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February 7, 2005

Securities and Exchange Commission
450 Fifth Street, NW
Washington, D.C. 20549-0069

To Commission Members and Staff:

Re: File Number: S7-25-99, Release Number: 34-50980

CERTAIN BROKER-DEALERS DEEMED NOT TO BE INVESTMENT ADVISERS

I would like to respectively submit comments from Farm Creek Securities, LLC (Farm Creek). Farm Creek, which opened about one year ago, is a registered broker-dealer and a member of NASD. This rule making is important to us as we use an asset-based fee structure and are working to develop a competitive firm. For clarity I will write in the third person plural.

Summary

Farm Creek Securities, LLC agrees with most of the Securities and Exchange Commission Release addressing the application of the Investment Advisers Act of 1940 to broker-dealers. In particular:

- We agree the use of asset-based fees by broker-dealers should not invalidate their exemption from the Advisers Act.

- We strongly agree that the exercise of discretion should be a bright-line test which invalidates a broker-dealer's exemption. Importantly for investor protections, we believe this "bright-line" is clearly visible to the public. They understand there is a fundamental difference in duties and responsibilities when someone moves from giving advice to making decisions.

- We think the Commission should conduct an orderly retreat from its proposal to "clarify" what services are solely incidental to being a broker-dealer. The Congress left this open-ended and so should the Commission. In fact, in further releases we hope the Commission clearly states that a responsible broker should have no fear that he or she could be too thorough.

- For broker-dealers required to register under the Advisers Act, we request the Commission allow them to register directly with the SEC rather than using the state by state approach until a certain number of states are tallied. The logistics and costs of state by state registration were important factors in Farm Creek's decision not pursue activities which would require registration under the Advisers Act.

Before proceeding we would like to briefly review the dynamics of the relationship between investors and financial professionals. Understanding this interaction is important for framing the issues before us. In particular, everyone needs to focus on the investor when he or she asks: "What should I do or buy?" Our experience is that the same question is asked worldwide, from the smallest investor to the largest and most sophisticated. Everything advisers and brokers do flows from this fundamental question. The issue facing the Commission is how does it want financial professionals to respond? Does it want brokers to answer in one way and advisers in another?

Discussion

Fee Structures

We agree with the Commission's position in Section 202(a)(11)T that just because a broker-dealer uses an asset-based fee structure it should not lose its exemption from the Advisers Act.

Farm Creek uses an asset-based fee structure and strongly believes this is in line with investor interests. The fee structure grew somewhat organically from how we believe investors are best served when they ask: "What should I do," balanced with our desire to run a for-profit business. Our basic fee is 25 basis points per year on assets plus a ticket charge of $15 per transaction. For a complete discussion and description of our fee structure, please see Appendix I on page 9.

We request that the Commission remove some confusion with respect to proposed Section 202(a)(11)-1. We think the Commission should be clear – asset-based fees are not, in and of themselves, "special compensation" and will not affect a broker-dealer's exemption from the Advisers Act. With this clarity, a broker-dealer using asset-based fees receives its exemption relying on Section 202(a)(11)(C) without reaching 202(a)(11)-1. And therefore, it looks like these fee-based accounts will not be subject to the additional disclosure in 202(a)(11)-1(a)(1)(iii). We think that this is a mistake and that fee-based accounts should receive additional disclosures. But, we think it makes more sense for the Commission to use its direct regulatory power of broker-dealer disclosures rather than running it through the Advisers Act.

In any case, Farm Creek only offers one type of account and therefore by definition can not receive "special compensation" as there is no other account to which it can be compared. Therefore, it appears that Farm Creek will continue to obtain its exemption

from the Advisers Act from Section 202(a)(11)(C) and will not be covered by the disclosure Section 202(a)(11)-1(a)(1)(iii). Is this what the Commission intended?

Please see Appendix II to review Farm Creek's current disclosure which we devised in conjunction with our clearing firm. We think the important issues of fees, discretion and advice are discussed in a clear and concise manner.

Scope of Solely Incidental Broker-Dealer Services

We think the Commission will be marching into an abyss if it proceeds with its proposal to "clarify" what services are solely incidental to being a broker-dealer. We have grouped our comments into 5 categories.

