



Rebalancing your portfolio Tax efficiencies of asset allocation

In order to maximize the after-tax returns on your investments, it's important to combine diversification and tax efficiency. It has been proven that more than 90 per cent of the variation on portfolio returns can be explained by the differences in long-term asset mix. Combine this with having a tax conscious portfolio manager and you are on your way to maximizing your after tax-returns.

However, keeping your portfolio in the desired asset mix can be a challenge. Switching between asset classes or rebalancing may be taxable. Those tax consequences mean that you may put it off longer than you should, or don't rebalance at all. Let's demonstrate this through an example. Suppose on a \$100,000 portfolio, you wanted to maintain a mix of 50 per cent Canadian equities, 30 per cent foreign equities and 20 per cent fixed income. If there was

20 per cent growth in the overall portfolio, primarily in the Canadian Equity Fund, you could be looking at a 65/18/17 split. To get back in line with your desired asset mix you must sell the fund in the gain position, there is no other choice.

In other words, you would have to move \$18,000 from the Canadian Equity Fund and pay \$1,486 in taxes (at a 46 per cent marginal tax rate). This means that the first 1.25 per cent of the returns earned on the new portfolio would already be eaten up by the taxes paid. However, you do have two solutions to this problem.

First, you can use an asset allocation fund where the asset mix is kept in balance by the portfolio manager. The second alternative is to invest in shares of a mutual fund corporation where switching between the different asset classes is not a taxable event.

When the manager of an asset allocation fund is rebalancing to the desired asset mix, dollars are merely moved from one asset class to the others. A manager, unlike the individual investor, does not have to sell the





securities that are in a gain position. The manager could sell the securities in a loss position, or in a gain and some in a loss to minimize the tax consequences, or not sell securities at all but instead use the cash flows to rebalance. Rebalancing by a portfolio manager doesn't have to be taxable.

The second alternative is to select the desired asset mix within a Mutual Fund Corporation. Rebalancing

inside a Corporation is not a taxable event because you are selling and buying shares of the same Corporation. Rebalancing in a Corporation is not immediately taxable.

Either option will help you maintain your long-term asset mix, which combined with tax efficiency will equal performance and thus, maximize the after tax returns on your investments.

Example – Investor Managed

Desired mix on \$100,000	20% growth - primarily Canadian equity	Rebalanced \$120,000
50% Canadian Equity Fund (\$50,000)	65% Canadian Equity Fund (\$78,000) (must sell here to rebalance)	50% Canadian Equity Fund (\$60,000 - \$1,486 tax)
30% Foreign Equity Fund (\$30,000)	18% Foreign Equity Fund (\$21,600)	30% Foreign Equity Fund (\$36,000)
20% Fixed Income Fund (\$20,000)	17% Fixed Income Fund (\$20,400)	20% Fixed Income Fund (\$24,000)
		\$118,514

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