Taxing decisions

For high net worth investors, avoiding shakedown from Uncle Sam among key strategies

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May 30. 2005 6:01AM

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Rising oil prices, growing consumer debt, volatile markets.

There's a lot of uncertainty in the market right now — but financial planners say there's opportunity as well, especially for high net worth investors.

"This is where professional money managers really shine," said Chris Cwiklinski, a vice president at Huntington Bancshares Inc.

The investment strategy for a high net worth investor, an individual with more than $1 million in liquid assets, is significantly different than for lower income investors, money managers say. Most investment strategies for high net worth clients are designed with taxes in mind.

"They can feel it a lot more than most," said Mark Haley, a portfolio and money manager at Winfield Associates Inc. in Cleveland.

The alternative minimum tax can become an issue with those in higher tax brackets, Mr. Cwiklinski said. They are also more "sensitive" to short-term capital gains that are taxed at individual income levels.

To offset the tax issue, municipal bonds might be an answer.

"They make a lot of sense because you're not paying federal and state taxes," he said.

A number of investment firms recommend dividend-paying stocks for taxable accounts. Investment firm Charles Schwab & Co. notes that individuals taxed at 33% and higher keep 85% of dividends before state and local taxes. Holders of taxable bond coupons, meanwhile, keep 67% or less after taxes are taken out.

"Dividend-paying stocks can be a good investment for high net worth investors," said Tim Swanson, chief investment officer for Cleveland-based National City Corp.'s private client group.

Often, high net worth clients are retirement-age executives who have as much as 90% of their money in their company's stock, Mr. Haley said. The trick in that situation is to devise a tax plan to hedge their position, he said.

"One of the most simple ways is to position yourself against that particular sector," he said. "For example, a client with Intel can short the index of semi-conductors."

Mr. Swanson said another typical strategy for high net worth clients is to purchase a put option, which places a floor price on a particular stock, while also writing a call option, which allows the investor to sell a security in the future for a specified amount.

The combined tactics are referred to as a "collar" and are particularly useful for those with a sizable portfolio value because it limits volatility and preserves value.

"A retired executive, they still have a pretty healthy time horizon looking forward," Mr. Swanson said.

The simplest option, he said, might be to just bite the bullet and sell the shares outright. Tax law changes in 2003 set the tax for long-term capital gains at 15%, which makes selling less painful.

“That’s a relatively small price to pay,” Mr. Swanson said.

As it is with all investors, diversification is important. But those with assets of $1 million or more to invest have more options at their disposal, said Brian Zavalkoff, first vice president and senior portfolio manager at Chicago-based LaSalle Bank, which operates a regional office in Cleveland.

For a minimum $1 million investment, LaSalle offers its brand of separate managed account called Capital Advisors.

“These are not mutual funds,” Mr. Zavalkoff said. “Mutual funds are a co-mingled group of funds where the client has no control. This is a separately managed account where the client holds individual stocks or bonds.”

Investors who want to try to wring the maximum returns out of today’s markets can look for signs that hint at whether a company is a worthwhile investment, some money managers said.

Cash flow is one of the best indicators, Mr. Haley said. If a company is using its cash to buy back stock, that increases dividends for shareholders and is evidence of free cash flow.

“It shows management is not just sitting on their hands,” he said.

Pay attention to what bondholders are doing as well, Mr. Cwiklinski said.

For instance, the bonds at WorldCom Inc. were trading at a discount before accounting fraud problems were revealed at the telecommunications giant.

“In my opinion, bondholders take a closer look at cash flow fundamentals,” he said.