A. Authority Issues
B. Comparison of Advisers and Broker-Dealers
C. Market Structure
D. Practicality Issues
E. Investor Protection

A. Authority Issues

We realize that the Commission can regulate broker-dealers in numerous ways and that it has many avenues open to it. But it is not clear how the Commission gains regulatory authority over the scope of broker-dealers' services from Section 202(a)(11) of the Advisers Act. It appears that this section is focused on exemptions to the Act, not limitations of the various professions mentioned.

If the Commission gains authority to limit broker-dealer activities from this section does it also gain authority to limit banks and newspapers? How about lawyers, accountants, engineers and teachers? These professions were referred to in a very similar fashion to broker-dealers.[1]

The issue of "clarifying" what activities are solely incidental to the broker-dealer profession is a red-herring. It detracts from the goal of assuring that investors are protected and receive good advice. Why does the Commission feel it needs to define "solely incidental" when Congress chose not too. It had plenty of opportunities to limit broker-dealer's thoroughness and sophistication. It appears the Congress knew it fool-hardy to predict how lawyers, accountants, engineers, teachers and broker-dealers might give advice to investors. So they exempted them from the Act in a broad and open-ended fashion.

[1] Section 202(a)(11)(B)-(C): "any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; (C) any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor;"

B. Comparison of Advisers and Broker-Dealers

Some of the comments the Commission receives may argue that either advisers or broker-dealers are more qualified to help retail investors answer their fundamental question of "what should I do?" But we think these assertions divert attention from the more important question of how the Commission ensures that both groups are capable of helping investors. Congress knew in 1940 that brokers and advisers shared the same profession and it appears investors still feel that way.

If the Commission does get caught up in a discussion of the respective qualifications of brokers and advisers, we offer a few thoughts. First, we are astounded by the lack of requirements or continuing education for advisers when compared with brokers at both the "firm" and the "representative" levels. The barriers to entry seem pretty low, especially for "representatives."

This is borne out in the Commission's cost/benefit analysis. In discussing the benefits to broker-dealers avoiding the costs of complying with the Advisers Act, the release lists all sorts of costs saved, but nothing about broker training or testing. On the flip side, in the cost section for the broker-dealers that will need to register as Advisers, there is nothing about training or testing. This is very curious. If advisers are more capable and/or better trained in providing investment information, we would have expected to see a significant cost for brokers upgrading their competency to the level of advisers. But there are no costs because no upgrading is necessary. Imagine if the tables were turned and the costs involved if advisers had to register as brokers and take the Series 7 and their bosses the Series 24?

We think that limiting broker-dealers with respect to advisers in how thorough they advise investors is ridiculous. In the release the Commission indicated broker-dealers are well regulated, so where is the problem.

C. Market Structure Issues

We are surprised the Commission wants to micro-manage the structure of the financial services industry. And we are even more surprised the commission wants to become embroiled in these issues due an exemption in the Advisers Act. We would have thought it would have wanted a clear mandate to restructure the industry.

Are Brokers a Subset of Advisors or an Independent Group?

Let us start by discussing the field of financial professionals and the spatial relationship between broker-dealers and advisers. Specifically, is the broker-dealer group independent of the adviser group or subset of it? This distinction is critical since which premise is accepted significantly shapes the discussion. For example, if an exempted group (RRs) is independent of a "regulated" group (Advisers), no explanation for the exemption is expected or required. However, when a subset (RRs) is exempted from its

larger group (Advisers), a reasonable explanation is rightly demanded. In this context, we think broker-dealers are clearly independent of advisers.

We are concerned that if the Commission accepts the false premise - that broker-dealers are a subset of advisers, it may find itself trying to offer a "reasonable" explanation for the exemption. If the Commission accepts the correct premise - that brokers are independent from advisers, no explanation of the exemption is required.

What do Brokers and Advisers Do?

Let us examine the relationship between what brokers and advisers actually do? There is substantial overlap as both groups give advice while brokers can exclusively execute orders and advisers have the exclusive on managing money. Which group spends more time giving advice? We are not sure, but we think it takes more time to manage money than it does to execute orders and that most RRs spend much of their day giving advice to investors.

If the Commission believes it is in investors' interest to limit advice from broker-dealers, where does its market structuring authority come from? If the Commission does get drawn into an explanation, we suspect it will end up drawing all sorts of artificial boundaries on the ever-changing competitive landscape limiting growth and evolution. Farm Creek is proof that new ideas are being tried all the time. The Commission's ultimate goal should be assuring investors get good answers when they ask: "What should I do" and let the marketplace determine if investors go to a broker or an adviser.

