



How You Can Employ a Deft Tax-Efficient Strategy

Fund distributions can undermine returns for taxable investors.

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KEY INSIGHTS

- A long-term horizon, low portfolio turnover, and tax loss harvesting are essential elements to minimize the impact of taxes on an investment portfolio.
- In-depth research and a growth-oriented investment approach can help to build a portfolio of high-quality companies with durable growth potential.
- An investment strategy that includes appropriate asset allocation and asset location can help minimize an investor's tax bill.



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Mutual funds provide investors a convenient, low-cost approach to creating a professionally managed, well-diversified portfolio. At the same time, taxable investors must pay taxes on the dividend and capital gain distributions that both equity and bond funds may make each year, based on the interest and dividends they earn on their investments and any capital gains realized from the sale of securities.

Some funds may be able to avoid or minimize capital gain distributions if they are carrying losses on sales of securities in prior years that can be used to offset gains earned in current or future years (also known as tax loss carryforward). And a mutual fund's tax efficiency is less relevant when it is held in a tax-advantaged account, such as an individual retirement account (IRA) or a 401(k) plan, since taxes on distributions are deferred until the money is withdrawn in later years.

For investors holding funds in taxable accounts, however, taxes on dividends and capital gain distributions can pose a significant drag on returns. So it's important for taxable investors to be cognizant of the tax implications in managing their portfolio.

An analysis by Morningstar shows that, on average, tax payments on distributions trimmed the average annual return for large-cap growth funds by more than two percentage points over the one-, three-, and five-year periods ended December 31, 2018. (This is known as the "tax cost ratio," which measures how much a portfolio's annualized return is reduced by taxes investors pay on distributions, based on the highest income and capital gains tax rate in effect at the time of the distribution.)

For some, that potential reduction in return may seem like a small price to pay over shorter time periods, but it can produce an enormous difference when compounded over long time periods. (It is important to note, however, that

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(Fig. 1) Low Turnover Can Improve Tax Efficiency

Annual Portfolio Turnover Rates
As of December 31, 2018

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
T. Rowe Price Tax-Efficient Equity Fund	32%	60%	41%	27%	30%	20%	18%	11%	18%	17%	11%
Morningstar Large Growth Category Average ¹	100	110	91	74	73	72	70	69	62	58	43

Sources: T. Rowe Price and Morningstar (see Fig. 1).

¹ Large-growth funds invest in big companies that are projected to grow faster than other large-cap stocks. Most of these focus on companies in rapidly expanding industries.

investors who reinvest fund distributions in additional shares, as most do, can add the total value of those distributions to their cost basis, which may reduce their taxable capital gain when fund shares are eventually sold.)

While the 2018 tax act lowered income tax rates for many investors (but also eliminated certain deductions), over time taxes have taken an increasing bite out of investors' returns. A decade ago, the tax rate on capital gains and qualified dividend income was 15%, and the top marginal income tax was 35%. Now the maximum rate on dividends and capital gains is 23.8% and the top marginal rate is 40.8% (including the 3.8% net investment income tax).

Moreover, an increasing amount of fund assets is held in taxable accounts. As of the end of 2018, 43% of mutual fund assets under management in the United States, or USD 7.6 trillion, was held in taxable accounts, according to the Investment Company Institute.

Equity fund investors can minimize the tax drag on their portfolio and improve their after-tax return potential by using a tax-efficient investment approach that employs different strategies and tactics.

The Importance of Asset Location

Every investor should focus on asset allocation as a first step in building an effective investment portfolio. This includes an assessment of your time

horizon, risk tolerance, and other factors to determine a mix of stocks and bonds that maximizes your opportunity to meet your financial goals.

But a thoughtful tax-efficient investment approach doesn't end with asset allocation. Once you've determined an asset allocation that is appropriate for you, then you should consider asset location—the optimal placement of your assets into taxable and tax-advantaged accounts, such as Roth IRAs and other retirement plans. The right asset location strategy (also known as tax diversification) could make a portfolio more tax-efficient and potentially improve long-term returns.

Generally, investors should use tax-advantaged accounts for higher income-oriented assets, such as taxable bonds and bond funds, high dividend-paying stocks or stock funds focusing on such securities, and real estate investment trusts. Since ordinary income is generally taxed at a higher rate than long-term capital gains, it is better earned in a tax-advantaged account. This may also apply to equity funds with relatively high turnover rates, generating capital gain distributions.

Alternatively, a taxable account is usually best suited for holding individual stocks over long periods of time, tax-advantaged securities such as municipal bonds, certain types of index funds, and actively managed

equity mutual funds that tend to have relatively low turnover, low yields, and a growth-oriented investment approach.

Additionally, most equity portfolio managers are measured and compensated based on pretax returns. As a result, they tend to have higher turnover rates that may generate more capital gain distributions, creating a potentially significant taxable event for shareholders. Over time, this could create a large difference between the pretax performance of a tax-blind

investment approach and what an investor actually earns after taxes.

