



As a Money 101 Education Investment Segment student, you know that one of our core messages is that building wealth through investing need not be complicated.

The basic steps are:

1. **Decide when you will need your money.** Money needed soon should not be invested the same way as money you will not need for many years.
2. **Based on your time horizon, select an appropriate allocation among U.S. stocks, international stocks, and bonds.** Use the Investment Allocation charts provided to help you decide.
3. **Decide whether you want the allocation to stay fixed or change over time.** If you want the allocation to stay fixed, you might choose an Asset Allocation fund. If you want the allocation to gradually become more conservative over time, you might choose a Target Date fund.
4. **Select ONE fund that matches your goals.** A one-fund approach can be a wonderful solution because the fund manager handles the allocation and rebalancing for you. Use Morningstar as a research tool, and consider investing in a fund offered by your financial custodian to avoid purchase fees.
5. **Decide on how much you can afford to invest annually,** and divide that amount by 52. That is the amount you will set up to be automatically invested - making small regular transfers to your investment account is better than waiting to make a large transfer (which often does not happen), ... and yes, you can invest \$10 a week.
6. **Contact your financial institution (where you hold your investment accounts) and have them set up automatic investing.** They will arrange to take the weekly amount you designate and transfer it from your checking account (which can be at a different bank) to your investment account, where it will be invested in the one fund you chose. This works for both a retirement account and a taxable brokerage account. Just remember: if you are contributing to a retirement account, make sure you do not contribute more than the government allows each year. (The automatic process works like a charm.)

After that, you can generally sit back and relax.

The Good News

The good news is that a one-fund approach keeps **investing simple**.

If you choose an appropriate asset allocation fund or target date fund, the fund manager is responsible for keeping the fund aligned with its stated target allocation. This means you do not have to constantly watch the market, rebalance your investments, or decide when to buy and sell. For many investors, this simplicity is a very good thing.

The Bad News

The bad news is that if you are in a **high tax bracket** and have a taxable brokerage account, in addition to a retirement account, a one-fund approach is not the most tax-efficient strategy.

To improve tax efficiency, you would allocate investments between retirement and non-retirement accounts based on taxable income. This is called **asset location**.

- **Income-producing investments**, such as taxable bonds and REITs, would be held in retirement accounts because the interest and dividends they produce are not taxed.
- **Stock funds**, especially broad-based U.S. and international equity index funds, would be held in taxable brokerage accounts; they are generally held for long-term growth and not taxed until sold. While they may pay some dividends, much of their return may come from capital appreciation.

Consider Asset Location - to Achieve a More Tax-Efficient Approach

Thus, if you are willing to do more work, you could improve the tax efficiency of your overall portfolio by holding several separate funds rather than a single all-in-one fund.

In your taxable brokerage account, hold:

- U.S. stock fund(s) – where the dividends paid tend to be low, and where you get a benefit from long-term capital gains, as they are taxed at a lower rate
- International stock fund(s), where you may earn foreign tax credits, which can be used to reduce income taxes
- A tax-exempt bond fund (if you wanted more bond exposure than your retirement accounts allow). The tax-exempt bond funds pay a lower interest rate than a taxable bond fund because they give the investor the benefit of tax-free income

In your traditional retirement account (NOT A ROTH), hold:

- Taxable Bond fund(s) that generate interest income, which is taxed at ordinary income rates, generally higher than long-term capital gains rates.
- A REIT fund(s) that generates dividend income

In your Roth retirement account, hold:

Assets you expect to have the **highest long-term growth**, because a Roth has no required minimum distributions as traditional IRAs do, investments grow tax-free, and withdrawals, when taken, are tax-free.

These will be the last funds you ever touch, and if you plan properly, the account should be intact at the time of your death, so your heirs could remove the proceeds without income tax consequences. Generally, the best investments to locate in your ROTH are:

- US Stock fund(s)

To maximize tax efficiency, an investor needs investments in both a taxable brokerage account and a traditional retirement account

To take advantage of the multi-fund tax-efficiency approach, you need to hold investments in more than one type of account. The extent to which you can use this strategy depends on how your investments are allocated. See three examples at the end of the handout that show how funds would be invested based on target ratios AND investment locations.

The Trade-Off

The trade-off is that this approach requires more effort.

If you hold several separate funds, you need to review your overall portfolio at least once a year to see whether your allocation is still close to your target.

