

The Real Thing

OVER THE LAST TWO DECADES, TOTAL return has been popular as an easy way to compare investment results. Total return includes income from dividends and interest, as well as appreciation or depreciation over a given time period, perhaps a number of years.

But more often than not, total return has been inappropriately used to compare different asset classes, products and strategies on a purely absolute basis—even though the comparisons mean very little. Among institutional investors such as schools and universities, pensions and nonprofits, the concept of using total return to compare various asset classes has become the norm.

The Bank Administration Institute started this trend in the early 1970s by releasing formulas for calculating rates of return, which included time weighted rates of return, which were the precursor to absolute total return analysis.¹ This was useful for ranking competing investment projects (in theory, the higher the time-weighted rate of return, the better the project). Similarly, total return, in the early days, was designed to support the institutional marketplace and was never intended for use in the individual retail investment marketplace.

In the early days, before the passage of ERISA, many company pension funds were casually turned over to a corporation's CFO or another top executive to manage on a part-time basis while also fulfilling his full-time managerial duties. Not surprisingly, once ERISA was passed, these corporate executives and business



owners discovered the negative aspects of being saddled with the fiduciary responsibilities of pension fund management. “We have a real problem,” they realized. “If the funds lose money, we can be held personally liable.” It was this legal vulnerability that led to the trend of hiring outside investment management firms and consultants to oversee the funds.

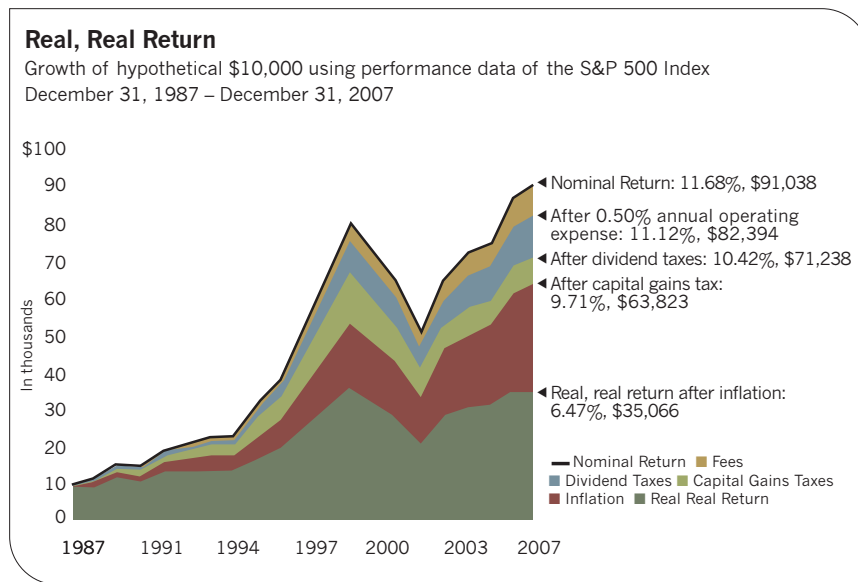
The stated motivation of these corporate chieftains—when they delegated to others the responsibilities of pension fund management—may have been to grow and protect their funds’ assets, but the real core issue was their potential liability in the event the funds lost money. The solution to their dilemma was provided by investment consultants who offered new performance and benchmarking comparison tools that protected plan fiduciaries while allow-

Investment returns need to be evaluated after taxes, expenses and inflation—but few do that.

By Ken Ziesenheim

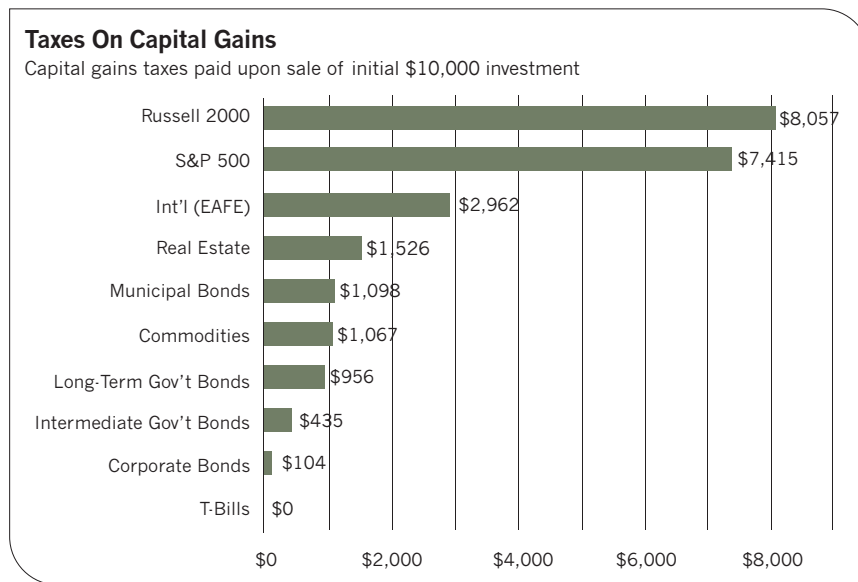
¹ The rate of return that would make the present value of future cash flows plus the final market value of an investment or business opportunity equal to the current market price of the investment or opportunity; in other words, the rate of return at which the net present value of the project is zero. If the internal rate of return exceeds the cost of financing the project, then the project is viable.

