Why do we need The Efficient Tax Portfolio Optimizer(ETPO)?

What can the ETPO do?

The ETPO Can Build Significant Extra Long-term After-tax wealth

As a large cap value money manager, I've been doing detailed quantitative fundamental valuation research on the components of the S&P 500 and the NASDAQ 100 for over 25 years. It's my fiduciary responsibility to help my clients meet their retirement goals within their risk tolerances.

I developed the ***Efficient Tax Portfolio Optimizer*** to meet those goals as measured by specific criteria. Including the encompassing of **nine words** that describe what is most important to any individual investor: **After-tax Capital Efficiency, Within Risk Tolerances, Net of Fees**

- **After-tax** – This is your real spendable return. You don't get to keep, reinvest or spend your taxes.
- **Capital Efficiency** – Investment choices must appropriately balance risk and reward. A 10 percent projected return on steadfast Johnson & Johnson is preferable to an 11 percent projection on more volatile US Steel. The extra 1 percent isn't enough reward for the extra earnings risk.
- **Within Risk Tolerances** – This means we tailor our asset allocation so that we only take on as much risk as we need to meet our goals.
- **Net of Fees** – Similar to taxes, we must deduct any fees to get to our real return.

The Fallacy of Tax Efficiency

Most taxable portfolio managers today strive to minimize taxes, following a discipline known *as Tax Efficiency*, which has well defined metrics. For example, if you end the calendar year with a 10 percent before tax rate of return, and a 7 percent return after deducting your realized tax liabilities, you have a 70 percent tax efficiency. The higher that number, the better job you're doing. On the surface, that sounds reasonable. But if we look more closely, that set of metrics fails to measure after-tax returns properly***.***

Let's say that 25 years ago you inherited shares of XYZ Corp. and the value of those shares has risen considerably. As a result, you have a deferred tax liability that's not due until you sell it. So let's say that last year the market was up 10 percent, your portfolio was up 12 percent, but XYZ Corp. was up 15 percent. So you decide it's a good time to sell it all. ***Tax Efficiency metrics would have you offset 25 years of accrued tax liability against one year's stock performance***. This violates two key accounting principles. First, it doesn't match revenues and expenses; one year's revenue effectively offset with 25 years of accumulated tax liability expenses. Second, it mixes cash and accrual accounting.

Cash accounting would ask: what did you pay for something, what did you sell it for, what are the taxes, what's left after a certain period of years. The **accrual method** is the correct choice to determine how much better off an investor is after tax over time. By comparing the after-tax value of a portfolio over time. We first ask: ***what could an investor buy now with any after-tax proceeds, if an entire portfolio were liquidated?*** To calculate after-tax returns over time, we take a portfolio on January 1st and ask: if you were to sell everything and pay the tax -- what would you have left? An accountant would put the market value of the securities on the asset side of the balance sheet and put the deferred tax liability on the liability side. The difference would be the **after-tax wealth**. Then at the end of the year, what's the **after-tax value** of the portfolio? The difference between those two values is your **after-tax wealth accumulation**. Minimizing taxes is the wrong goal. Maximizing your after-tax wealth is the right goal. ***We want to minimize taxes, but not at the expense of future after tax wealth accumulation, so that we're more optimally capital efficient.***

What is the ETPO?

The Efficient Tax Portfolio Optimier is a capital efficiency tool that helps money managers assess when it's no longer in the interest of an investor to hold on to a security, because they can do better by investing in something else. Even after taking taxes into account. Think of it as a **radar, or a digital map of information** to help guide good investment decisions via a **just-in-time stock portfolio management system.** Using intra-day market pricing. Allowing each investment to be compared with each other investment, on a risk adjusted investment merit basis, after-tax. All of the time.

The ETPO analyzes the after-tax value of holding shares versus selling them and reinvesting elsewhere. It compares investments at the tax-lot level, calculating how much extra return is needed from a new investment in order to justify the tax incurred by selling an existing asset. It factors in the cost basis; applicable tax rates; realized gains and losses; and future expectations about price performance to produce alerts with sell recommendations.

For example, let's say you own shares of Coca Cola and we project the value in three years (including paying any capital gains taxes projected upon sale, having collected dividends, and subtracting any dividend taxes and brokerage and advisory fees along the way) will total $100. The ETPO will identify whether there exists better projected returns in any substitute or replacement investments sufficient to pay the tax on any sale, and deliver material additional market returns over time. For example, if you were to sell Coca Cola, pay the tax and reinvest in Pepsi, which you believe has a higher forecasted rate of return, you might earn $110, after tax.

