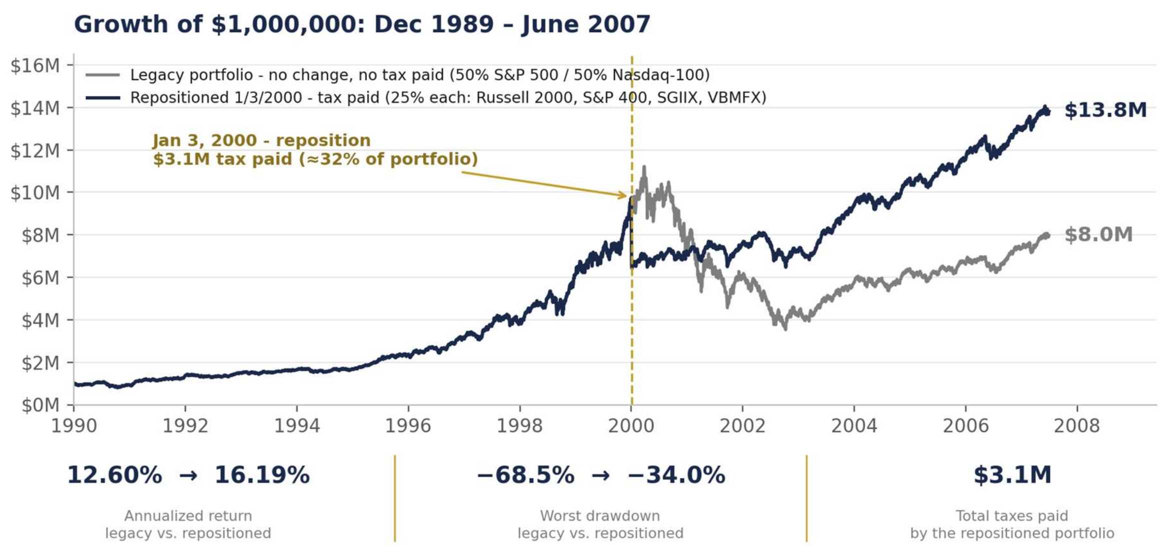
At the December 1972 peak, the group traded at an average of 41.9 times earnings against 18.9 times for the S&P 500. Over the following five years from 1973 through 1977, the S&P 500 returned roughly +2.5% annually;

the Nifty Fifty returned roughly **−4.4%** annually. Most of the group went on to lag the broad market into the early 1980s.[1,2] *Because no official list of the fifty names ever existed, published figures for the group vary by source and should be treated as approximate. See the references and disclosures at the end of this letter.*

The Dot-Com Peak, 2000. The technology and telecom names that had produced extraordinary gains through the late 1990s - and therefore carried the largest embedded gains in every taxable account in America - were precisely the positions that led the subsequent decline. The Nasdaq Composite took roughly fifteen years to reclaim its March 2000 level. Over that same stretch, the assets that had been unloved and cheap in 2000 - value stocks, small caps, mid caps, and bonds - delivered a very different decade.

Consider this deliberately exaggerated illustration: an investor begins with $1,000,000 at the end of December 1989, invested 50% in the S&P 500 and 50% in the Nasdaq-100 - exactly the right portfolio for the decade that followed. By January 3, 2000, that $1,000,000 has grown to roughly $9.8 million.

Now the investor faces the decision this letter is about: repositioning into a portfolio built for the world after the bubble - 25% each in the Russell 2000, the S&P MidCap 400, an international equity fund (SGIIX), and a core bond fund (VBMFX) - means liquidating the entire legacy position. The tax bill is roughly **$3.1 million, about 32% of the portfolio's entire value**. It is exactly the kind of number that stops the conversation.



Hypothetical illustration. Index returns are price-based, do not reflect fees or expenses, and are not investment recommendations. Tax assumes a 23.8% federal (incl. NIIT) plus 11.7% state rate applied to the full embedded gain at 1/3/2000. Indices are unmanaged and cannot be invested in directly. The following example is a hypothetical illustration created with the benefit of hindsight and is intended solely to demonstrate the potential relationship between taxes and long-term investment outcomes. The illustration does not represent any actual client account, does not reflect portfolio management decisions that could reasonably have been made in real time, and should not be viewed as evidence that future market transitions can be identified in advance.

Our advice in this hypothetical example; pay it anyway. Through June 2007, the untouched legacy portfolio grows to **$7,972,893** - an annualized return of 12.60% and a peak-to-trough drawdown of 68.5%. The repositioned portfolio, having handed over more than $3.1 million to the government, grows to **$13,814,225** - an annualized return of 16.19% and a maximum drawdown of 34.0%. Paying $3.1 million in taxes produced $5.8 million more wealth with roughly half the pain because the forward returns on either side of that secular change were wildly different.

