

# STRATEGIES; As Investors Worry More About Their Tax Bills, Managers Should, Too

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UNTIL recently, mutual fund managers had little incentive to care about the tax consequences of their investments. After all, very few investors were choosing funds according to after-tax performance. Nor were any managers' reputations suffering because their shareholders' after-tax returns were so much lower than their pretax returns.

This situation is finally changing. Investors are realizing that certain actions taken by their fund managers, as well as by their fellow shareholders, can have a huge effect on how much tax they owe.

A recent example of the impact comes from the Warburg Pincus Japan Small Company fund. This year through mid-August, the fund had already lost more than 48 percent of its value. Then the fund distributed short-term capital gains that were equal to more than half its net asset value.

That means investors will have sizable tax bills to pay, beyond losing big in the fund itself.

But some investors aren't taking it any more. New research confirms that investors' increased sophistication about taxes is making a difference. The study, "Do After-Tax Returns Affect Mutual Fund Inflows?," by an M.I.T. economics professor, James Poterba, and one of his graduate students, Daniel Bergstresser, is available from the National Bureau of Economic Research at [www.nber.org/papers/w7595](http://www.nber.org/papers/w7595). The authors found that investors are beginning to discriminate among funds based on after-tax performance. Funds with superior after-tax returns, they said, are receiving significantly more new money than funds that do as well before taxes but not after.

The effects of this behavior shift are likely to be huge. Many mutual fund companies base at least part of their managers' compensation on total assets under management. Reduced inflows mean lower pay, so managers have an incentive to do a better job of reducing the tax impact of their strategies.

The tax rules governing mutual funds are complex. Funds do not pay taxes themselves, on either the dividends they receive or the capital gains they realize. Instead, they are required to distribute those dividends and capital gains to their shareholders at least once a year. Those distributions are made equally on all shares, regardless of how long investors have held them.

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There are three categories of distributions. The first is all cash dividends that the fund has received over the previous year; these are taxed as ordinary income. The second is short-term capital gains -- the net amount of all realized gains and losses on positions that, as of the date of sale, had been held for less than a year; these are also taxed as ordinary income. The third is long-term capital gains, those on investments that had been held for more than a year at the time of their sale; they are taxed at the capital gains rate, which is lower than the tax rate on ordinary income. The current maximum capital gains rate is 20 percent.

For a tax-conscious fund, the ideal is to keep distributions to a minimum. Then the fund's after-tax performance would approach its pretax returns. The equity funds that consistently come closest to perfect tax efficiency are generally index funds, whose trading activity -- and, therefore, realized capital gains -- are kept to a minimum.

The Warburg Pincus Japan Small Company fund, however, is a model of tax inefficiency, and for several reasons. Its large capital gains distribution in August was entirely in the form of short-term gains. The fund says it had no choice but to sell stocks, realize these gains and make this distribution so that investors who sold fund shares, after several market timers had advised doing so, could be paid back.

If this fund had been attracting new money earlier this year as rapidly as it received redemption requests, it could have met those requests without selling any stocks. But its poor returns kept investors away.

Some funds that are hit with heavy redemptions can take losses on some stocks to balance gains on others. But most of the stocks that the Warburg Pincus fund owned earlier this year showed a profit, because the fund gained an astounding 328 percent in 1999. Going into this year, the fund therefore had huge unrealized gains, creating what is known as a tax overhang.

Neither could the fund concentrate on taking long-term rather than short-term capital gains. With an annual turnover rate of 250 percent, it holds stocks for an average of less than four months.

So how should an investor with taxable mutual fund accounts proceed? The Poterba and Bergstresser research suggests some answers.

\* Start by paying attention to a fund's tax burden over the most recent year. While this burden varies, it depends greatly on the manager's investment strategy, which is unlikely to change much from year to year. There are several sources of data on funds' after-tax returns. Morningstar Inc. is perhaps the best known and most comprehensive, but it is not the only one. In 1999, the Vanguard Group also started reporting after-tax returns of its funds.

\* Check the fund's turnover rate. In general, funds with the highest turnover generate the highest tax burdens. But there is an exception: tax-managed funds, including Vanguard Tax Managed Capital Appreciation and Schwab 1000. Much of the turnover in such funds reflects their managers' efforts to take short-term capital losses, which reduce taxes.

\* Watch the tax overhang. Morningstar has also begun to report this data. Though investors cannot know exactly how last year's overhang will affect the current year's distributions, they might watch out for frequent trading of the sort that generated so many short-term capital gains at Warburg Pincus.



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\* Avoid buying funds late in the year, especially those that have high turnover and large gains. Because most domestic equity funds pay out their capital gains near year-end, a late investor could be stuck with the tax bill for other investors' profits.

\* Avoid funds that have recently changed managers. New managers tend to clear the decks of stocks bought by their predecessors, generating abnormal levels of capital gains. If you want to buy such a fund, wait six months to a year, until the fund has distributed any realized capital gains. By then, the new manager will have culled his predecessor's picks -- and the fund will have reduced, if not eliminated, the tax overhang. In such cases, a fund that has a high tax burden one year may very well have a low burden the next.

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