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Practical Applications of The 50% Rule: *Keep More Profit in Your Wallet*

Stuart E. Lucas and Alejandro Sanz

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Overview

Taxable investors are always searching for returns, but how much profit they pocket after taxes and expenses is often overlooked. In **The 50% Rule: *Keep More Profit in Your Wallet***, published in the Fall 2017 issue of ***The Journal of Wealth Management***, **Stuart E. Lucas** and **Alejandro Sanz** of **Wealth Strategist Partners** analyze how such "leakages" eat away at returns for taxable investors and provide guidelines for how to manage taxable portfolios to retain at least 50% of profits, a bottom-line strategy they call the "50% rule."

Profit retention rates can vary dramatically simply based on product fee structures. For example, the "two and twenty" fee structure of hedge funds, where managers earn 20% of profits on top of a 2% management fee, can make it difficult for investors—especially taxable investors—to retain at least 50% of profits. Taxable investors who use hedge funds and other high-fee vehicles should measure more than pre-tax returns. Because of fees and taxes, they might get a much lower net return than they had expected.

Practical Applications

- **Know your retention rate.** Because many taxable investors are unaware of the share of profit they're pocketing, an important first step is to analyze their after-tax, post-expenses retention rate.
- **Plan portfolios with profit-retention goals.** On top of risk-and-reward measures, taxable investors should target a retention rate of at least 50% to optimize after-tax returns.
- **Searching for lower volatility may cost investors.** Taxable investors may want to add alternative investments, such as absolute return hedge funds, to dampen volatility, but their high fee structures and, in many instances, tax inefficiencies, can result in low retention rates and lower net returns.

Discussion

"When we present to groups of wealth owners, we ask, 'What do you think is a fair retention rate?'" says Stuart E. Lucas, co-managing partner and CIO of Wealth Strategist Partners. "People will say, 'Well, I think it should be 70% or maybe 60%.' I've never had anybody say less than 50% is fair. But when we did the numbers, they saw in many cases the retention rate is below 50%. They were quite surprised."

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Maintaining high profit retention rates is critical for the wealth of taxable investors, yet it's an often-overlooked issue, partly because financial vehicles and managers are usually focused on pre-tax returns, according to Lucas and his co-author Alejandro Sanz. Their rule of thumb advises investors to aim for a minimum of 50% profits after leakages. Investors who fall below this threshold should consider a new approach, they advise. Their fundamental view: Taxable investors need to think differently.

Although it's become easier to find after-tax information, there are investment vehicles where taxable investors may need to dig deeper to find data, such as those held with hedge funds and other partnerships.

PAY TO PLAY?

Retention rates are greatly influenced by investment strategy and structure, which Lucas and Sanz illustrate with a hypothetical wealthy Illinois resident who has invested in four vehicles: an index fund, an actively managed equity mutual fund, a private equity fund, and a hedge fund.

The taxable profits distributed by index and mutual funds are net of management fees, but that is usually not the case for the fees levied by private equity and hedge funds, the authors note. All four vehicles violate the 50% rule under some conditions, and the index and mutual funds cross the 50% threshold soonest. For instance, the active mutual fund hits the threshold when returns before taxes and fees reach 3%. But hedge funds violate the 50% rule even when gross returns are as high as 25%.

> "It's one thing to intuitively think hedge funds have a lower retention rate than index funds, but once you quantify it, that's when the surprise comes."
>
> **—Alejandro Sanz**

Of course, investors choose hedge funds and other high-fee vehicles for a variety of reasons, only one of which is alpha creation, Lucas notes. On occasion, investors find specific investment opportunities that are so compelling that they are willing to retain less than 50% of the profit, but this should be a considered decision. The authors' findings suggest taxable investors may need to think twice about the value of some vehicles.

"The lower the retention rate, the harder it is to actually find managers or investments that are going to add value net of fees or taxes, especially in public markets," Lucas says. "As attractive as these assets may sound, one really needs to approach them carefully to make sure the manager has the expertise to have a reasonable probability of adding value with these more actively traded assets."

INDEXING TECHNIQUES

Another way to look at the issue is to calculate the gross return needed to provide a 5% net after-tax return for a taxable investor. Index funds must generate a gross return of 6.8% to achieve that goal, compared with 12.9% for hedge funds.

For many middle-income investors, low-cost, diversified investments such as index funds may allow them to increase their retention rates and therefore their returns after fees and taxes. High-net-worth investors, however, have a wider palette of options, such as incorporating tax-loss harvesting techniques in a portfolio that closely matches an index. When shares decline in value and are sold, the tax loss can be used to offset gains elsewhere in the portfolio.

Key Definitions

Retention rate

The percentage of profits retained by taxable investors after taxes, management fees, and carried interest are deducted from returns.

50% rule

The minimum retention rate that taxable investors should aim for when planning their portfolios, to help them maximize their net return after management fees and taxes.