Tax lots

A tax lot is the portion of shares purchased on a particular day at a particular cost. An investor may purchase the same stocks on different days, or at different costs, but the sale of each lot represents a separate taxable event, with its own set of economics. A lower cost basis, or higher applicable tax rate, raises the tax liability, which would also increase the return required from an alternate investment to justify selling the tax lot.

Tax loss harvesting is a critical component of After-tax Capital Efficiency.

A stock holding with a paper profit is worth its market value less any imbedded deferred tax liability, while an investment showing a loss is worth its market value plus the tax savings value of the loss. Even if an alternative investment might earn a smaller return, if the loss value is greater than that difference, we are still better off realizing a loss.

The goal is to realize the loss on a stock that's fully valued and offset that loss by selling a profitable position that's also fully valued. This frees up the full proceeds of both investments, which can be deployed at higher rates of return.

The ETPO can also be used to specify economic conditions necessary to justify transactions. Assume that the switch from Coca Cola shares to Pepsi would result in only $103 in value after three years – a 1 percent advantage each year. If we prefer higher excess returns, we can input a minimum alpha, which will filter out recommendations with less than 2 percent extra after-tax upside per year. If the three-year projected value of the Pepsi shares is $106 or higher, it could satisfy the conditions worth making the switch.

Capital efficiency can be demonstrated across an unlimited number of scenarios. Let's say a client calls a bank trust department manager to say he needs $50,000 to add a room to his garage and wants to sell assets in the most intelligent manner. The ETPO allows them to input known realized gain and loss values into all of the client's tax lots and calculate which tax-lots to sell first, second third, and so on, in order to generate the greatest after-tax alpha. And which tax-lots to hold on to because they offer the greatest after-tax return potential remaining on a risk-adjusted basis. That's how you accomplish minimizing taxes, but not at the expense of future after-tax wealth accumulation.

As an illustration as to how powerful the Efficient Tax Portfolio Optimizer can be, let's say we start with an 8 percent before tax rate of return. Then subtract 2 percent for taxes, 2 percent for inflation, and 1 percent for fees leaving you 3 percent real return, after tax. If you add a 1 percent after-tax alpha, that represents a 33 percent improvement in your real after-tax wealth accumulation over time, on a purchasing power basis.

Where does the ETPO get its price targets?

Price targets can come from any source. ETPO clients can input their own, or they can use Value Line's three to five year price targets for example, which licenses for redistribution its Buy Side, investment grade price targets on 1,700 stocks to Efficient Tax LLC. The ETPO can use projections based on a share price or an earnings-based price target, which incorporates an earnings base, a compound growth rate and a price earnings multiple, plus future dividends, to calculate a total projected after-tax value at the end of a three, four or five year chosen investment time horizon.

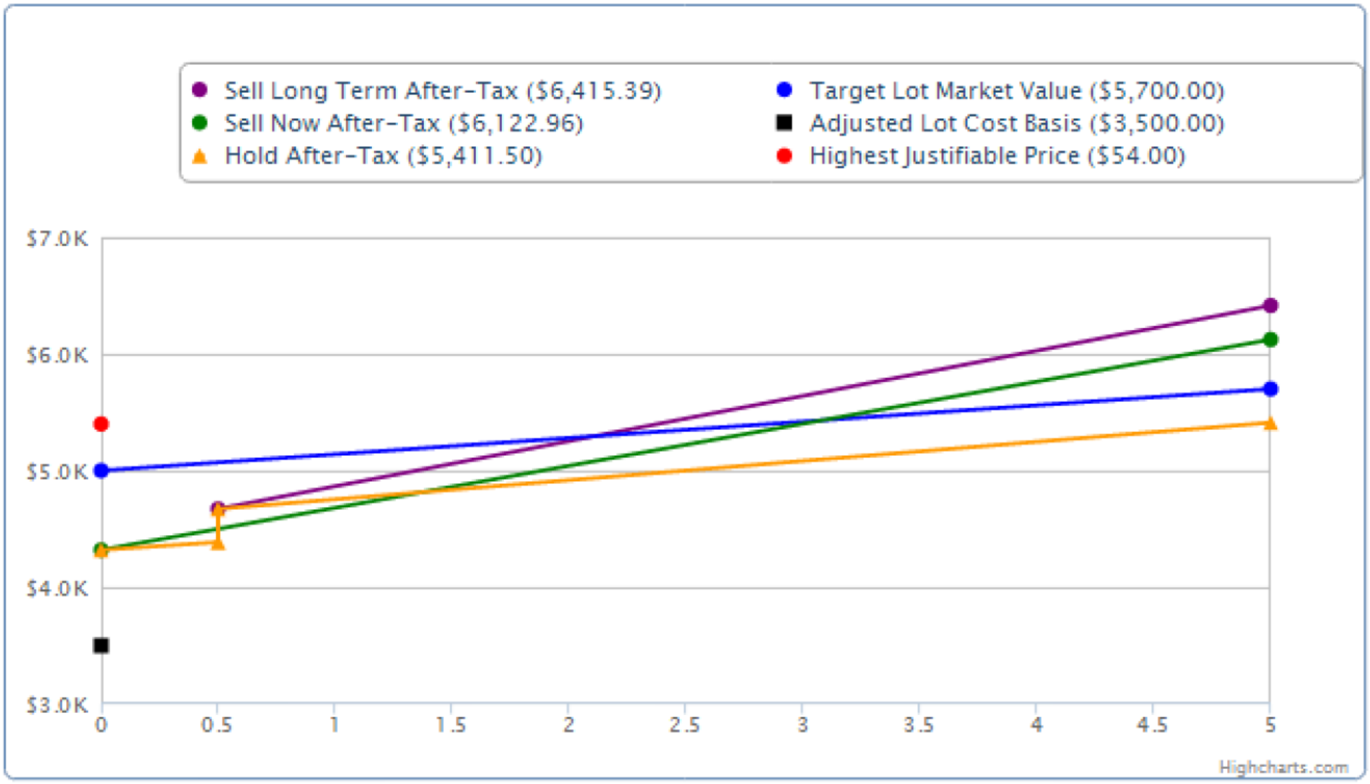
How do clients access ETPO?