Figure 1



Source: Ibbotson and Associates and Thornburg.

Figure 2



Source: Ibbotson and Associates and Thornburg. Assumes all investments were sold on 12/31/2007 after a 20-year holding period. Capital gains were applied at a 15% rate on the nominal amount of appreciation

ing them to comply with ERISA.

Now these generally accepted measurement standards and practices—even though they were originally designed for institutions and the protection of corporate officers and plan fiduciaries—have spawned an entire industry, and their use has been broadened. They are now not only used to provide protection in down markets, but also used by financial advisors to compare absolute investment re-

turns in the retail marketplace and add value. For example, if the market were down 15%, but your company's fund was down only 10%, these new tools have enabled performance comparison and analysis, and thus allowed the fund to show up in the top quartile of its peers, even though absolute performance may have been negative. This new practice has gained widespread acceptance in both the institutional and retail markets.

However, these institutional tools were originally only used among tax-free organizations. When they became more prevalent in the retail marketplace, they became widely misused, since the comparisons rarely incorporated tax considerations. As a result, in their original form, the comparisons weren't that relevant to individual investors (even though the investors thought they were) because they did not accurately measure absolute risk. Individual investors were primarily concerned about whether their money was growing at all, not how it was growing relative to other investment alternatives.

The changing demographics are only exacerbating this issue as baby boomers are now focused primarily on accumulating and/or preserving money for an extended period of retirement. Without considering other aspects of investment return, including taxes, inflation and investment expenses, investors may unknowingly be misled into believing they have adequate resources or that they are achieving satisfactory total returns in absolute terms, when, in reality, they are not. If they seek funds with the best total return without considering all aspects of total return, they may find themselves with inadequate growth of real wealth and insufficient assets at a time when they need assets the most—during retirement.

As the baby boomers become more sophisticated investors, they will have greater amounts of money to deal with. They will learn, as have the very wealthiest people in the country, that it's not how much you earn - it's how much you keep. Instead of using total return as a basis for evaluating investment returns, they will need to evaluate their returns after taxes, after expenses and after inflation. This is sometimes referred to as "real, real returns," and was a technique developed at my old employer, Thornburg Investment Management, the creator of a 14-year study on investment returns.

These "Real, Real Returns" study will help you explain to your clients aspects of total return that are extremely relevant to their circumstances and financial goals and objectives. (See Figure 1.)

The results shown here were compiled by the Thornburg investment team and

reviewed in 2008 by Dr. Bryan Taylor, a former professor of finance at California State University, Los Angeles.

Every time I have discussed the results of the study in large group presentations, inevitably a large number of advisors tell me the same thing: “I knew this intuitively, but I never had a way of explaining it until I saw the ‘Real, Real Returns’ chart.”

There are three things that can erode the total return and value of an investment. The first is the cost of investing, or the ongoing fees charged to an investment, which can be substantial even though they have been coming down in recent years. But fees are subject to competitive factors and can sometimes be negotiable. The other two factors, meanwhile—taxes and inflation—apply uniformly to all investors.

