A Strategy That Pays Dividends

Dividend Tilts in Taxable Insurance Portfolios

Taxable insurance portfolios can enhance returns by employing the tax code's preference for dividends. By orienting their holdings toward equities that pay higher dividends, taxable investors can shift their total return to the more favorably-taxed dividend return component and away from the price return. The end result: after-tax alpha relative to a passively managed index portfolio.

Introduction

Trillions of dollars of negative-yielding debt has caused investors across the globe to search for yield wherever they can find it. Yield-hungry investors have poured into dividend-paying domestic equity securities. Like other investors, taxable insurance funds have felt the squeeze and looked to dividend-paying stocks for help. Yet there may be further benefits to owning higher dividend-paying stocks in taxable insurance portfolios than just additional yield potential.

In the current tax environment, there are benefits to shifting a portion of the total return of a taxable equity insurance portfolio from the price return to the dividend return component of the portfolio. By taking advantage of the tax code's preferential treatment of dividend returns, taxable insurance funds may generate after-tax alpha and, thereby, improve performance.

It is worth stressing, however, that it's not that easy to generate after-tax alpha in a taxable equity insurance portfolio and many factors must be considered. A dividend tilt is no free lunch, and considerations such as tracking error relative to the benchmark, taxable portfolio turnover, realization of capital gains and losses, among other things, must be factored into a fund's individual analysis.

Still, diligent monitoring of these factors and awareness of a complicated tax code could lead to after-tax alpha in an actively managed high dividend equity portfolio relative to a passively managed, tax-indifferent index portfolio. In today's low interest rate environment, such after-tax alpha may be well worth it.

Taxes

To avoid triple taxation of a single income flow to the investor, common stock dividends paid from one taxable corporation to another are eligible for the federal dividends received deduction (DRD) of 70%.[1] Insurers are also subject to the additional proration provision of the tax code for dividends, which, in the case of non-life insurance companies, adds 15% of the tax-exempt dividends back to taxable income.[2] Therefore, the resulting effective tax rate on a common stock dividend from an unaffiliated

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[1] *See Internal Revenue Code §243(a). The amount of the DRD depends on the level of a corporate shareholder's stock ownership in the dividend-paying corporation. The DRD is generally 70% for portfolio stock investments. However, if a corporate shareholder owns 20% of another corporation, it is entitled to an 80% DRD. A 100% DRD is permitted for certain intercorporate dividends received from members of the same affiliated group. The analysis herein assumes that the 70% DRD applies.*

[2] *See Internal Revenue Code §832(b)(5)(B). Life insurance companies are subject to different proration rules, which allocate a life insurance company's income and deduction items between the company and the policyholders. See Internal Revenue Code §§805(a)(4)(A)(ii) and 812. This paper does not take into consideration the effect of those proration rules on life insurance companies. The following analysis only takes into account the effect of the 15% proration rule on the investment return of a non-life insurer.*

Note: NISA Investment Advisors, LLC does not purport to be experts in, and does not provide, tax, legal, accounting, recordkeeping or any related services or advice.

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company is 14.175%, as demonstrated below. Please note, state taxes are ignored throughout this paper.

Exhibit I: Breaking Down the Effective Tax Rate for Dividends

$$((1 - \underbrace{70\%}_{\text{DRD}}) \times \underbrace{35\%}_{\text{Corporate Rate}}) + (\underbrace{70\%}_{\text{Exempt Dividends}} \times \underbrace{15\%}_{\text{Proration}} \times \underbrace{35\%}_{\text{Corporate Rate}}) = 14.175\%$$

Increasing the dividend component of the total return

By shifting returns away from the 35% capital gains rate and towards the 14.175% dividend tax rate—and, importantly, achieving the same total return—the effective long-term tax rate of the portfolio could be reduced and after-tax alpha may be obtained.

In the illustrative analysis presented below, a benchmark portfolio and a series of modeled portfolios are shown with varying degrees of dividend tilt. All portfolios were given an illustrative annual total return of 7.0%, with the benchmark receiving 2.0% of its total return from dividends. The sample portfolios' dividend yields were increased as shown in the tables below (e.g. a portfolio with a +1% dividend tilt will have an annual price return of 4.0% and an annual dividend return of 3.0%). For simplicity, zero turnover was assumed for all portfolios. As shown in the tables below, as the degree of dividend tilt increases, after-tax alpha increases as well.

Exhibit II: Return Components and Realized Annualized After-Tax Alpha

Portfolio Return

Return Components	Degree of Dividend Tilt: 0.5%	1.0%	1.5%	2.0%
Price	4.50%	4.00%	3.50%	3.00%
Dividend	2.50%	3.00%	3.50%	4.00%
Total	7.00%	7.00%	7.00%	7.00%

Annualized After-Tax Alpha

Investment Horizon	Degree of Dividend Tilt: 0.5%	1.0%	1.5%	2.0%
1 year	0.11%	0.21%	0.32%	0.43%
5 years	0.11%	0.22%	0.32%	0.43%
10 years	0.11%	0.21%	0.32%	0.43%
15 years	0.10%	0.20%	0.31%	0.41%
20 years	0.10%	0.19%	0.29%	0.39%
30 years	0.08%	0.17%	0.26%	0.35%

For example: a portfolio with a 100 bps annual dividend tilt would provide a tax alpha of 20 bps per year over a 15-year horizon.