D. Practicality

We wonder how the Commission might limit brokers' freedom and responsibility to offer good advice. How does it want brokers to respond when investors ask, "What should I do?" One indication that appears encouraging is the SEC approval of NASD IM-2210-6. But this also makes it to very difficult how the SEC will navigate the issue.

It is somewhat surprising that the issue of brokers helping and advising investors make the right long-term decisions, is even on the table. The Commission and the SROs let broker-dealers publish extremely thorough, in-depth analyses of individual companies and securities for their clients. Yet it questions if broker-dealers have the competence to help investors plan and invest for the long-term.

There are other practical problems with restricting broker-dealers' advice. Will the Commission look at the percentage of time a broker spends advising his clients to determine if he has been too thorough? We think this is unworkable as it assumes other work stays constant. For instance, trade processing continues to become more automated. By making order entry and booking keeping more efficient, should brokers fear that they have freed up too much time to advise their clients? It will be interesting if

on one side of a broker-dealer, the SEC insists security analysts be more thorough while simultaneously restricting its brokers' thoroughness.

We also encourage the Commission to clear up some of the confusion with labels and titles. Our suggestion is that financial professionals serving retail clients fall into three categories.

- **Brokers** – no change here except with the exercise of discretion.
- **Advisers** – Limited to organizations that manage money and/or exercise discretion.
- **Planners** – Professional organizations which advise retail customers on how to manage their finances yet choose not to be broker-dealers or advisers.

Getting down to Farm Creek's particulars, why would the Commission want to limit the thoroughness of our inquiry and advice to clients? Is the Commission suggesting that if a broker gets too much experience or training, they have to become an adviser? That seems wrong. Should brokers with the CFA designation, use only Level I knowledge in discussions with investors and suppress the lessons of Levels II and III? Should CFAs be barred from being brokers?

Here is a practical test. In Appendix III we have attached a new report designed to advise customers on how to separate their investments between their taxable and tax-qualified accounts in order to maximize after-tax returns. The report clearly flows from customer interest on where to hold certain investments. Does it help customers plan better? We hope so. Is this report incidental to being a broker-dealer? Of course it is. Is it planning and advice? You bet it is. Is it against the law? We hope not!

E. <u>Investor Protection</u>

Does the Commission really want a rule that limits brokers' thoroughness or sophistication when servicing investors? As long as a broker-dealer stays within their competence, how are investors' interests served by such limitations?

None of this is to argue that the Commission should not be very concerned if broker-dealers:

- "Out-run" their competence
- Over-promise and/or under-deliver with respect to planning issues
- Just plain mislead the customers

But broker-dealers already have rules to address these problems and the Commission has plenty of authority to protect investors from broker-dealers without the cover of the Advisers Act.

As we have made clear, we do not see a good reason to limit the advice brokers give investors, but, we will be even more concerned if the Commission decides to go half-

way. We think partially limiting a broker's advice could potentially be worse for investors than banning broker advice. If a partial course is used it will be fuzzy and confusing. How will investors know when the broker has reached his limit and they should call an adviser for further information? It seems that the only way to protect the investor in these circumstances is for the Commission to ban all advice.

Another issue if the Commission only imposes partial restrictions on advice is the likely chilling affect on the quality of the dialogue between RRs and investors. Not only will individual brokers be overly cautious but well-intended compliance departments will get into the act and restrict RR's activities even further. The reality on the street is that when the Commission draws a line in the sand, compliance departments keep employees "two feet from the line." The unfortunate fact is that a compliance department's incentives are not always perfectly correlated with an investor's best interests.

Page 24 Problems

We have disagreements and quibbles with a few statements on page 24. The release says fee-based accounts are not suitable for customers who rarely purchase or sell securities. Our understanding is that cost, not the form of pricing, determines reasonableness and suitability. Farm Creek believes its fee structure is very suitable for relatively inactive traders and in fact we encourage our customers to be inactive for their own good.

Next, why is the Commission suggesting investors with large mutual fund positions avoid fee-based accounts? The Commission's premise here is that fee-based accounts must be expensive, which is false. We also recommends investors avoid most actively managed mutual funds. The "average" mutual fund under-performs their benchmark by a large margin and broad-based ETFs generally under-perform by much less.

NASD's Notice to Members 03-68 - November 2003

Lastly, the Commission refers to NASD's Notice to Members (NTM) 03-68 of November 2003 and we think it is generally good. Here are a few observations.

