Morgan Stanley WEALTH MANAGEMENT

Investments for International Clients

International

Investment decisions require taking into account investment factors, including but not limited to, beta, alpha, current interest rates, and economic cycle status. Moreover, the tax implications of the investments is a factor that has recently become an important consideration with regard to investment decisions.

Wealth and Estate Planning Strategists
Family Office Resources

The Decision Tree for Investments

Before implementing a portfolio strategy, an investor must determine the level of risk they can sustain over time. This determination may lead to the appropriate asset allocation to help achieve their goals and objectives. Once the client's asset allocation—which may include equities, fixed income, and alternative investments —is determined, the portfolio can be constructed and implemented.

As tax systems have evolved across countries from simple territorial income taxation[1] to worldwide income taxation with complex anti-deferral provisions—where income tax is paid on income generated worldwide even if generated or accumulated under foreign entities or investment vehicles—investors need to consider the tax consequences of investments with more scrutiny[2]. These considerations should not be limited to tax rates but should also include the differences in filing and reporting requirements.

In today's global economy there are many investment vehicles and products that can be used to help an investor achieve their goals. Investors have many ways to achieve a diversified portfolio. Here are three ways:

Notes:
[1] The territorial system taxes income earned within a country's borders. It applies to all businesses that operate and income that is generated within a country's boundaries. Income generated outside of the country's borders is not subject to taxes.
[2] As provided by FINRA Rule 2111, the "tax status, such as marginal tax rate" is one of the nine key data items relevant to determine the appropriateness of investments.

- Constructing a portfolio of securities themselves, held in their individual names, with or without the advice of an investment broker;
- Hiring one or more investment advisors to construct and manage their portfolio of securities (which is usually known as Separate Managed Accounts (SMAs);
- Buying or investing in exchange traded funds (ETFs) or mutual funds. Both products are commingled or pooling vehicles that invest in diversified portfolios given a certain strategy or objective. The difference between these products from an investment perspective is that the ETFs generally invest in a more passive or index linked manner while mutual funds are more often actively managed.

The strategies that are available have different taxation and fee levels, which, when compared against each other, could have substantial differences in after-tax returns.

For purposes of this article, we will consider that the profits of the investment account are subject to income tax in the country of the client's residency.

Please note that these are not recommendations, that Morgan Stanley does not provide tax advice, and that some products may not be available in certain jurisdictions.

Comparison Between The Above Described Portfolio Building Methods

Possible Tax Treatment of the Strategies

In the first two cases, self-management of individual securities and SMAs, the portfolio would be comprised of bonds, stocks, derivatives, and other financial investments. In both cases, all activity may have an immediate tax impact for the clients. Some countries impose different tax rates on interest, dividends, or capital gains. Investors should understand the tax rates on interest, coupons, and dividends received and the capital gains tax applicable each time a security is sold. One of the main differences between the two portfolios resides in the fact that with self-managed accounts the client may consider the tax implications of each individual security, while investment managers of SMAs are usually more accustomed to achieving a tax neutral approach and may not vary the strategy based on the tax domicile of the client. A frequently used strategy by investors and managers is tax loss harvesting: the practice of selling a security that has experienced a loss to offset taxes on gains and in some cases other income.

Apart from the financial implications, the strategy employed in the portfolio may require the disclosure of each investment transaction on the client's tax return, creating an administrative burden not only on account of the tax due calculation but also the filing requirements. SMAs may have an active strategy that requires a higher quantity of transactions to be disclosed.

In the case of implementing a portfolio using pooling vehicles, the investor purchases shares or participating units in one or more investment vehicles (ETFs or mutual funds, among others; for purposes of this article we will call them "Funds"). These pooled investments each invest in a diversified portfolio following its specific strategy. Unlike US mutual funds that are required to make distributions of income and gains to their investors, offshore Funds may offer accumulating share classes that reinvest the income and gains without providing an income stream to the client. Due to the fact that the investor has no control of the Fund, depending on the tax laws of the client's country of residency , a taxable event may be triggered only upon distributions from, or disposition of, the Fund. This allows the client to defer realization of income or gains on the underlying activity until the distribution or disposition. Other advantages may be that (i) capital losses and cost of leverage may be offset against income or capital gains at the Fund level, (ii) fluctuation of currencies related to the Fund's underlying investments would not make an impact until redemption, and (iii) if there are no distributions or redemptions, the information to include on a tax return could be significantly reduced when compared with owning individual securities.

Another aspect to consider is the tax paid or withheld abroad. When taxes are withheld in the name of the client, it may be possible to credit these amounts to offset the tax applicable in the client's country of residency. In the case of taxes paid by or withheld to a Fund or foreign vehicle, the tax credit may not be considered, which may possibly create double taxation on certain income.

