

“Tastes Great - Less Taxing”

1995 has been a tremendous year for investors, with the Standard & Poor’s 500 equity average up over 30% through the end of November. Now that December is here, however, you may be getting a little seasonal surprise -- a tax bill based upon your mutual fund’s realized capital gains distributions.

Mutual funds distribute to each shareholder a pro-rata share of the annual net realized capital gains. Fund companies tend to make the distributions in December based upon realized gains in the calendar year. For long term taxable accounts, taxes tend to be an investor’s largest cost, far exceeding management fees or transaction costs. Avoiding taxes altogether is not possible, but understanding several key aspects to tax-efficient mutual fund management can bring more returns to your bottom line.

1. Focus on after-tax, not pre-tax returns. In selecting fund managers, investors often focus solely on reported performance numbers. Selecting a mutual fund on performance alone is always a mistake, but it can especially be misleading for a taxable account. Not all equity returns are created equal -- some mutual funds are a lot more “tax-efficient” than others. The following table shows that after-tax returns can vary substantially from pretax returns:

3 Year Annualized Returns (period ending 9/30/95)			
<u>Fund</u>	<u>Pre-Tax Return</u>	<u>After-Tax Return</u>	<u>Portfolio Turnover</u>
Dodge & Cox Stock Fund	19.29 %	17.54 %	9 %
MAS Funds Value Portfolio	19.46 %	15.25 %	51 %

Data Source: Morningstar

An investor would pick MAS Value relying solely upon the ubiquitous “performance sweepstakes” tables in the popular press, but would wind up with an after-tax return of more than 2 percent less than an investor in the Dodge and Cox fund. For a person investing \$100,000, the difference amounts to more than \$9,300 after three years. This table only reflects assumed federal taxes -- add in state income tax and the differences would be even bigger.

2. Watch out for high portfolio turnover. Why the difference in the table above? First, many equity funds are managed by firms whose clients are predominantly tax-exempt retirement plans, foundations and endowments. For

these managers, tax results for clients are not an important factor in making buy and sell decisions. Second, competition within the mutual fund industry leads some managers to look for short term results. This short term thinking can lead to higher portfolio turnover (how often the manager buys and sells the fund's holdings) and an increased percentage of capital gains realized each year. Third, some investment management styles are less tax friendly. "Momentum" fund managers, who are trying to surf the latest market trends, are more likely to produce higher turnover than managers who buy and hold emerging growth stocks. Portfolio turnover isn't the whole story, however. Taxable distributions result from a combination of portfolio turnover and a mismatch between realized gains and losses. Some high-turnover funds remain tax friendly because the manager matches gains and losses.

3. Be careful buying equity funds late in a calendar year. Most funds make their taxable distributions in late December. Consider two purchasers of a fund selling at \$15 per share with \$5 in realized gains. An investor purchasing one share the day before the distribution will receive a \$5 taxable distribution and be left with one share of the fund at \$10 (the fund's price adjusts for the distribution). Even if he reinvested the distribution so that he has 1.5 shares of the fund, he will still have to pay tax on the \$5 distribution. In contrast, an investor who waited another couple of days would buy 1.5 shares of the fund for \$15 and incur no tax liability. This late-year tax trap is especially a problem in years like 1995 where funds are likely to have substantial realized gains due to rising market prices.

4. Try and match gains and losses yourself. If you own any mutual funds that are selling below their taxable basis, "harvesting" the loss by selling the fund can offset the taxable distributions from your other funds. When you sell a stock to realize a tax loss, you must wait 31 days to repurchase the stock for the IRS to count the loss. With thousands of mutual funds available, however, you are likely to have a very close substitute mutual fund available to purchase on the same day you sell your loser.

This is a good time of year to take a look at the tax status and efficiency of your mutual funds. If you are interested in finding out how your funds fare from a tax standpoint, contact us.

The foregoing is not intended to be a definitive discussion of the tax treatment of mutual fund investors -- consult your tax adviser.