

What kinds of investments go where?

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Most investors have several different kinds of investment accounts that they use for investing funds. Included among them are fully taxable accounts, Roth IRA's, and retirement plans (IRA, SEP, SIMPLE, 401-k, profit sharing, pension). A well diversified portfolio usually contains a combination of fixed income (bonds, CD's, treasuries, municipals) as well as equities (stocks, mutual funds, exchange traded funds). How do you decide what investments to make in each account? Here are some pointers.

Fully taxable accounts should contain those investments that have the least ongoing tax cost. For fixed income that generally means municipal bonds rather than taxable treasuries, CD's or corporate bonds. However, you should compare the after tax yields to determine the best course of action. For equities the issue becomes one of turnover of the portfolio and income taxes. Whether you are investing in mutual funds, exchange traded funds, or individual stocks, high portfolio turnover can often lead to high income tax bills. The average mutual fund has a 90% turnover rate each year. This compares to turnover rates of 20% to 30% as recently as the 1970's. Capital gains taken on assets held for less than one year are taxed at ordinary income tax rates. Assets held longer than one year are taxed at a lower rate of 20%. All taxes paid will reduce the after tax returns to shareholders.

Here are some suggestions on what investments are appropriate for different accounts:

Taxable accounts: municipal bonds, exchange traded funds, mutual funds with low turnover rates, individual stocks that you plan to hold for many years

Retirement plan accounts: taxable bonds and bond funds, individual stocks that you plan to hold for under two years, mutual funds with high turnover rates, high dividend paying stocks & funds

Roth IRA's: individual stocks that you plan to hold for under two years, mutual funds with high turnover rates, aggressive growth oriented investments

Finally, when doing your asset allocation, be sure to include all your investment accounts to get good portfolio diversification. Diversification is about "giving up the ability to make a killing in exchange for protecting yourself from getting killed."