Costs Associated with the Strategies

In the case of self-management of the investments, clients need to consider the transactional costs of the activity. If the client receives the advice of an investment advisor, a wrap fee may be agreed to include the fee for the advice and for the transactions. When we compare ETFs with mutual funds, we usually see a lower overall cost in ETFs due to the more passive investment strategy. In the case of SMAs, they may have some pricing advantages compared to mutual funds due to the fact that they do not have the costs to set up and maintain the legal vehicles, among other regulatory expenses (registration, public listings, etc.). Notwithstanding the foregoing, institutional share classes of mutual funds are competitive from a cost perspective as well.

Transparency and Information about Investments

When the final investments are held in the clients' accounts, as we have described for self-management and SMAs, all the transactions and the positions held are disclosed in the account and the clients has access to the positions. They have full disclosure of the investment strategy. Regarding Funds, clients only see one position in their investment account. They do not have access to the underlying securities other than through the monthly or quarterly reports. These reports may describe only the largest holdings or activities and provide detailed aggregate data, but do not usually list all the investments and activities.

Portability of Investments

In addition to the distinctions above, there are other factors that may also be relevant to clients such as the portability of the investments if they desire to move the investment to another financial institution. Individual securities can usually be held in the custody of most broker dealers or financial institutions and may be transferred freely. With regard to SMAs, even though the securities may be transferred, the manager might be required to be an approved vendor of the new financial institution, meaning that assets may be transferred but the client may be required to replace the investment manager. Lastly, in the case of ETFs and mutual funds, financial institutions need to have an agreement with the issuer to be able to custody said investment. Therefore, the clients, in some cases, may be required to redeem or sell the position instead of transferring it out.

	SELF-MANAGED ACCOUNTS	SEPARATELY MANAGED ACCOUNTS (SMAS)	ETFS	MUTUAL FUNDS
Cost	Transaction cost or wrap fee	Might be more efficient than mutual funds due to fewer regulatory expenses	Might be more efficient than mutual funds or SMAs due to passive investment strategies	Includes active management and regulatory fees. Institutional classes are highly competitive.
Tax Treatment	Depends on each asset and transaction. Investments may be tailored to the tax status of the client.	Depends on each asset and transaction. The manager may not take into consideration the tax status of the client.	Accumulating share classes may be taxed upon sale of the ETF on the appreciation in value	Accumulating share classes may be taxed upon redemption of the mutual fund on the appreciation in value
Transparency	Full disclosure of investments and activity	Full disclosure of investments and activity	Limited information on monthly or quarterly reports	Limited information on monthly or quarterly reports
Portability	Assets may be transferred freely	Assets may be transferred but may require the replacement of Investment manager	May be transferred to financial institutions that have an agreement with the issuer	

Important Disclosure

This material has been prepared for informational purposes only and is subject to change at any time without further notice. Information contained herein is based on data from multiple sources and Morgan Stanley Smith Barney LLC (“Morgan Stanley”) makes no representation as to the accuracy or completeness of data from sources outside of Morgan Stanley. It does not provide individually tailored investment advice. The appropriateness of a particular investment or strategy will depend on an investor’s individual circumstances and objectives. Be aware that the particular legal, accounting and tax restrictions, margin requirements, commissions and transaction costs applicable to any given client may affect the consequences described.

Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment. Companies paying dividends can reduce or stop payouts at any time.

An investment in an exchange-traded fund involves risks similar to those of investing in a broadly based portfolio of equity securities traded on exchange in the relevant securities market, such as market fluctuations caused by such factors as economic and political developments, changes in interest rates and perceived trends in stock prices. The investment return and principal value of ETF investments will fluctuate, so that an investor's ETF shares, if or when sold, may be worth more or less than the original cost.

Tax laws are complex and subject to change. This information is based on current federal tax laws in effect at the time this was written. Morgan Stanley Smith Barney LLC, its affiliates, and Financial Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

Morgan Stanley has an extensive number of investment products, managers and strategies to allow a foreign client to implement his or her portfolio depending on his or her particular circumstances. The client shall involve its legal and tax advisors in the design and definition of his or her tailored investment strategy.

Investors should carefully consider the investment objectives, risks, charges and expenses of a mutual fund or exchange traded fund (ETF) before investing. The prospectus contains this and other information about the mutual fund or ETF. To obtain a prospectus, contact your Financial Advisor or visit the mutual fund or ETF company’s website. Please read the prospectus carefully before investing.

The term “Family Office Resources” is being used as a term of art and not to imply that Morgan Stanley and/or its employees are acting as a family office pursuant to Investment Advisers Act of 1940.

NOT ALL PRODUCTS AND SERVICES ARE AVAILABLE IN ALL JURISDICTIONS

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