The Best Investments for Tax-Deferred Accounts
You know how much money you'll need to retire. And you know that you'll need to squirrel money away in both taxable and tax-deferred accounts to meet your goal.

But what goes where? What type of investments will make the most of the tax advantages that employer-sponsored retirement plans and IRAs have to offer? And which investments will allow you to maximize your aftertax returns in your taxable accounts?

The Old and New Approaches
The traditional approach says to hold bonds in a tax-deferred account and stocks in a taxable account. The rationale is that you're better off deferring taxes on securities, such as bonds, that generate a lot of taxable income.

Newer research is drawing somewhat different conclusions. It says that, in many cases, you should own stocks in tax-deferred accounts and bonds in taxable accounts, especially if you're investing for 15 years or longer.

Why? Because if you're investing long enough, the higher total returns of stocks over time can generate a greater tax burden than the income of bonds over the same time.

Let's look at an example from T. Rowe Price Associates. Investor A and Investor B each decide to place $10,000 in a bond fund and $10,000 in a growth-stock fund. Investor A keeps her bond fund in a taxable account and her growth-stock fund in a tax-deferred account. Investor B does just the opposite, placing the bond fund in the tax-deferred account and the growth-stock fund in the taxable account.

Assuming an ordinary income rate of 28%, a capital-gains rate of 20%, and liquidation of both accounts after 20 years, Investor A, who put the stock fund in the tax-deferred account, ended up with the best aftertax results--$197,700 over the period studied versus $184,500 for Investor B. This pattern held up for higher tax rates (31% and 36%), too. Only when the time period was less than 10 years did the pattern break down.

Rules of Thumb
You can draw a handful of conclusions from the findings of these studies:

- The higher your tax bracket in retirement and the shorter your time horizon until retirement, the more you are likely to benefit from holding stocks in taxable accounts and bonds in tax-deferred accounts.

- If you are 15 years or more away from retiring and you expect to be in a lower tax bracket upon retirement, hold stocks in your tax-deferred accounts and bonds in your taxable account.

- If you are less than 15 years away from retiring and you expect to be in a higher tax bracket upon retirement, hold stocks in your taxable account and bonds in your tax-deferred accounts.

- Because the Roth IRA allows you to withdraw money in the future with no tax consequences at all (providing you meet the requirements), hold stocks in your Roth IRA.
Conditions
Of course, studies are merely that—studies. They don't always reflect your real-world situation. For example, these studies don't address what an investor who is 100% in stocks ought to do.

A few rules of thumb for all-stock investors:

- Place individual stock holdings that you plan to hold for a long time in your taxable account; hold shorter-term stock investments and stock mutual funds in your tax-deferred account.

- Place stock funds with very lower turnover ratios—say, below 20% per year—in your taxable account and those with higher turnover ratios in your tax-deferred account.

- Place large-company index funds in your taxable account—they tend to be tax friendly.

Moreover, the study doesn't touch on the quality of the fund choices available within the tax-deferred plan. Say your retirement plan offers only two choices: a highly rated large-cap index fund or a poorly rated high-turnover small-cap fund. If you listened to the study, you'd probably choose the small-cap fund for tax reasons—even though it's not the better investment overall. Don't let taxes considerations overshadow the quality of an investment.

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