- One of the important aspects of the NTM is that broker-dealers should periodically review their fee-based accounts for reverse churning. We think these reviews are better than none at all, but broker-dealers only have to review their accounts relative to the other accounts it offers and so this weakens the NTM from an investor protection standpoint. Standing alone, this NTM may not protect all investors from being overcharged.

- Farm Creek effectively falls outside the requirements of this NTM. Since we only offer one type of account there are no other accounts for comparison to see if our clients would be better off. However, we believe investors are well protected by NASD rules on the "reasonableness" of fees along with other regulations.

- On the downside, at the margin brokers may encourage their clients to do a few "extra" trades a year to justify the asset based fee. If an RR knows the compliance department reviews all accounts with 10 trades or less, there is an incentive to get to 11 trades.

- All in all this NTM is good and we hope there are similar efforts for advisers to review the reasonableness of their fees.

Information on Farm Creek

Ed Hynes is the founder and President of Farm Creek Securities, LLC. He has over 20 years of experience in the securities business including fundamental equity research, institutional sales and trading; program trading sales, OTC equity derivative sales and various management positions. He has worked for top firms (Lehman Brothers, CS First Boston and Swiss Bank/UBS) in financial centers such as New York, Tokyo, London, Chicago and San Francisco. His current registrations are Series 4, 7, 8, 24 and 63. He completed the requirements to use the Chartered Financial Analyst (CFA) designation in 2001. In 1977 he earned a B.A. in Political Science from The George Washington University.

Please call or write if you have any questions or comments.

Sincerely,

"Signed"

Ed Hynes, CFA
President

Appendix I - Farm Creek's Fee Discussion

Farm Creek rejected the traditional broker-dealer revenue model for a few reasons. The most important reason being that if clients followed our recommendations they would generate very little revenue from commissions, loads/fees and/or margin fees. For example:

- Commissions: Farm Creek thinks most investors should trade infrequently and avoid individual stocks. This recommendation, in conjunction with the low-cost of execution services, makes relying on commission income untenable.

- Loads/Fees: Most of the evidence indicates that actively managed mutual funds under-perform their benchmarks and Farm Creek does not recommend them. Therefore, we could not rely on sales loads or back-door fees such as 12(b)(1)s. Our customers can buy a fund with a load or a 12(b)(1) fee, but we will not broadly recommend products where we get additional fees.

- Margin: When a firm does not recommend leverage or active strategies, it can not expect much in the way of margin income, a major source of income for many brokers.

Farm Creek wants to help investors implement their strategy in a low-cost, tax-efficient manner. For many US investors a portfolio of two broad-based Exchange-Traded Funds (ETFs) would give them a well diversified and balanced retirement portfolio. One ETF would track the S&P 1500 (ISI) and the other the Goldman Sachs Corporate Bond Index (LQD). The difficult question for investors (and their broker and/or adviser) is how they should allocate their assets between the two. (We do not recommend a separate allocation to international equities for a number of reasons. See Farmcreeksecurities.com for more information.)

Tying this all together we decided on a fee structure with an asset-based fee of 25 basis points a year and a flat $15 ticket charge per transaction. We wanted to have a small ticket charge to discourage trading. Investors hurt themselves by overtrading, so we did not want it to be free. Interestingly, a number of very desirable side benefits flow from this fee structure such as:

- All fees are transparent to the investor and clear from the start.
- All monetary incentives are removed from our core investment recommendations as we are unencumbered by potential fees.
- The structure "allows" us to recommend ETFs which are excellent products.

Appendix II

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Addendum to Farm Creek Securities' New Account Opening Form

We are asking all customers to read and sign the following statement when opening an account which will confirm your understanding of Farm Creek Securities, LLC's fee structure.

> I understand that a principal component of Farm Creek Securities, LLC's Fee Schedule is a charge based on my assets at Farm Creek Securities, LLC and held at its clearing firm. The asset-based fee is currently set at 0.25% (25 basis points) per year. In dollar terms the fee is $25 a year for every $10,000 in assets. This fee will be automatically deducted from my account on a quarterly basis.
>
> Farm Creek Securities, LLC is not acting as a Registered Investment Adviser and will not accept any discretionary authority over our account. Any and all investment advice given by Farm Creek Securities, LLC will be provided in the normal course of its being a Registered Broker/Dealer and its agents being Registered Representatives.
>
> Account holder's take responsibility for all investment decisions in this account.
>
> The undersigned will hold Farm Creek's clearing firm, Southwest Securities, Inc. free and harmless from any action as a result of this request. It is also understood by the undersigned that funds disbursed as a result of this request are being transferred to Farm Creek Securities, LLC a broker/dealer through a Fully Disclosed Clearing Agreement with Southwest Securities, Inc. I also acknowledge receipt of Southwest Securities, Inc.'s Customer Information Brochure (which has been made available to me via Farm Creek's web site) by signing below."

