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While our "Alpha" article does use an indexed mutual fund to develop the empirical evidence that taxes are a very important consideration in portfolio management, we do not intend to suggest that passive strategies are the only way — or indeed the best way — to cope with this problem. We have suggested that the primary objective in a taxable portfolio should be to "build a portfolio you can live with for a long, long time." What we perhaps did not make sufficiently clear is that accomplishing this objective is *not* a simple matter.

As Jeffrey said in a recent speech:

> In a dynamic world, portfolios must be pruned to deal with the maturation process that is ever present; but because of transaction costs, and especially taxes, this pruning — this turnover — should be used as thoughtfully and as sparingly and with as much pre-planning as possible.

There is ample opportunity for active managers who understand that there is a big difference — especially in taxable portfolios — between activity and accomplishment.

We turn now to the six points raised by Hertog and Gordon.

1. The "taxes don't matter" or the "taxes don't matter as much as you say" schools persist in arguing that "sooner or later...capital gains taxes must be paid,"

and therefore that to disregard the deferred taxes on unrealized gains is improper. We would respond that *to the extent* that "people [do] need to spend from their portfolios," the portfolios should be constructed and managed accordingly.

But the converse is equally true. Many people have portfolios — or parts of portfolios — from which the principal will likely never be spent, and here the unrealized gains should clearly be maximized. Deferring taxes, like any other expense, is almost always advantageous. And where there is also the likelihood of a stepped-up cost basis at death, which eliminates the tax liability, the value of the deferral is even greater.

Consider the not atypical case of a portfolio owner who is likely to die in the next five to twenty years. While the "zero alpha" shortfall between the return of the more active (25% turnover) portfolio and the less active (5% turnover) portfolio is 58 basis points (using Hertog and Gordon's data), the shortfall more or less doubles when the stepped-up cost basis at death obviates the deferred tax problem.* For mortal investors, Hertog and Gordon's 58-basis point hurdle would seem to be understated.

We would also note that the hurdle would be even more understated if the less active portfolio were to have a lower management fee than the more active portfolio. Given that active management fees for funds of just a few million dollars, which are fairly typical among taxable accounts, can easily run to 100 basis points or more, this fee differential could be quite material.

2. Hertog and Gordon are quite correct in calling attention to the fact that deferring capital gains taxes becomes less advantageous (and even disadvantageous) if future rates turn out to be higher (except when the stepped-up cost basis at death applies). We would point out, however, that, since the Tax Reform Act of 1986, capital gains tax rates, both for individuals and corporations, are higher than they have often been in the past. Much of the talk we hear in Washington centers on ways to *lower* capital gains rates while the rates on ordinary income go up.
3. We wholeheartedly endorse the idea of harvesting all economical losses within the portfolio and in sister portfolios, but it has been Jeffrey's experience that low-turnover equity portfolios do not afford as many loss realization opportunities as one might expect.
4. While we understand that using appreciated securities is the most tax-efficient way to make contributions, we are not clear why the tax benefit would be greater in the higher-turnover portfolio. In fact, since the owner of the low-turnover portfolio would likely have greater unrealized gains, would it not therefore receive the greater tax benefit?
5. We agree completely (and point out extensively in the "Alpha" endnotes) that mutual fund investors are liable for the capital gains taxes triggered by other investors departing the fund. Although little-known, this "double tax" phenomenon is an unfair and not inconsequential drawback for mutual fund investors. But the mutual funds' problem presents an opportunity for active separate fund managers who are willing to develop low-turnover strategies.
6. Heretofore, the focus in taxable situations has been largely on the mix of asset classes, e.g., equities versus municipal bonds, tax shelters, etc., but very little attention has been given to how the various portfolios could be managed in a more tax-efficient manner. The latter was our primary intent in "Alpha."

In summary, we think it is unfortunate that the much-needed focus on after-tax performance has tended to become an "active versus passive" issue. As already noted, we believe that minimizing turnover, which is so essential to good after-tax performance, requires just as much — and conceivably more — management attention as a high-turnover, non-taxable portfolio.

While we are pleased to see firms of the stature of Hertog's and Gordon's pursuing this opportunity, we would encourage less concern about competing with index funds and more about developing strategies where turnover is "used as thoughtfully and as sparingly and with as much pre-planning as possible."

## ENDNOTE

*If death occurs at five years, the "zero alpha" shortfall is 100 basis points; it is 115 at ten years, and 119 at twenty years.