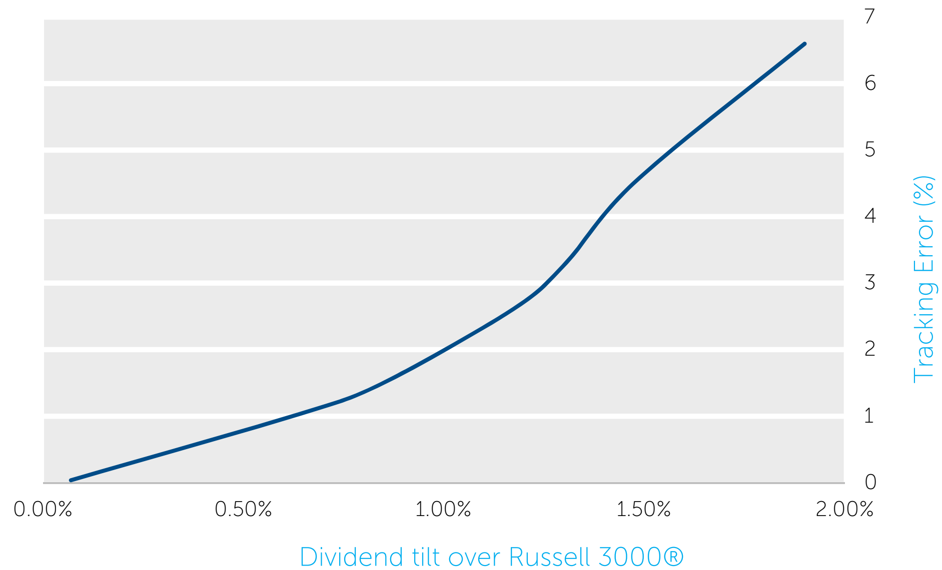
Source: NISA analysis.

The takeaway from the second table in Exhibit II is that as the dividend tilt increases, so does after-tax alpha. Due to our assumption of zero turnover, the above analysis assumes that capital gains taxes are deferred until liquidation. As a result, as the investment horizon increases, the after-tax alpha decreases and will eventually turn negative because the capital gains can grow shielded from taxes until they are realized, unlike the dividends. The growth in the unrealized gain in the lower yielding portfolios eventually outpaces the benefits of a shift to a portfolio with a higher dividend yield and lower overall tax rate. By adding a more realistic 5% taxable turnover component to the equation, the annualized alpha actually increases with time in all scenarios presented above.

Tracking Error

One important caveat is that as a portfolio's dividend yield tilts away from a stated benchmark, inevitably the tracking error of the portfolio relative to the benchmark increases. The graph below represents the relationship between dividend tilt and tracking error for portfolios modeled against the Russell 3000®.

Exhibit III: Dividend Tilt at the Cost of Tracking Error



Source: NISA analysis and Russell Investments.

As evidenced by the graph, tracking error will grow with the dividend tilt. The good news, however, is that although the tracking error of a portfolio is increasing, the primary risk factors in each portfolio remain relatively unchanged and each portfolio has a beta near 1.0 compared to the benchmark. Individual funds will have to decide, however, whether the after-tax alpha justifies the additional tracking error as their risk tolerance and particular circumstances dictate.

Turnover

Maintaining a higher dividend yield relative to a stated benchmark may lead to higher turnover in a portfolio as compared to the turnover in a passive, index-like portfolio. As a consequence, taxable turnover is a significant factor in after-tax performance and may erode any tax-alpha produced by a dividend tilt. As seen in the table in Exhibit IV below, by taxing capital gains at 35%, an active portfolio manager with 50% turnover would incur 29 bps of additional annual taxes over a 30-year horizon relative to a portfolio with zero taxable turnover. For reference, we estimate that the S&P 500 and Russell 3000 indices have annual turnover of ~4.5% and ~5.5%, respectively. In the table we have also included estimated transaction costs stemming from trading commissions, and assume that they increase with the portfolio's turnover rate.

Exhibit IV: Turnover Analysis

		Additional Annual Taxes					
Years	1	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
	5	0.00%	0.01%	0.01%	0.02%	0.03%	0.03%
	10	0.01%	0.04%	0.05%	0.07%	0.08%	0.09%
	15	0.03%	0.08%	0.10%	0.13%	0.14%	0.15%
	20	0.06%	0.12%	0.16%	0.20%	0.21%	0.22%
	30	0.11%	0.21%	0.25%	0.29%	0.31%	0.32%
Annual Turnover Rate		5%	15%	25%	50%	75%	100%
Est. Transaction Costs per Annual Turnover Rate		*0.02%*	*0.05%*	*0.09%*	*0.18%*	*0.26%*	*0.35%*

Source: NISA analysis.

Fortunately, actively harvesting losses may limit the turnover tax cost in the portfolio. A broadly diversified portfolio, holding a large number of securities with multiple tax lots, provides opportunities to effectively manage realized capital gains and losses while maintaining the overall desired yield or other style exposures. The reinvestment of cash flows (from dividends, corporate actions, securities sales, and contributions) results in the continued ability to effectively harvest tax losses. Realized losses can be used to offset realized gains from trading or corporate actions, reducing current taxes and enhancing after-tax return.

Conclusion

A tilt toward higher dividend paying stocks can provide taxable insurance portfolios with after-tax alpha at the cost of higher tracking error. Funds eager for higher yield may want to take advantage of the tax code's preference for dividends, provided the added tracking error is within their risk tolerance.

It is worth reiterating that there are several factors to look at when debating whether or not to increase the dividend yield of an equity portfolio relative to a benchmark to enhance the portfolio's after-tax return. Factors such as a portfolio's particular benchmark, DRD qualifying holding period (currently 45 days around the ex-dividend date), dividends not eligible for the DRD (like REITs, investment companies, and certain extraordinary dividends), and wash sale issues, among others, add complexity to the trade-off between the dividend tilt and tracking error and need to be considered.

That said, a dividend tilt is a simple and theoretically sound way of utilizing the tax code to generate after-tax alpha. For taxable insurance portfolios seeking yield in the current "lower for longer" environment, the added yield may make a lot of sense.

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