No one, of course, sells everything on a single January morning, and no real portfolio change is that stark. The point of the illustration is that a tax bill equal to a third of the portfolio, the largest imaginable objection to changing course, was not remotely large enough to make holding the wrong portfolio the better decision.

There are many examples of this throughout history. Large-cap leadership has repeatedly given way to small caps and back again; growth's dominance in the late 1990s yielded to a decade in which value led decisively; U.S. equities trailed international and emerging markets through most of the 2000s before overwhelming them for the fifteen years that followed. Each of these turns rewarded the investor willing to change and punished the one who could not.

The pattern is uncomfortable, and it is consistent: the positions with the largest embedded gains at the end of a regime are, disproportionately, the positions least likely to lead the regime that follows. The gain is evidence of yesterday's success, not of tomorrow's.

The Trap

Put those two ideas together and the trap becomes visible.

An investor holds a position that has done very well. It is now the single largest position in the portfolio, it carries an enormous embedded gain, and the environment that produced its returns is quietly shifting. Selling it means writing a check to the IRS: a real, immediate, quantifiable, painful check. Holding it costs nothing today. So, the investor holds.

This is the **tax tail wagging the dog**. And the asymmetry that makes it so seductive is that the cost of selling is certain, visible, and denominated in dollars, while the cost of holding is uncertain, invisible, and denominated in returns that never happen. Human beings are not built to weigh those evenly. We are built to avoid the check. And, there is no rebate for the taxes you successfully avoided on money you subsequently lost.

How We Think About It

We hold two ideas at once, and we do not let either one crowd out the other.

The first is that taxes are a real cost and we manage them relentlessly. We harvest losses when markets give us the opportunity. We execute tax-aware swaps that preserve exposure while realizing losses. We use appreciated shares for charitable giving. We stage large repositioning over multiple tax years when the situation permits, and we coordinate sales with low-income years, retirement transitions, state-of-residence changes, and estate planning. Nothing in this letter should be read as indifference to the tax costs of portfolio changes.

The second is that taxes are a *cost*, not a *constraint*. A cost is something you weigh against a benefit. A constraint is something that decides for you. When our Three Pillars framework signals that the regime has changed - that the economy, monetary policy, and market conditions together no longer support the portfolio we own – our response is to change the portfolio and manage the tax consequence as intelligently as possible. It is not to keep the portfolio because changing it is expensive.

One practical point deserves to be stated plainly, because we do not think we have communicated it well in the past. **We expect client portfolios to pay the taxes those portfolios generate.** Every financial plan we build for you already embeds that assumption: when a gain is realized inside an account, the tax on that gain is funded from that account. In the real world this is never as tidy as it looks in a plan - there are years when outside cash flow covers it, years when a distribution is already scheduled, and years when it simply comes off the top of the portfolio. But the assumption underneath the plan is consistent, and it is the right one: a portfolio that generates gains should also fund the cost of realizing them.

What This Means for You

We are not writing this to alarm anyone about an impending tax bill. We are writing it to be proactive.

Many of you have now invested with us for a decade or two, and the embedded gains in your taxable accounts are, appropriately, very large. That is what success looks like. At the same time, we see real potential for further secular change in the investment landscape ahead - and we would rather have this conversation ***before*** it is required than after.

In truth, we have already been acting on it. Over the last several years we have changed the composition of our stock portfolios, changed the composition of the equities held inside our diversified portfolios, and shifted meaningful assets into liquid alternative strategies to replace stagnant bond investments - the subject of our earlier letter on the Alternative Allocation. None of these were arbitrary. Each was driven by our **Three Pillars** investment process as the landscape shifted following the unprecedented policy response to the COVID pandemic and the lingering effects that remain with us today.

This Summer, we will follow up with each of you individually to review two things: your **tax summary**, which appears at the back of every monthly portfolio update, and the **tax budget** we have proactively established for every single client portfolio. Every situation is unique. Different savings plans and different distribution plans create very different potential tax impacts, and we will walk you through exactly what yours looks like.

If you have any questions, please reach out and we will set up a deeper conversation.

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REFERENCES

1. Siegel, Jeremy J. "Valuing Growth Stocks: Revisiting the Nifty Fifty." Financial Analysts Journal, 1998. Source for the December 1972 peak valuations (41.9x earnings for the Nifty Fifty vs. 18.9x for the S&P 500) and for the finding that, measured from that peak through August 1998, the group compounded at 12.2% annually versus 12.7% for the S&P 500.
2. Bridgeway Capital Management. "Party Like It's 1972: What Can the Nifty Fifty Teach Us About Today's Market?" Analysis of CRSP and Compustat data. Source for the 1973 and 1974 annual returns and the 1973–1977 annualized return figures for the Nifty Fifty and the S&P 500.

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