A Focus on Tax Efficiency and After-Tax Returns

A tax-efficient equity strategy is more focused on after-tax than on pretax returns compared with equity funds generally. Tax-efficient funds are managed to minimize annual distributions and tend to have lower turnover rates than traditional actively managed equity funds. The longer investors have to compound the

(Fig. 2) Higher Tax Efficiency Can Improve After-Tax Returns

Fund Returns and Tax Efficiency

Annualized Returns, Five Years Ended March 31, 2019

	Pretax Return	After-Tax Return Pre-Liquidation ¹	After-Tax Return Post-Liquidation ²	Tax Efficiency ³
T. Rowe Price Tax-Efficient Equity Fund	12.71%	12.21%	10.06%	96%
U.S. Large-Cap Growth Funds	11.26	8.95	8.41	80
U.S. Mid-Cap Growth Funds	8.99	6.88	6.59	77
U.S. Small-Cap Growth Funds	8.45	5.88	5.97	70

Average Annual Total Returns as of March 31, 2019

	One Year	Five Years	Ten Years
T. Rowe Price Tax-Efficient Equity Fund Before-Tax Annualized Returns	13.08%	12.71%	17.29%
T. Rowe Price Tax-Efficient Equity Fund After-Tax Returns Pre-Liquidation	12.74	12.21	16.96
T. Rowe Price Tax-Efficient Equity Fund After-Tax Returns Post-Liquidation	7.94	10.06	14.75

Current performance may be higher or lower than the quoted past performance, which cannot guarantee future results. Share price, principal value, and return will vary, and you may have a gain or loss when you sell your shares. To obtain the most recent month-end performance, go to troweprice.com/tmc.

The fund's gross expense ratio was 0.83% and the net expense ratio was 0.78% as stated in the most recent prospectus. The Fund operates under a contractual expense limitation that expires on June 30, 2019. As a result of class-specific expense limitations, T. Rowe Price Associates, Inc. waived fund-level expenses ratably across all classes.

Sources: T. Rowe Price and Morningstar.

¹ These returns reflect payment of taxes on annual dividend and capital gain distributions but assume that investors did not sell their shares at the end of this 5-year period.

² These returns reflect taxes paid on annual dividend and capital gain distributions and any capital gains tax due on the sale of all fund shares at the end of this 5-year period.

³ Tax efficiency measures how much of a fund's annual return is earned after taxes, so the higher the number the better. These data reflect taxes paid on annual dividend and capital gain distributions but assume investors did not sell their shares at the end of this 5-year period.

The returns presented reflect the return before taxes, the return after taxes on dividends and capital gain distributions, and the return after taxes on dividends, capital gain distributions, and gains (or losses) from the redemption of shares held for the periods shown. The after-tax returns reflect the highest capital gains rate (23.8%) and highest rate applicable to ordinary and qualified dividends (40.8%) currently in effect. State and local taxes are excluded. During periods when the fund incurs a loss, the post-liquidation after-tax return may exceed the fund's other returns because the loss generates a tax benefit that is factored into the result. An investor's actual after-tax return will likely differ from those shown and depend on his or her tax situation. Past before- and after-tax returns do not necessarily indicate future performance. Average annual total return figures include changes in principal value, reinvested dividends, and capital gain distributions.

The Impact of Security Selection

Identifying growth companies with durable business attributes

The extensive efforts of our research analysts help us identify steady, reliable growth companies with durable business attributes, including a consistently high return on equity (ROE); a prudent capital allocation program; a solid business model—a demonstrated ability to steadily increase revenues, earnings, and cash flow; strong management; attractive business niches; and a sustainable competitive advantage.

11%

Tax-Efficient Equity
Fund turnover rate
in 2018.

96.2%

Tax-Efficient Equity
Fund tax efficiency
ratio since 2000.

return without paying taxes on large distributions each year, the better off they should be.

One of the primary ways a portfolio manager can employ tax efficiency is to invest for longer time horizons than others. For example, the trailing 12-month turnover rate for the T. Rowe Price Tax-Efficient Equity Fund as of December 31, 2018, was 11%, implying a 9.1-year ownership period for the average fund holding. For comparison, the 2018 average portfolio turnover rate for actively managed U.S. large-cap growth funds, according to data from Morningstar Direct, was 43%, implying a holding period of about two years.

Given our long-term horizon, it's almost inevitable that companies will encounter periods of adversity. But we prefer to let our winners run, rather than realize gains, unless a company's long-term outlook has fundamentally deteriorated.

The fund's 11% turnover rate in 2018 was extraordinarily low for any actively managed fund. It is notable that this rate also includes extra trading for loss recognition, which is done to reduce the capital gains that are distributed to shareholders. It's very unusual for a fund that focuses on pretax returns to steadily harvest losses to minimize distributions. In down markets, however, the turnover rate of a tax-efficient fund, as well as other equity funds, can be higher than normal as more losses will exist in the portfolio.

This process of tax loss harvesting is critical because it can improve after-tax returns over time since accumulated losses can be used to offset gains that are later realized in the portfolio. However, the strategy is not risk-free. If the stock you sell outperforms the stock you replaced it with, then you created a poor tax shield and that's probably a losing trade.

A longer investment time horizon and a low portfolio turnover rate are essential for maintaining a high tax-efficiency ratio, which is calculated by dividing a portfolio's after-tax return by its pretax return. The 96.18% tax-efficiency ratio of the Tax-Efficient Equity Fund, for example, indicates that the fund has made minimal taxable distributions from its inception on December 29, 2000, through March 2019.

Taxes are a constant consideration for investors pursuing long-term financial goals. While avoiding all taxes is virtually impossible, investors can make some important portfolio decisions and adjustments to adopt a more tax-efficient investing strategy. A successful strategy—one that includes an appropriate asset allocation and asset location with a focus on after-tax returns for assets in taxable accounts—should help an investor reduce his or her tax bill to Uncle Sam.

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