____________________	____________________	__________
Applicant's Name	Signature	Date
____________________	____________________	__________
Co-Applicant's Name	Signature	Date

Appendix III

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Comment
February 7, 2005

Ed Hynes, CFA
President

Fundamental Portfolio Management Series

Save Money by Carefully Deciding How Your Investments Should be Separated into Your Taxable and Tax-Qualified Accounts

We believe that investors who pay attention to this area of portfolio management will save themselves money. How much depends upon a number of factors, but for some investors it could be 0.30 - 0.50% of your portfolio's value every year. If you have a portfolio of $100,000, that comes to $300 to $500 in the first year. This may not sound like much money, but if you save it every year and your overall portfolio grows, the savings could be substantial. While we cannot predict the future, we believe that committing an hour or so of your time to understand these concepts is definitely worthwhile. First, you can determine if there are good opportunities to start saving money now. Secondly and just as importantly, you can start to incorporate these best practices into all your buying and selling decisions. If you do that, hopefully you will reap the potential long-term benefits of this strategy with relatively little effort each year.

The strategy hinges on the fact that most investors hold investments in two types of accounts: one that is taxed "normally" and another which has special tax advantages such as 401(k) or IRA. In order to distinguish them we will refer to the "normally" taxed accounts at "taxable" and the accounts with special tax advantages as "tax-qualified."

Over the past few years, many tax-qualified plans like 401(k)s and IRAs have been giving account holders more control over how their money is invested. Farm Creek recommends you use this flexibility to maximize your after-tax returns by carefully separating your investments into your taxable and tax-qualified accounts.

This may sound complicated and difficult, but it is really not that hard. This short report, a little patience and some basic math are all you need. Here is the plan:

I. First, read the overview to see the big picture and how the strategy works.

II. Next, learn some important features of taxable and tax-qualified accounts. Or, you can skip this section without losing continuity.

III. Now make a list of your major investments. Investments such as stocks, bonds and mutual funds should be included, but you can leave out real estate and other investments that are difficult to hold in a tax-qualified account. This section requires some patience.

IV. We will now walk you through the steps to calculate the "potential" tax for each investment. This part calls for a little basic math.

V. You will finish by creating a "road map" which will be your guide for efficiently separating your investments into taxable and tax-qualified accounts.

VI. Finally, read this last section too see how we arrived at our estimates of the strategy's potential savings. This part may also be skipped.

We want to remind readers that when evaluating investment strategies, they should carefully consider all their unique circumstances before making decisions. These include but are not limited to:

- Liquidity needs
- Investment objectives and time horizon
- Risk tolerance
- Transaction costs
- Potential legal and tax considerations

Please do not work to capture 0.30 - 0.50% with this strategy and inadvertently throw away 1.00 – 2.00% or more in the process. For individual tax advice, please contact a tax professional.

I. <u>Strategy Overview</u>

The key to the strategy is that the government allows us, in fact encourages us, to have both taxable and tax-qualified accounts, which are not surprisingly taxed at different rates at different times. But, the after-tax return for many investments can be greatly affected by the type of account in which they are held. In most cases, investors need to determine which of their investments would be best held in their tax-qualified accounts. The basic rule of thumb is to hold your investments with highest "potential" taxes in your tax-qualified account.

Here is a simple example (although it may not seem simple until you finish this report). Suppose you have two investments: $50,000 in a stock index fund and $50,000 in a bond index fund. If your IRA (a tax-qualified account) has room for $50,000 of investments, which investment should you hold in the tax-qualified account? All else being equal, the rule of thumb is that you should hold investments with the highest "potential" tax in the IRA. So we need to look at the income from these two investments and how they are

taxed. If the bond fund has interest income of 4% a year; and this income is taxed at 25%, the "potential" tax is 1.00% of your investment (0.04 * 0.25 = 0.01 or 1%). If the stock fund generates dividend income of 2%, which is taxed at 15%, you potentially lose 0.30% to taxes (0.02 * 0.15 = 0.003 or 0.3%). Therefore, in order to earn the highest after-tax returns it is best to hold the bond fund in the IRA and the stock fund in your taxable account.

