

Better Predictors

Compare tax drag to the tax exemption multiple (TEM) and the tax deferral multiple (TDM)

	Tax Drag	TEM	Difference in Value After 20 Years (Tax-Exempt Portfolio)	TDM	Difference in Value After 20 Years (Tax-Deferred Portfolio)
Asset Class 1	1.12%	2.46	\$24.6 million	1.97	\$19.7million
Asset Class 2	1.28%	.99	\$9.9 million	0.35	\$3.6 million

Note: Assumes an initial value of \$10 million, and capital gains tax rate remains constant. Returns exclude management fees.

— Deutsche Asset & Wealth Management

the most logical choice for use in private placement portfolios.

Which asset classes could be more powerful in a private placement portfolio? Emerging market equities have, by far, the most utility. The difference in the value of a dollar invested in that asset class in a private placement (versus taxable) portfolio over 20 years is more than three times the difference of a dollar invested in emerging market bonds, for example. The difference in the value of a dollar invested in developed market equities in a private placement (versus taxable) portfolio is anywhere from 1.5 to 2.5 times greater than one dollar invested in emerging market bonds. The combination of expected return, turnover and tax rate makes all the difference.

It's important to note that these are our long-term asset class assumptions and are based on index returns. Actual returns might differ depending on the particular manager. Moreover, they reflect Deutsche Asset & Wealth Management's views. With the help of a good advisor, an investor can combine their own views and the characteristics of their selected managers, to create a custom set of tax deferral metrics.

Once an investor has determined what percentage of their overall portfolio they'd like to place in private placement, and his advisor has calculated the tax deferral metrics for each available asset class, the investor and advisor still need to determine which asset classes should be placed in the private placement portfolio and which should remain in the taxable portfolio: the so-

called "asset location" strategy.

One asset location strategy that's perhaps the easiest to execute, is simply to mirror the target taxable allocation in the private placement portfolio, with minor adjustments to optimize for a tax-free structure. We'll call this the "mirror strategy." The results are a taxable portfolio and a private placement portfolio that are nearly identical from an asset allocation perspective. This method offers the advantage of limiting the administrative burden that arises when the faster tax deferred growth (and often higher growth asset classes) in the private placement portfolio cause the asset classes to become out of bal-

ance. Because the allocations are near-identical, an investor needn't worry about reallocating between the private placement and taxable pools but only within each of the pools separately. A disadvantage of this method is that it inhibits an investor from taking advantage of the superior tax deferral benefit of certain asset classes by concentrating them in the private placement portfolio. "Asset Allocation Advantage," p. x, demonstrates the effect of this disadvantage over time.

The most potent approach is to locate in private placement portfolios only the asset classes with the highest TEM. If the client views the assets in both the taxable and private placement pools as a single portfolio, this approach has a distinct disadvantage: the considerable administrative burden of reallocating between the private placement and taxable pools. This process is a very manual one and, at times, becomes impossible to fully execute without changing the overall allocation.

Another approach is to consider the private placement portfolio as distinct from a broadly diversified asset allocation. This "tactical" portfolio would consist of certain "high conviction" asset classes that are also best suited to the benefits of private placement. The goal of this pool would be absolute returns rather than risk-adjusted returns. In this way, TEM is an excellent metric to determine which asset classes from the high conviction set offer the greatest benefit from tax deferral or tax-exemption.