Less is More

The majority of news and numbers published about investments relate to pre-tax returns, and understandably so, given the complexity of tax regulations and differences in tax circumstances from person to person. A fair amount of press also focuses on the impact of portfolio turnover, adding trading expenses and highlighting the difficulty of making profitable short-term trading decisions. Reference is usually made to a heightened tax impact from more frequent trading, but often without providing any numbers for context. What is the impact of portfolio turnover to after-tax returns in an equity portfolio?

Consider a Canadian individual with a 45% marginal tax rate and $100,000 stock portfolio. Let's assume that the portfolio earns 7% per year, with 2% coming from dividends and 5% from stock market gains. Under the Canadian tax code the dividend gains each year are taxed at the marginal rate, after being grossed up and then accounting for a tax credit. Realized capital gains, on the other hand, vary with the level of turnover, with half of the gains each year subject to tax at the marginal rate. The table below shows the impact of different trading levels over the course of 20 years to our $100,000 account. Even with an entirely hands-off approach, the posted 7.00% rate of return is reduced to 6.33% by virtue of dividend taxation each year. A more proactive investor, turning over half of the portfolio each year, will pay enough in capital gains taxes each year to reduce this to 5.77%, and an investor trading the entirety of the account every twelve months shaves just over a full percent from their after-tax returns by virtue of realizing the entirety of capital gains.

$100,000 Portfolio Over 20 Years

Turnover Rate	Ending Value	After-Tax Rate of Return
0%	$341,294	6.33%
20%	$327,137	6.11%
50%	$306,942	5.77%
80%	$287,936	5.43%
100%	$275,892	5.21%

According to industry group Morningstar, a typical mutual fund in the United States exhibits turnover of 130% annually, and not surprisingly, estimates for the tax burden on rates of return for mutual funds owned outside of tax-deferred accounts align with our simple table above. Guardian Funds typically run substantially lower, with more concentrated portfolios having higher conviction positions, helping reduce the impact. It should be stressed that it is key to not let tax issues become the primary guiding force behind investment decisions, as the returns from security selection and asset allocation are potentially much larger than the "tax drag" created by portfolio turnover alone. That said, this is an era where many market participants are actively switching between investment vehicles offering incremental savings measured in basis points. In this context, investors should be mindful that lower turnover in their portfolio can translate to better after-tax returns, where less can often equate to more.