II. <u>Some Basics of Tax-Qualified Accounts</u>

The basics of how tax-qualified accounts work are relatively simple. Tax-qualified plans such as a 401(k), 403(b) or Traditional IRA are generally funded with pre-tax income and the assets are allowed to grow untaxed. When funds are removed from the plan they are taxed at the investor's ordinary tax rate at that time. Except under special circumstances funds cannot be removed before age 59½ without a penalty and after age 70½ you are required to make annual withdraws. Tax-qualified plans are very attractive since they allow investors to invest pre-tax dollars. Even though you have to pay taxes on the income eventually, it is a big advantage to have more cash to invest today. If your marginal tax rate is 25%, you get to invest $100 per-tax instead of $75 after-tax. To give you a sense of how important this is, your overall returns could be 1-2 percentage points higher per year over a 10 year period. The exact result will depend on market behavior and actual tax rates in the future. The most important reason investors would not want to do this would be if they thought their tax rates would be much higher when the money is withdrawn. There are also other positive aspects to these plans which include:

- Possible matching contributions by your employer.
- The hope or expectation that your tax rate will fall before the funds are withdrawn.
- You actually own the plan. Most pension plans are just promises made to you by a company, union or the government and these promises can be broken.

One thing to note in this discussion is that there are differences between Roth IRAs and Traditional IRAs. Roth IRAs are funded with after-tax dollars unlike Traditional IRAs which are mostly funded with pre-tax dollars. For some investors Roth IRAs are very attractive as all income earned on assets goes untaxed if withdrawn properly. We caution readers that the main focus of this report covers Traditional IRAs, not Roth IRAs. With Roth IRAs, we would alter the analysis to more thoroughly take into account capital gains which occur on an ad hoc basis, but we do not think the changes would be significant.

Let us move on to taxable accounts, which do not have any special tax or savings benefits. These accounts, like an IRA will probably be located at a brokerage firm, a mutual fund company or a bank. Collectively we will refer to your investments in these accounts as "taxable." How they are taxed can be very complicated and that is why tax professionals are very important. But for this note we want to lay out a few important highlights.

- Gains on investments are called capital gains and are generally only taxed when the investment is sold. If the investment is held for less than one year gains are taxed as a "short-term capital gain." Under current law, short-term capital gains are taxed at the same rate as a person's other or "ordinary" income. Gains on investments held for more than one-year, are taxed as "long term capital gains" at a lower preferential rate of 5% or 15% or a combination of both depending on the taxpayer's marginal tax rate.

- Many mutual funds must annually distribute their realized short and long-term capital gains. Owners of these funds are responsible for the taxes even if they do not sell the fund.

- Dividend income now comes in two types, "qualified" and "non-qualified." "Qualified" dividend income is taxed at your preferential rate, the same as long-term capital gains. "Non-qualified" dividends are taxed as ordinary income.

- Taxable interest income is taxed just like short-term capital gains, at the taxpayer's ordinary tax rate. Importantly, this income is taxed even when there is no actual payment of interest as with zero-coupon bonds or adjustments to Treasury Inflation Protected Notes (TIPs). Interest on municipal bonds is generally untaxed at the Federal level.

- This analysis excludes real estate investments. We also exclude any impact of the Alternative Minimum Tax (ATM) and state and local tax issues from this analysis.

III. Listing Your Major Investments

The easiest way to tackle this is to list your investments and associated tax considerations as shown below and in Table 3. (We recommend using a spreadsheet, but you do not need to.) When listing your major investments, do not go crazy itemizing everything; grouping similar stocks, bonds or funds together is fine, especially at this point. When making decisions, if you find some of the investments fall on the cusp, you can always go back and drill down further. While it does not really matter in what order you list your investments, here is a simple example that makes sense.

Short-term Fixed Income
- CDs
- Treasury Bills
- Exchange Traded Funds
- Short-term Fixed Income Mutual Funds

Bonds - Intermediate & Long Term Fixed Income
- Exchange-Traded Funds (ETFs)
- Individual Bonds
- Bond Mutual Funds

Tax-Free Bonds
- Municipal Bond Funds
- Individual Municipal Bonds

Stocks
- Exchange-Traded Funds (ETFs)
- Index Funds
- Individual Stocks (as a group)
- Stock Mutual Funds
- REIT Funds

IV. Calculating Each Investment's Potential Tax

Now that you have your list of investments, continue with these steps to calculate the "potential" tax.