Taxes

Taxes have a detrimental effect on every investment (at least in taxable accounts). But while you can't entirely avoid or negate them, you can help stem the erosion using various portfolio management strategies to enhance total returns. You might realize long-term capital gains instead of short-term capital gains. You can use tax-deferred investments or tax-qualified accounts or place investments in appropriate taxable or nontaxable accounts. You can use investments that generate “qualified” dividend income and/or use tax-free investments instead of taxable investments—when they're not in a qualified plan or tax-deferred account. Given the wide variety of investment vehicles, as well as the different tax consequences of holding and titling investments, it is essential that the portfolio and all accounts be viewed in totality so that the overall tax impact can be better managed. While it is relatively simple to control taxes using common stocks and municipal bonds, managing taxes in alternative asset categories such as commodities or real estate can be more difficult. The management of real estate tax issues, in particular, can be difficult where debt is involved since such real estate often has negative unintended consequences in qualified retirement accounts. The current taxation of

bonds and commodities can be deferred when you place them in tax-deferred accounts, but ultimately, the investment returns will be taxed when they come out of these accounts (except when they are in Roth IRAs and involved in other special types of arrangements). Similarly, long-term capital gains, which normally would be taxable at a current 15% rate if held outside of retirement accounts, could be converted to a higher normal income tax rate when they ultimately are distributed from the retirement account. These are all legitimate issues investors should consider with each investment they own. (See Figure 2.)

It's difficult to actively manage taxes in a passive environment. Within a separately managed account, taxes can be actively managed. However, within a mutual fund or other managed or pooled account, it is the investment

your clients become smarter and more sophisticated investors.

An investment manager's goal is not just to make money, but also to increase wealth for shareholders and investors. To accumulate wealth, investors and advisors must use several common strategies: They identify managers with a history of generating alpha. They avoid unnecessary taxes. They must know the historic rates of return of various asset classes, and diversify among asset classes with the highest returns and lowest risk profiles. But investors' main discipline when constructing portfolios should be to consider and evaluate asset classes and historical rates of return using the concept of real, real returns. All potential investments or strategies should be analyzed within the context of returns adjusted by the costs of inflation, taxes and investment expenses. When an asset class has historically not

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manager who has the ultimate control over tax consequences. It is, therefore, extremely important that when considering investment managers, due consideration is given to the after-tax adjusted returns, as well as current realized or unrealized gains within the fund. Because of the wide variety of investment strategies and the wide spread of after-tax results among managers, the task of selecting investment managers becomes more challenging, but, nevertheless, extremely important.

Inflation

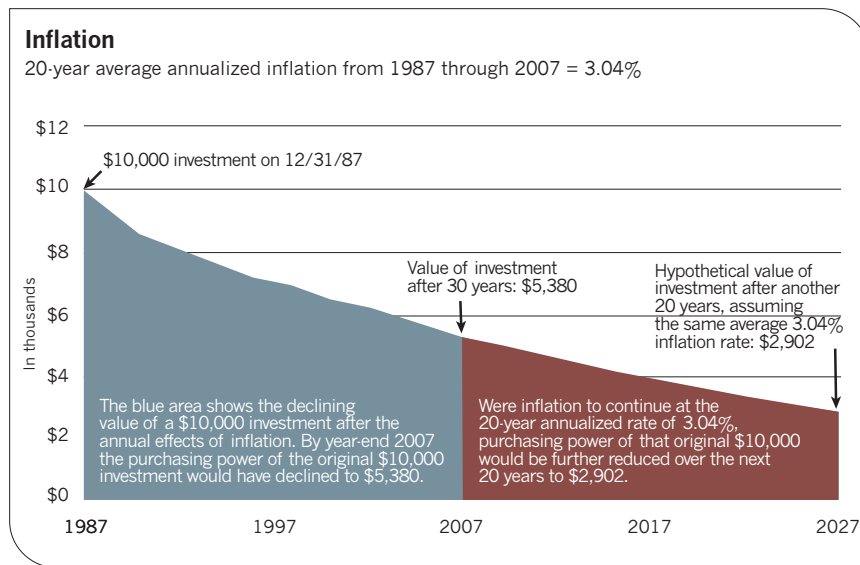
The true impact of inflation on investment returns is rarely considered, but the real, real return study proves that inflation is indeed a serious factor that has, in many cases, deprived investors of accumulating real wealth. (See Figure 3.) While you have no control over inflation, knowing and understanding how various asset classes have performed against historical inflation rates means you can help

generated returns that exceed the costs of inflation, taxes, and investment expenses—in other words, when it has not contributed to the accumulation of real wealth—it should be avoided, or at least minimized.

As investment returns move in cycles, longer periods of 20 years or more should be considered when reviewing historical rates of return. Just as the rate of stock appreciation in the '90s wasn't a realistic rate for a full 20-year period, the rate of real estate appreciation in the early 2000s was also not a long-term realistic rate—as we are quickly learning. However, over the course of 20 years, or a full investment cycle, returns are a more accurate reflection of what is likely to be experienced in the future.

