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THE IMPORTANCE OF TAX STRATEGY

WITH GIL BAUMGARTEN

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With tax season upon us, it seems an appropriate time to discuss tax strategy with a local specialist. Investors might assume that the frontline professionals for advanced tax strategy are CPAs. However, some investors find that their CPAs work retroactively, focusing on preparing tax returns more than strategizing with their clients about optimal ways to reduce or eliminate taxes. Our highlighted executive today is not a CPA but has four decades of investing experience while navigating IRS rules and has developed a reputation as a specialist in reducing tax friction in his clients' investment portfolios.

Gil Baumgarten is the CEO of Segment Wealth Management, a top wealth management firm in Houston, as ranked in our annual Book of Lists. Baumgarten is perennially ranked in the Top 1200 Financial Advisors in America by Barron's, wherein he also ranked in the Top 25 Advisors in Texas. His book, *Foolish: How Investors Get Worked Up and Worked Over by the System*, became an Amazon Best-Seller in 2021.

Q: Gil, can you tell us the basic premise of how you approach investments and taxes?
A cohesive tax strategy can yield consistently superior investment results compared to the path most investors take. They chase fleeting and vexing investment results, changing investment strategy at every turn. This process has repeatable disadvantages. It exposes investors to tax friction and higher costs that are immediately and calculably detrimental to portfolio returns. Investors experience the thrill of victory and the agony of defeat. Most investors would benefit by switching mindsets away from chasing returns to one of optimizing tax outcomes since the two are often mutually exclusive.

Q: Are you saying that sitting still has advantages?
Yes. Stocks tend to move in lockstep, meaning your list of ten stocks and my list will act much the same. When two lists of stocks have 100 names or more, the behavior is often nearly identical. Trading becomes an illusion of sophistication that feeds the ego of investors and the commission pots of brokers. Trading also generates avoidable taxes since the IRS allows tax deferral until a sale. The farther that sale takes place in the future, the better for investors.

Q: Would proper tax policy merely delay trading activity?
It's more complex than that since the taxing authorities levy taxes in more than 100 different ways. I prefer to view it as a winding path through the jungle. If you understood the optimal path, you would probably make optimal choices. For example, the IRS penalizes certain activities like earning interest versus a dividend. The taxes on dividends are essentially half. The IRS also penalizes trading activity inside of a 12-month holding period; here again, taxes are twice as costly as those held longer than one year. These intricacies give strong incentive to think in terms of more permanence. Optimizing the path through the jungle would consider all the investor-specific circumstances, like income tax rate, and would then coordinate investment policy with the path offering the greatest incentives.

Q: What mistakes do you see investors make that they could avoid if they simply understood the rules better?
Most investors don't understand the step-up in basis rule. This rule allows profitable investments held until death to be capital-gain tax free to inheritors. The step-up applies to both spouses, too. Investors who understand this benefit tend to avoid excess trading activity, instead selecting securities with structural advantages to optimize that eventual tax-free outcome.

Q: What kind of structural issues would be beneficial?
Mutual funds are a very popular way to participate in stock investing rather than choosing your own component companies. However, open-ended mutual funds require commingled accounting among all investors. Thus, other investors' buy and sell activity creeps into your taxable 1099, causing near yearly taxes, eroding your unrealized gain and your compounded return whether you sold your shares or not.

On the other hand, Exchange-Traded Funds (ETFs) are a special type of mutual fund that does not utilize commingled accounting. This solves several problems with fund investing. It prevents compounded return erosion caused by paying taxes over the years, often decades too soon. That structural feature can add a fourth to all your investment results. ETFs also preserve the powerful step-up rule since original cost basis is maintained during the holding period, potentially making the gains tax-free at death. Of course, ETFs also offer some of the lowest fees around.

Q: Do you believe ETFs are the best way to invest?
For most investors, probably yes. But this assumes they will hold forever and have more limited investing resources. For wealthier investors, there are better investment vehicles than ETFs. That top position would belong to a personalized direct index strategy, which would be akin to breaking the ETF down and buying the component securities individually.

Q: What advantage would direct indexing provide?
Well, first, it would eliminate the ETF fees. Second, it would provide tactical management of the cost basis of each security. For example, when one position is down by -30%, you can sell and take the loss to offset other gains, like real estate you may have sold. Then, 31 days later (to avoid a wash sale), you can buy it back. We often purchase similar positions as substitutes to ensure clients participate in the rebounds.

Further, having big gainers allows a charitably minded investor to cherry-pick those positions for gifting to a church or other charity. Qualified charities are exempt from taxes on sold positions. Donors can contribute cash back to their investment account and immediately repurchase the same stock. This powerful tactic rinses capital gains from the investor's taxable portfolio mix.

Q: So, is deferring gains the only tool people have to manage taxes?
Absolutely not. We help high wage earners open coveted Roth IRAs. We also strategically convert IRAs to Roth IRAs to reduce estate taxes. We manage gifts to grandchildren to optimize intergenerational wealth transfer. We also manage other parts of the charitable giving cycle to optimize the power of gifts.

Q: Tell us about your book, *Foolish*. Why did you write it?
The investment system is quite complex and regulations allow brokerage firms to prioritize their own profit interests over those of their clients. This creates a machine that also tends to generate more taxes than need be. As an ex-insider, I wanted to tell the story of how investors are disadvantaged by that system and explain the ecosystem in an understandable way.

The book's first section deals with how the brokerage industry operates and engages with investors. It explores how brokerages get paid in layers, far beyond what the clients are typically aware of, and the narrative they use to garner greater profits for themselves. The book also explores the ego needs of investors who seek the affirmation of short-term wins at the expense of overall profits. It describes the long-term benefits of understanding your own emotional biases and choosing optimized investing methods, like what we're discussing here.

To read more about tax strategy and other investment topics, sign up for Gil's email list at: https://segmentwm.com/blog/