1. For each investment determine the amount of annual income you expect in percentage terms. For instance, short-term fixed income investments might yield income of 1% and corporate bonds around 5%. For stocks and stock index funds, use their dividend yield as your income estimate. Remember, some investments generate more than one type of income. This is especially true with mutual funds which must distribute their short and long-term capital gains. If you use our suggested layout in Table 3 this information should be entered in column B.

2. For each income stream listed in step 1, determine what type of income it is (see Table 1). Bonds generate Interest Income while stocks and stock index funds generate mostly Qualified Dividends. This information goes in column C.

3. Find your marginal tax rates in Table 2. Investors will have two tax rates; one for ordinary income which includes interest income and short-term capital gains, and a lower preferential rate for qualified dividends and long-term capital gains. In the Table 3 we use hypothetical tax rates of 25% for ordinary income and a 15% preferential rate. Your correct rates should be entered in column D.

4. Now to calculate the "potential" tax, multiply the expected income (col. B) by the tax rate (col. D). For example, the Short Gov't. Fund has an expected income of 2% that would be taxed at 25%. This would result in a "potential" tax of 0.50% (0.02 * .25 = 0.005 or 0.50%). Enter these results in column E.

5. Finally rank your investments from the highest to the lowest by their "potential" tax and put the result in column F.

Table 1

Types of Income and Federal Tax Rates

Type of Income	Tax Rate Category
Short-term Capital Gains	Ordinary Income
Long-term Capital Gains	5% or 15% (See Table 2)
Nonqualified Dividends (i.e. REITS)	Ordinary Income
Qualified Dividends	5% or 15% (See Table 2)
Interest Income	Ordinary Income
Interest on Municipal Bonds	Zero

Table 2

Marginal Tax Rates for 2004

	Filing Status			Preferential Rate for
Total Income	Single	Married	Ordinary Tax Rate	Qual. Divs. & LT Gains
greater than:	0	0	10%	5%
	7,150	14,300	15%	5%
	29,050	58,100	25%	15%
	70,350	117,250	28%	15%
	146,750	178,650	33%	15%
	319,100	319,100	35%	15%

Table 3

Potential Federal Tax if Assets are Held in Taxable Account

Asset (A)	Hypothetical Estimated Income (B)	Income Type (C)	Tax* Rate (D)	Potential Tax (E)	Tax Bite Rank (F)
Fixed Income					
Short Gov't. Fund	2%	Interest	25%	0.50%	5
Bond Fund	4.0	Interest	25	1.00	
	0.5	LT Cap. Gains	15	0.08	
		Total		1.08	3
Municipal Bond Fund	4.0	Municipal Interest	0	0.00	
	0.5	LT Cap. Gains	15	0.08	
		Total		0.08	7
Stocks					
Stock Index Fund	2.0	Qualified Divs.	15	0.30	6
Value Mutual Fund	0.5	ST Cap. Gains	25	0.13	
	2.0	LT Cap. Gains	15	0.30	
	2.0	Qualified Divs.	15	0.30	
		Total		0.73	4
Aggressive Growth Fund	5.0	ST Cap. Gains	25	1.25	
	2.0	LT Cap. Gains	15	0.30	
		Total		1.55	1
REIT Fund	5.0	Nonqualified Divs.	25	1.25	
	1.0	LT Cap. Gains	15	0.15	
		Total		1.40	2

* Hypothetical Rates: Ordinary Income at 25% and Preferential Income at 15%.

V. Shift investments between accounts in order to minimize tax payments.

Now take the information from Table 3 and re-sort the order of your investments based upon their rankings in column F. The result should resemble the format illustrated in Table 4. This is your road map for making decisions. To the extent reasonable, you will want to fill your tax-qualified accounts with the investments at the top of your list and work your way down.

In our example the asset with the greatest "potential" tax is the Aggressive Growth Fund. It has a "potential" tax of 2.5% due to short-term capital gains of 10% and a tax rate of 25% (0.10 * 0.25 = 0.025). The second most highly taxed investment is the REIT fund where dividends are treated as ordinary income and do not qualify for preferential tax

treatment. Near the bottom of Table 4 are stock index funds which distribute a small amount of dividends and little or no capital gains. And of course tax-free municipal bonds, upon which you pay no federal income tax, are at the bottom.

