

Remarks by Chester Spatt on the Presentation of the Paul A. Samuelson Award for Publication on Lifetime Financial Security by TIAA-CREF, January 7, 2005, at the Allied Social Science Association meetings in Philadelphia:

Since I am currently serving as Chief Economist of the U.S. Securities and Exchange Commission I should say at the onset of my remarks that the views being expressed are my own and not those of the Commissioners or my colleagues on the SEC staff.

My collaborators, Robert Dammon and Harold Zhang, and I are delighted with the selection for this honor of our paper, "Optimal Asset Location and Allocation with Taxable and Tax-Deferred Investing," published in the June issue of the *Journal of Finance*, for TIAA-CREF's Paul A. Samuelson Award. It is a particularly special honor to us in light of the seminal contributions of Paul Samuelson to the field of economics in general, and to the problem of lifetime financial security in particular, over the last seven decades.

Our joint research program has focused upon introducing taxes into the investor-consumer's life-cycle consumption and portfolio planning problem for which Paul Samuelson has been a pioneer. We have viewed taxes as perhaps the most important friction that investors face and through our work have tried to focus attention both upon the importance of taxes for portfolio decision-making and the effects that realistic modeling of tax frictions imply. In a prior paper that represented the initial portion of our research program we introduced capital gains taxes into the investor's dynamic decision

problem, developing a numerical methodology for solving the problem—characterizing the tradeoffs between capital gains taxes and portfolio rebalancing and highlighting the impact of the reset of the investor’s capital gains tax basis at death.

In the paper for which we are receiving the Samuelson Award we introduced tax-deferred investing into the investor’s planning problem, since many investors are able to invest in both taxable and tax-deferred accounts. The investor is able to earn the full pre-tax return for investment in his tax-deferred account in that only withdrawals (and not realized investment returns) trigger tax liability, but experiences after-tax returns with full deferral of capital gains in his taxable account. The problem of asset location (what to locate in each account) is an important one because of the difference in tax treatment between the taxable and tax-deferred accounts. We analyze the optimal asset location and allocation decisions both analytically using arbitrage methods and numerically by solving the investor’s life-time expected-utility maximization problem. Because the investor is simultaneously investing in the two accounts he locates the heavily-taxed assets, such as bonds, in his tax-deferred account and lightly-taxed assets, such as low-yielding equity, in his taxable account. In fact, under current tax law investors should fully exploit their ability to hold taxable bonds in the tax-deferred account before considering investing in tax-exempt bonds in the taxable account. This overall advice runs counter to some versions of common folklore, which focus upon equity as a desirable investment in a long-term (e.g., retirement) account as well as counter to observed behavior. It’s been gratifying to us that even some distinguished finance professors have altered their asset location after reading our paper.

Since the investor controls simultaneously the taxable and tax-deferred accounts, the investor focuses upon his desired overall portfolio balance, locating assets in the most efficient fashion across the two contexts. Without the ability to borrow, the investor's equity holding in the taxable account is limited to 100% of taxable wealth. If this limit binds, the investor is forced to hold additional equity in the tax-deferred account, which is inefficient from a tax perspective. Consequently, the investor chooses to hold a smaller amount of equity on an overall basis. In this case the split of wealth between the taxable and tax-deferred accounts plays an important role in determining the optimal asset location and allocation choices.

As part of our analysis we quantify the utility and effective wealth costs associated with poor asset location patterns and how the relative value of taxable and tax-deferred wealth varies across the underlying economic states. Finally, we examine the role of the investor's liquidity constraints in situations in which there are consumption shocks. Consumption shocks have a larger impact on the contribution to the tax-deferred account rather than on the location of the assets. For many investors the need to finance consumption shocks or labor income shocks does not overturn the basic results on asset location, even when considering the penalty for early withdrawal from the tax-deferred account.

To conclude my comments we would like to publicly thank TIAA-CREF, both for the selection of our paper for this important honor and also to publicly acknowledge the

support through a series of research grants that we have received from it in the late 1990s and early 2000s at a crucial stage in the development of our research program on taxes and life-time investment.

References

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