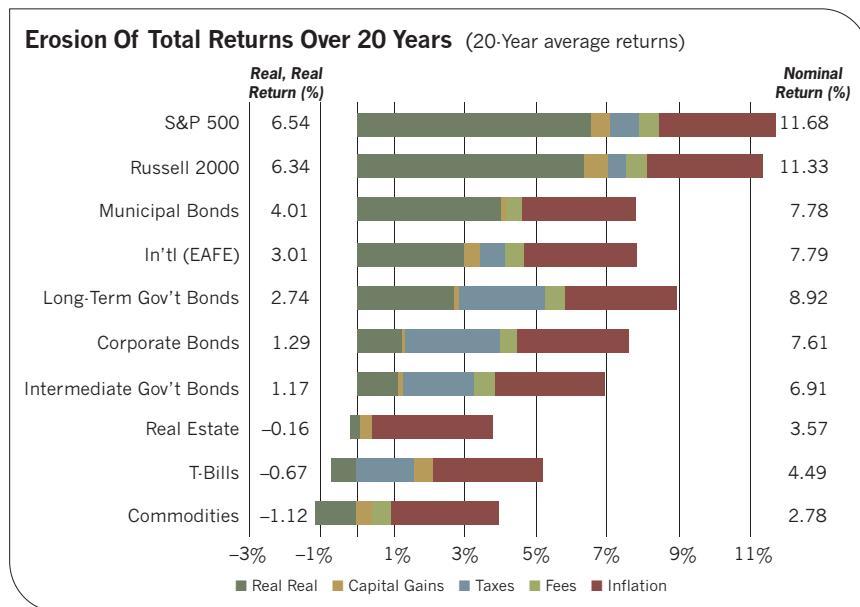
As noted in Figure 4, all of the traditional asset classes have positive 20-year annualized nominal returns. However, for all but two of the asset classes, the nominal returns were cut by more than half over the past 20 years by taxes, inflation and investment expenses.

Figure 3



Source: Ibbotson and Associates and Thornburg.

Figure 4



Source: Ibbotson and Associates and Thornburg.

Of the generally accepted asset classes, only two have historically and consistently resulted in the creation and preservation of real wealth: Common stocks, as represented by the S&P 500 (and small-cap stocks have actually done better) and municipal bonds. The latter have a relatively high return when compared against government or corporate bonds—primarily because their returns

do not suffer from the erosion of income taxes. However, municipal bonds are not totally immune from the drag of income taxes, as some may be subjected to the alternative minimum tax. As a result, even this relatively simple asset class de-

mands more research and effort when an investor constructs a portfolio.

While municipal bonds do not offer the capital appreciation opportunities of stocks, they do serve a wealth protection strategy. And while there's no real growth in municipal bonds, they have at least maintained their real value, and even gained a little bit.

What we know: Fundamentals of successful investing rarely change.

Solutions

- Nominal returns for most asset classes over 20 years are solid. But strong nominal returns are only part of the picture.
- Every investment should be analyzed based on real, real returns.
- You need to know what you can do to increase real, real returns for your clients.

What You Can Do

- Construct portfolios designed to generate real, real returns after inflation, taxes and investment expenses.
- Understand the real, real returns of all asset classes—evaluate each investment on a real, real return basis.
- Search for “tax efficient” active managers.
- Consider where investments should be held and how they are titled in light of real, real returns.
- Change the nature of the conversation with your clients to one that focuses on real, real returns rather than absolute returns.

Take Away

- Advisors have to start calculating returns on an after-tax, after-expense basis instead of on a total return basis.
- Your clients do not live in a tax-free environment.
- Every investment should be analyzed based on real, real returns.
- Individuals try to offset taxes with incrementally higher total returns, which is unrealistic and has never worked.
- A re-education is needed to shift gears and go against the historical conventional wisdom.



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Statements contained herein are based upon information furnished to us from independent sources. While we do not guarantee their correctness, we believe them to be reliable and have ourselves relied upon them.

The Consumer Price Index (CPI) measures prices of a fixed basket of goods bought by a typical consumer, including food, transportation, shelter, utilities, clothing, medical care, entertainment and other items. The CPI, published by the Bureau of Labor Statistics in the Department of Labor, is based at 100 in 1982 and is released monthly. It is widely used as a cost-of-living benchmark to adjust Social Security payments and other payment schedules, union contracts, and tax brackets. Also known as the cost-of-living index.

