BLACKBIRD FINANCIAL

To the Partners of BlackBird Financial LP:

It's that time of year again, and I've received numerous inquiries as to whether BlackBird takes any measures to reduce our tax liability. As we know, taxes can have a meaningful impact on the results of an investment program. Given two otherwise identical investments options, it's obvious that the higher return will come from the one taxed at the lower rate. Perhaps less apparent, but equally true, is that when the tax rate is identical, the better return will come from the one taxed later.

While a tax liability will develop as soon as an investment goes to profit, it does not get paid until the investment is sold. Deferred tax liabilities from unrealized capital gains are essentially interest-free loans from the government. This allows you to control more capital than you otherwise would.

To illustrate this point, let's imagine we just inherited $2 million and we choose to invest the funds equally between two money managers, Mr. Steady and Ms. Turnover. We won't need the money returned until our retirement in 50 years (life expectancy is increasing, ya know). As it turns out, both managers achieve an annual return of 15%. On both investments, you'll pay a tax rate of 20% (which is the long-term capital gains rate for an individual earning more than $441,450, which is applicable to most of you). The only difference is that Mr. Steady buys a few stocks and holds them for the duration of your investment, while in Ms. Turnover sells her positions at the end of each year to reposition her portfolio. Here are the drastic results:

	Initial Investment	After-tax Ending Value	Total Tax Liability
Mr. Steady	$1,000,000	$866,925,953	$216,731,488
Ms. Turnover	$1,000,000	$289,002,190	$72,000,549
Difference $	N/A	$577,923,763	$144,730,939
Difference %	N/A	300%	300%

Note that the gap would be even wider if Ms. Turnover transacted more frequently and were subject to short-term capital gains rates (much higher). Interestingly, you'll notice that the difference in total tax liability in this example is exactly proportional to the difference in your net gain. In other words, you benefit from low turnover, and so does Uncle Sam.

All of that said, it's important to differentiate between the means and ends. Ultimately, the goal is to earn the highest after-tax rate of return. Reducing Uncle Sam's take is only one factor to consider. *"All things being equal"* is most useful in the classroom and does not reflect our reality. As prices shift for the securities we own and all the alternatives, the most promising investments may be somewhat different next year than they are today. The pre-tax benefit from owning the optimal securities will almost certainly outweigh the negative tax implications. The only caveat would be when there are only a few remaining days until the one year threshold, in which case the benefit in paying the lower long-term rate will usually justify the short delay.

The good news is that because of BlackBird's long holding period, most of our capital gains have been of the long-term variety, and I expect this to persist. Additionally, much of our tax liability will likely be deferred for many years before being paid. While this will be beneficial to our long-term results, it will remain a secondary consideration.

American historian Albert Hart once said, *"Taxation is the price which civilized communities pay for the opportunity of remaining civilized."* (It's a good thing there's no *UNSUBSCRIBE* button here or I'd lose my entire libertarian audience!)

Your fiduciary,

Judah Spinner
Chief Investment Officer