

Mutual Funds: Tax Bite or Tax Benefit?

As another tax filing season rolls around, investors who hold mutual funds in taxable accounts may find themselves with an unexpected tax bite.

Even though an investor may have held a mutual fund for a year or longer, that has little relevance to how long the manager holds the stocks in the fund. The fund manager buys and sells stocks, depending on market changes, strategy and cash inflow and outflow.

The trading activity can result in short-term gains, distributed to each investor and taxed at the investor's income bracket (top Federal rate is 35%) as opposed to 15% for long-term gains on individual securities. Short-term gains can double the investor's tax bite.

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Many investors are looking for a better way, and rightly so. They are surprised to find a short-term tax liability for a mutual fund, which they thought would be a passive, longer-term investment.

So, due to the nature of mutual fund trading, the fund actually sells stocks with short-term gains, resulting in a tax liability that is passed on to the investor.

The exact size of the tax bite can only be understood by carefully reading the prospectus. No mutual fund company advises or seeks permission from their clients before trading.

Investors lose money with every tax bite. And to see just how much, look at one actual example, directly from the Phoenix Real Estate Securities Fund prospectus for period ending 12/31/05.

One, Five and Ten-Year Before & After-Tax Returns on an Actively-Managed Equity Fund:

1 Year:

Return before taxes = 7.85%

Return after taxes on distributions = 6.84%

5 Years:

Return before taxes = 18.47%

Return after taxes on distributions = 16.62%

10 Years:

Return before taxes = 15.28%

Return after taxes on distributions = 13.16%

(These figures reflect the highest individual federal marginal income tax rates, but they do not reflect the impact of state and local taxes.)

And, if you think that doesn't look like much ... look again. On a \$20,000 investment, over 10 years, the difference between 15.28% and 13.16% returns is over \$14,000.00. This is money that investors lost, due to inefficient tax management. And it also equals over 20% of the return. That's a sizeable bite.

No matter how small the amount may seem to some, every dollar investors keep is one more in their bank account, instead of going to the government treasury.

From the example above, it's easy to see that the after-tax return is a far more important and accurate measure of performance. But since this information is usually buried somewhere in the prospectus, investors are totally unaware of the bite that taxes are taking out of their overall returns. That is, until tax time.

A 2002 study by The Lipper Company, a global leader in supplying mutual fund information, found that during a prior 10-year period, the average stock fund surrendered approximately 23.5% of its load-adjusted return to taxes.

The same study, by Lipper, said the average bond fund did even worse, surrendering approximately 45% of its load-adjusted return to taxes. (Load-adjusted returns reflect the return of mutual funds after sales commissions and fees.)

Another study, by Alliance-Bernstein, looked at 1,201 U.S. large-cap stock funds for a 15-year period, from 1988 through June 2003. The study found that the average mutual fund shareholder had an average annualized pretax return of 10.0%. BUT, after federal taxes, that 10.0% return was reduced to 7.7%. That's a reduction of 23%. (Source for both studies: *The Bogleheads' Guide to Investing*, Wiley Publishing, 2006)

Are There Any Solutions to This Problem?

There is a solution. Why not turn the bite into a benefit? You'd do it by taking the gains long-term and take only losses short-term. The result? You could possibly cut your tax bill in half.

When buying a mutual fund, look for funds with low turnover and consider buying fund shares after the distribution date. Also, consider selling fund shares before the distribution date. And always check a prospective fund's prospectus and find those with minimum tax bites.

One simple way for investors to avoid this hefty tax consequence is to buy a mutual fund alternative, in a Ready-to-Go Folio from FOLIO*fn*.

FOLIO*fn* offers 100 choices of these pre-selected portfolios, which contain from five to 50 stocks, covering nearly every sector of the market. Not only are these Folios unique in so many ways, but so is the tax management service provided to all our investors. (Ready-to-Go Folios are not registered with SEC and are not under professional management.)

For example, every security is identified for its tax implications – i.e., when a short-term gain is going long-term or when a short-term loss could be taken for tax purposes. And, of course, there are no fees charged for this tax accounting service.

**Proactive investors can minimize their tax bite this time next year,
by taking some definite steps now.**

Take a close look at FOLIO Investing and see how easy it is to hold onto more of your investment dollars, with our flat-fee pricing. Even the **low, monthly fee** may be recouped in tax savings from the tax management features that our Folios allow. (Tax considerations do not apply to non-taxable accounts, such as IRAs and 401ks.)

The tax benefit of FOLIO Investing is just **one of many reasons** why a growing number of investors consider us to be a smart alternative to mutual funds.

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STAN CRAIG’S BIO:

Stan Craig is the chief marketing officer for FOLIO*fn*, located in Vienna, VA. Mr. Craig has over 35 years of successful investment experience. He spent 27 years at Merrill Lynch, as a financial advisor, product developer and corporate officer.

Mr. Craig’s last position at Merrill was to head the Office of Investment Performance. The purpose of this endeavor was to educate financial professionals and their clients on successful strategies and habits for positive investment performance.

Mr. Craig has spoken around the world to investors and advisors. And he’s been quoted in nearly every investment publication, including the WSJ, Smart Money, Forbes and Business Week. He’s also appeared on CNBC.

Stan graduated the University of Kentucky, Southern Seminary and the Wharton Graduate School of Business' executive development program.

Mr. Craig lives in Southport North Carolina, with his wife, Gloria. They have six children and eight grandchildren.