Real real returns were calculated by Thornburg Investment Management using data obtained from the following sources: Inflation/Consumer Price Index–Urban (CPI-U) and Treasuries data were obtained from the Ibbotson SBBI® 2007 Yearbook, ©2007. All rights reserved. Used with permission. Municipal bond, commodity, and real estate data were obtained from Global Financial Data. Corporate bond data was obtained from Lehman Brothers (May 2008). Index data for the S&P 500, MSCI EAFE, and Russell 2000 were obtained from FactSet. In our example, fees of 50 basis points (0.50%) were applied to the investment, with the exception of real estate.

Bonds are debt investments in which an investor loans money to an entity (corporate or governmental) which borrows the funds for a defined period of time at a fixed interest rate. Bonds are subject to certain risks including loss of principal, interest rate risk, credit risk, and inflation risk. The value of a bond will fluctuate relative to changes in interest rates; as interest rates rise, the overall price of a bond falls.

Government bonds, or Treasuries, are negotiable debt obligations of the U.S. Government, secured by its full faith and credit and issued at various schedules and maturities. Income from Treasury securities is exempt from State and local, but not Federal, taxes. Treasury bill data is based on a one-bill portfolio containing, at the beginning of each month, the bill having the shortest maturity not less than one month. Intermediate government bond data is based on a one-bond portfolio with a maturity near five years. Long-term government bond data is based on a one-bond portfolio with a maturity near twenty years.

Municipal bonds are debt obligations issued by States, cities, counties and other governmental entities. Municipal bonds offer a predictable stream of income which is free from Federal and, in some cases, State and local taxes, but may be subject to the Alternative Minimum Tax. Because of these tax-savings, the yield on a muni is usually lower than that of a taxable bond. Higher grade munis have higher degrees of safety with regard to payment of interest and repayment of principal and marketability in the event you must sell before maturity. This study uses Moody's 10-Year AAA Municipal Bond Index as a general representation of the municipal bond market. The index consists of munis with a AAA credit rating from across the United States.

A corporate bond is a debt security issued by a corporation. Corporate bonds are taxable and have more credit risk compared to Treasuries. This study uses Lehman Brothers U.S. Corporate Investment Grade Index, which is a general representation of the investment-grade corporate bond market.

A stock is a share in the ownership of a company. As an owner, investors have a claim on the assets and earnings of a company as well as voting rights with the shares. Compared to bonds, stock investors are subject to a greater risk of loss of principal. Stock prices will fluctuate, and there is no guarantee against losses. Stock investors may or may not receive dividends. Dividends and gains on an investment may be subject to Federal, State or local income taxes.

Standard & Poor's 500 Stock Index is an index consisting of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large-cap universe.

The Russell 2000 Index measures the performance of the small-cap segment of the U.S. equity universe. The unmanaged index is a subset of the Russell 3000® Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership. Small-cap stocks are subject to greater volatility than large-cap stocks.

The Morgan Stanley Capital International (MSCI) Europe, Australasia, Far East Index (EAFE) is a generally accepted benchmark for major overseas markets. Index weightings represent the relative capitalizations of the major overseas developed markets on a U.S. dollar-adjusted basis. The index is calculated with gross dividends reinvested in U.S. dollars. There are special risks associated with international investing, including currency fluctuations, government regulation, political developments, and differences in liquidity.

Compared to the other investments in this study, single-family homes are relatively illiquid. Property values can fluctuate and there are no guarantees. Gains on the sale of a property may be taxable at the Federal, State, or local level. Real estate data in this study uses the Winans International Real Estate Index,™ which tracks the prices of new home prices in the United States with Census Bureau data.

A commodity is a physical good – such as food, grain, oil, natural gas, and metals – which is interchangeable with another product of the same type, and which investors buy or sell in an active market, usually through futures contracts. If you buy a futures contract, you are basically agreeing to buy something that a seller has not yet produced for a set price on a specific future date. The futures market is extremely liquid, risky, and complex. Commodity prices can be affected by uncertainties such as weather and war and there are no guarantees against losses. In this study, commodities are represented by the Dow Jones-AIG Commodity Index (DJ-AIGCI),® from 1990 to present. Prior to that, returns are represented by the Dow Jones Futures Price Index. The DJ-AIGCI is designed to be a highly liquid and diversified benchmark for commodities traded on U.S. exchanges. For purposes of this study, it is assumed that commodity exposure is obtained through a vehicle tracking the index and not by purchasing the underlying futures contracts.

The performance of an index is not indicative of the performance of any particular investment. Unless otherwise noted, index returns reflect the reinvestment of income dividends and capital gains, if any, but do not reflect fees, brokerage commissions or other expenses of investing. Investors may not make direct investments into any index.

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