Leakages

The taxes and management fees that reduce taxable investors' net profit.

> "The lower the retention rate, the harder it is to actually find managers or investments that are going to add value net of fees and taxes."
>
> **—Stuart Lucas**

"Suffice it to say, for the last 15 years, all of my clients have had a core equity portfolio that closely tracks an index," Lucas says. "We use tax-loss harvesting techniques because our clients have the scale, but a more typical private investor can get access through mutual funds or ETFs."

DIGGING INTO RESULTS

While it's relatively easy to find after-tax information for mutual funds and some ETFs, a taxable investor will need to inquire about the tax efficiency of hedge funds and private equity funds by asking for sample K-1s from previous years, Lucas and Sanz explain.

"Some hedge fund managers will do that and some will not," Lucas notes. Once an investor receives their own K-1, their accountant can help them analyze the tax efficiency of the investment.

Asset allocation for taxable investors, as seen through the lens of profit-retention rates, may be different from those for tax-exempt investors, they added. Volatility dampening, when accessed through hedge funds and other alternative investments, may prove expensive for individuals.

"Our investors invest for the next 20, 30, or 50 years," Lucas says. "Interim volatility, as long as the long-term direction is positive, is of less concern to them."

Because most individuals have a tax-deferred retirement account, such as an IRA or a 401(k), Lucas and Sanz advise investing in less-tax-efficient instruments through those accounts.

The takeaway for taxable investors: Examine the details, know how much you're paying in leakages, and be willing to make changes if you aren't pocketing half of the profit.

"It's one thing to intuitively think hedge funds have a lower retention rate than index funds, but once you quantify it, that's when the surprise comes," says Sanz.

Adds Lucas, "When confronted with information like this, some people would prefer to ignore it. But when it's your money, shouldn't the facts matter?"

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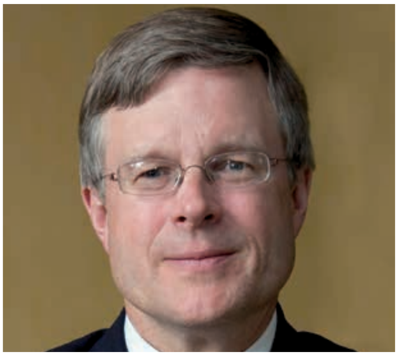

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Stuart founded Wealth Strategist Partners (WSP) as the successor to his family's investment platform, where he was co-chief investment officer for many years following the sale of Carnation Company, the business founded by his great-grandfather. The family remains a client of WSP.

Stuart has been an investment professional for over 35 years. In addition to his duties with WSP, Stuart is chairman of the investment committee of National Public Radio and is a board member of the National Public Radio Foundation. He is vice chairman of the board of directors and co-leads the investment committee of the Stuart Foundation, a $500 million foundation based in California.

Stuart designed and leads the University of Chicago Booth School of Business's Private Wealth Management continuing education program, which has served over 500 individuals and families in the 11 years since the course's inception. In the academic years 2015–2017, Stuart served as an adjunct professor of finance at the University of Chicago, Booth School of Business. His book *Wealth: Grow It and Protect It* (FT Press) has been published on three continents. He is the author of numerous articles on investing and wealth management, most recently "Pick Your Battles: The Intersection of Investment Strategy, Tax, and Compounding Return," in *The Journal of Wealth Management* (Fall 2016), co-authored with Alejandro Sanz.

Previously, Stuart was the senior managing director of the Ultra-High Net Worth Group within Private Client Services at Bank One (now JP Morgan Chase); director of a multi-family investment office in Paris; general manager of European operations of Wellington Management Company in London; and assistant portfolio manager of a Forbes Honor Roll mutual fund.

He has a BA with honors from Dartmouth College, an MBA from Harvard Business School, and is a Chartered Financial Analyst.

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Alejandro joined Wealth Strategist Partners (WSP) in 2010, and he is a member of WSP's investment committee. Alejandro evaluates investment themes, sources investment opportunities, conducts due diligence, and monitors managers. His research has included high-yield municipal bonds, European distressed debt, and upstream/midstream energy.

Before joining WSP, Alejandro led the establishment of his family's office and served as a portfolio manager of his family's investments in public and private markets. He co-founded his family's foundation and continues to serve as a board member for the foundation and as a member of his family's investment committee. In partnership with Stuart Lucas, Alejandro created the Private Wealth Management executive education program in Spain, now in its seventh edition.

Alejandro graduated from Colegio Universitario de Estudios Financieros (CUNEF) in Madrid with a degree in business administration and a major in financial management. He passed the CFA and CAIA level I exams and has completed several executive education programs on value investing, private wealth management, and entrepreneurship at the Wharton School of the University of Pennsylvania, the University of Chicago Booth School of Business, and Columbia University.