For example, if the US stock fund value has gone up a lot, your portfolio may now hold more US stocks than you intended. If bonds have lagged, your bond percentage may be too low. In that case, you may need to **rebalance** by buying and selling funds to bring the portfolio back to its target allocation.

This is not impossible, but it does require attention and discipline.

Bottom Line

A one-fund approach is usually simple, easy to maintain, and perfectly reasonable for many investors - especially those who only have a retirement account, and not a taxable brokerage account

A multi-fund approach can be more tax-efficient, especially for people with both retirement accounts and taxable brokerage accounts and a high taxable income, but it requires more work.

The goal is not to make investing complicated. The goal is to choose an approach that you understand, can stick with, and can maintain over time.

EXAMPLE: \$100,000 portfolio with the following target allocation

Asset class	Target %	Target \$
U.S. stocks	40%	\$40,000
International stocks	20%	\$20,000
Bonds	40%	\$40,000
Total	100%	\$100,000

Logic used for tax-efficient account placement examples

- Put stock funds in taxable accounts, because they are generally more tax-efficient.
- Put international stock funds in taxable accounts, when possible, because the investor may benefit from the foreign tax credit.
- Put bonds in the traditional IRA first, as bond interest is usually taxed as ordinary income.

Example #1: \$75,000 taxable / \$25,000 traditional IRA

The IRA has less than the desired amount of bonds (\$40,000). So, the traditional IRA holds \$25,000 of bonds, and the remaining \$15,000 of bonds must sit in taxable.

	Account	U.S. stocks	International stocks	Bonds	Account total
#1	Taxable brokerage	\$40,000	\$20,000	\$15,000	\$75,000
	Traditional IRA	\$0	\$0	\$25,000	\$25,000
	Total portfolio	\$40,000	\$20,000	\$40,000	\$100,000

Example #2: \$50,000 taxable / \$50,000 traditional IRA

The traditional IRA can hold the full \$40,000 bond allocation. The extra \$10,000 in IRA space is allocated to U.S. stocks.

	Account	U.S. stocks	International stocks	Bonds	Account total
#2	Taxable brokerage	\$40,000	\$20,000	\$0	\$50,000
	Traditional IRA	\$10,000	\$0	\$40,000	\$50,000
	Total portfolio	\$40,000	\$20,000	\$40,000	\$100,000

Example #3: \$25,000 taxable / \$75,000 traditional IRA

The taxable account is small, so it is used for the most tax-efficient stock holdings first, especially international stocks. The IRA holds all the bonds plus the remaining U.S. stocks.

	Account	U.S. stocks	International stocks	Bonds	Account total
#3	Taxable brokerage	\$5,000	\$20,000	\$0	\$25,000
	Traditional IRA	\$35,000	\$0	\$40,000	\$75,000
	Total portfolio	\$40,000	\$20,000	\$40,000	\$100,000

Each example reaches the same \$100,000 portfolio target:

If numbers in the tables confuse you, a simple way to illustrate this would be as follows :

- If you have a \$1 million portfolio of which 40% (\$400K) is in bonds that are producing a 5% interest income = (20K) yield,
- If your marginal federal tax rate is 24%, having that interest income taxed every year results in an annual tax bill of \$4,800. Instead of paying taxes, that money could have compounded for years to come if the income had been earned in a non-taxable retirement account.

The conclusion is that three factors should primarily drive your investment **location** decision:

- Portfolio size - the bigger it is, the more likely you are to benefit from optimizing location.
- Bond allocation - the bigger it is, the more likely you are to benefit from optimizing location.
- Income tax bracket - the higher it is, the more likely you are to benefit from optimizing location.

Understand that the primary growth mechanism for stocks is long-term appreciation, which is taxed only when you sell the investment and **realize** the gain. At that time, the taxes due are usually lower, as they benefit from the long-term capital gains rate.

Conversely, the main growth mechanism of bonds, albeit a more modest one, is interest income, which is paid and taxed based on the bond terms, and that timing is not of your choosing. Every time you get interest on bonds, income tax will be due unless it is sheltered in a retirement account.

Additionally, if you are in the wealth accumulation phase of your journey and are not withdrawing these monthly or quarterly interest payments, then you are essentially volunteering to pay taxes on income that you did not ask for.

Simple MANTRA

If you have both a taxable brokerage account and a retirement account,
AND are in a high tax bracket:

Allocate investments with low dividends and long-term capital appreciation (Stocks) in your taxable account or ROTH IRA

Allocated investments with higher interest income (bonds and REITS) in your TRADITIONAL retirement account.

This will achieve greater tax efficiency.