The ETPO is available through InvestCloud, a one-stop shop for wealth managers to get the tools they need to run their businesses. Institutions can assemble a wide range of reports for their customers or for internal communication purposes. InvestCloud is a leader in bringing powerful cutting edge technology to the financial services industry.

The ETPO automatically imports customer portfolio information from brokerage accounts or related systems and updates the data at the end of each trading day. By the next morning, it will deliver a report to the portfolio manager identifying assets that they might wish to consider selling. Advisors can also evaluate all portfolios on demand.

In summary, ETPO can ensure that your holdings provide the greatest after-tax return potential available, given your risk tolerance and other investment parameters. The system is automated and will alert you when it sees opportunities to sell existing holdings and make more money with other investments. It does more than simply minimize your current tax liability. It incorporates capital efficiency into your tax management strategy, shifting your focus to after-tax wealth accumulation – where it belongs. ETPO can help money managers stay consistently disciplined and rational, even as they deliver customized service to each individual client. The Efficient Tax Portfolio Optimizer is the only investment management tool available that will directly deliver to investors their #1 goal; After-tax Capital Efficiency, Within Risk Tolerances, Net of Fees.

Investment Horizon Year: 5



Company Name:	Coca-Cola Company	Max Strategy:	SELL WHEN LONG-TERM
Ticker:	KO	Sell Now Total Tax-Lot Tax Liability:	$679.38
Purchase Date:	12/30/2013	After-Tax Annual Return on Taxes:	20.90%
Original or Residual Shares:	100	After-Tax Annual Avg. Rec. Advantage:	3.70%
Original or Residual Cost Basis:	$3,500.00	Hold Unrealized Gain:	$1,500.00
Cost/Share:	$35.00	Realized S.T. Gains/Losses:	$0.00
Price Assumption:	$50.00	Realized L.T. Gains/Losses:	$0.00
Current Lot Market Value:	$5,000.00	Adjusted Lot Cost Basis:	$3,500.00
Current Lot Gross After-Tax Value:	$4,320.62	Tax Loss Harvesting Matching Shares:	0
Simple Return:	42.90%	Tax Loss Harvesting Alternate Shares:	0
New Purchase After-Tax IRR:	3.10%	Months Until Long Term:	6
Existing Tax-Lot After-Tax IRR:	4.60%		
INPUTS			
Filing State:	NY	Current Market Price Per Share:	$50.00
Fed. Marginal Short-Term Tax Rate:	40.00%	Annual Dividend Assumption:	$0.80
Fed. Marginal Long-Term Tax Rate:	20.00%	Dividend Growth Rate:	2.50%
Other Income Offset:	$3,000.00	Before-tax Reinvestment Return Rate:	10.00%
Brokerage Cents per Share:	$0.00	Highest Justifiable Price:	$54.00
Brokerage Annual Wrap Fee:	0.00%	Stock Risk Premium Adjustment:	0.00%
Annual Advisor Fee:	0.00%	Minimum Compound Selling Advantage	0.00%
Portfolio Turnover:	50.00%	Price Targeting Option:	Price
		Price Target:	$57.00

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