Table 4

Assets Ranked by Potential Tax Liability

Strategy	Rank	Potential Tax
Aggressive Growth Fund	1	1.55
REIT Fund	2	1.40
Bond Fund	3	1.08
Value Mutual Fund	4	0.73
Short Gov't. Fund	5	0.50
Stock Index Fund	6	0.30
Municipal Bond Fund	7	0.08

Before you start rebalancing your portfolio, remember these points:

- Use common sense and plan before you start executing.
- You may not be able to do everything you want. But do not change a well planned portfolio simply to gain a small savings. It is not sound portfolio management.
- Be aware of all transaction costs before trading, including potential taxes.
- This analysis does not take everything into account. In particular, it does not factor in investments which generate large capital gains on a regular basis. If large capital gains are expected every few years, the asset may deserve a higher ranking in Table 4. On a related point unrealized gains are left out also. But unless an investor plans to realize these gains often, the analysis stands up.
- Lastly, never take money out of your tax-qualified accounts without consulting a tax expert.

One issue which at first confuses many investors is holding investments likely to be sold in an emergency, in a tax-qualified account where they can not be touched. Here is our recommended solution - in an emergency, if you need $5,000 from the short term bond fund in your IRA; you should sell $5,000 of an asset in your taxable account (i.e. stock index fund) to get the cash you need. Then in the IRA, move $5,000 from the short term bond fund to a stock fund. After the transactions your short-term investments will be reduced while your other investments will remain unchanged. Obviously you don't want to do this very often if your transaction costs are high as this took three transactions rather than one to complete the transfer. Also, there could be a tax liability on the sale of the fund in the taxable account.

We have seen some professionals suggest that a portion of each investment belongs in your tax-qualified account. But having all your investments represented in your tax-

qualified account, you will most likely be able to rebalance your portfolio each year while only making trades in the tax-qualified account and this should help avoid potential capital gains taxes. All of this is true, but we are not convinced that the potential savings are worth the added paperwork and complexity especially taking into account that putting stocks in tax-qualified plans and potentially forcing bonds into the taxable accounts has an immediate cost.

VI. Potential Savings

As mentioned in the beginning, the affect of "correctly" and "incorrectly" separating your investments can potentially result in a return difference of 0.30 – 0.50% of assets a year. In this section we will use an example to illustrate this difference in hypothetical returns. We will start with the same assumptions we used in section I.

1. The investor has two investments: $50,000 in a stock index fund and $50,000 in a bond index fund.

2. The investor's tax-qualified account has $50,000 in it and therefore can hold either all the stocks or all the bonds. The other must sit in a taxable account.

3. Should the investor put the bonds or stocks into the tax-qualified plan? Hopefully, everyone now knows the answer!

It turns out that under the current tax code it is always more advantageous to hold the bond fund in the tax-qualified plan and the stock fund in the taxable account. If done the other way around, returns would be 0.30 – 0.50% lower every year.

Table 5 shows the hypothetical after-tax returns of holding the investments in either configuration. Investments in both accounts grow at the same rate but are taxed differently. In the taxable account interest income and/or dividends are taxed at the appropriate rate and reinvested each year while capital gains are only taxed at the end of the period. In the IRA the only tax liability occurs when the assets are withdrawn after ten years.

It is interesting to note that while it would generally be assumed that the tax-qualified plan would be the optimum account for either asset, it is not true. The tax code's preferential treatment of long-term capital gains and qualified dividends overwhelms the power of dividend income growing tax-free and the stock fund performs better outside a tax-qualified plan at all tax rates. On the other hand, it is almost always more advantageous to hold your interest-bearing investments in a tax-qualified account since interest is taxed at ordinary rates.

Table 5

Account Holding Effect on After-Tax Returns

Annual Rates with a 10-Year Holding Period

More Tax Efficient			Less Tax Efficient			Difference More-Less
Taxable:	Stocks	7.04%	IRA:	Stocks	6.45%	0.59%
IRA:	Bonds	3.94%	Taxable:	Bonds	3.75%	0.19%
Total		5.49%	Total		5.10%	0.39%

Tax, Rate and Return Assumptions:

Marginal Tax Rate:	25%	Stock Capital Gains:	6.5%
Interest Rate:	5.0%	Dividends:	1.5%

Now is the time to take action. If you have gotten this far, collecting the information and doing the work will not be that hard. Do it!