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## What Investors Should Do When Funds Get Too Taxing

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**Mutual funds have stumbled across a shocking revelation: Investors don't like paying taxes.**

After years of dishing out huge taxable distributions to their shareholders, fund companies are starting to pay more attention to tax efficiency. This is long overdue. Actively managed funds, which have always struggled to beat the market, look even worse if you adjust their performance for taxes.

Indeed, after all taxes, 84% of stock funds lagged behind Vanguard Group's giant Standard & Poor's 500-stock index fund over the 20 years through year-end 1998, according to a study by Robert Arnott, Andrew Berkin and Jia Ye that appeared in the summer 2000 Journal of Portfolio Management.

Looking for less-taxing stock funds for your taxable account? Here are six pointers:

- Funds have begun publishing tax-adjusted returns. But these figures should be handled with care, because apparently tax-efficient stock funds may have been helped out by massive shareholder inflows.

If a fund collects a truckload of new investor dollars during the year, that will dilute the fund's year-end capital-gains distribution when figured on a per-share basis. This dilution doesn't affect the fund's overall return, but it does make the fund appear more tax efficient.

Conversely, a fund's tax efficiency can be torpedoed by shareholder redemptions. As investors flee, a fund may be forced to sell winning stocks, resulting in big capital-gains distributions for those shareholders left behind.

- Because tax-adjusted returns don't tell the whole story, pay attention to a fund's annual portfolio turnover. "If you are really interested in tax efficiency, you should be looking for 15% or 20% turnover, or even less," says John Brennan, chairman of Vanguard in Malvern, Pa.

At 15% turnover, a fund is hanging on to stocks for almost seven years. Only 6% of diversified U.S. stock funds engage in that sort of long-term investing, according to Chicago's Morningstar Inc.

- If a fund is slow to sell winners, it will amass unrealized gains. With any luck, these unrealized gains will shrink as a percent of fund assets as the fund garners more money from shareholders.

Without that fresh cash, the fund becomes a tax time bomb. That bomb could be triggered by a wave of shareholder redemptions or a change in the fund's investment strategy. To find out the size of a fund's unrealized capital gains, visit Morningstar's Web site ([www.morningstar.com](http://www.morningstar.com)<sup>1</sup>).

**My advice:** When investing through a taxable account, don't buy any fund with big unrealized gains unless you are confident it will continue to pursue a low-tax strategy. In practice, that means sticking with either tax-managed funds or market-tracking index funds.

- Don't ignore other investment costs in your pursuit of lower taxes. For instance, Eaton Vance Tax-Managed International Growth B, Liberty Tax-Managed Growth B and Prudential Tax-Managed Small-Cap B all charge more than 2% a year, in part because of hefty 12b-1 fees used to compensate brokers who sell these funds.

Such high-cost funds may generate superior returns, thus compensating for their sizable expenses. But I wouldn't count on it.

As a tax-managed fund seeks to limit capital-gains distributions by dumping losers and hanging on to winners, its portfolio will come to be dominated by stocks with large unrealized gains. At that point, the manager will be reluctant to sell existing stocks in favor of more-promising investments, because this trading will hurt the fund's tax efficiency.

These runaway winners will also tend to make a tax-managed fund increasingly risky. Exhibit A: Jeffrey Co., a private investment company in Columbus, Ohio, which has followed a tax-managed approach for 25 years.

Jeffrey started with a well-diversified portfolio but today has 27% of assets in just five stocks, including four drug companies. "Diversification is the taxable investor's biggest problem," says the company's retired chairman, Robert Jeffrey.

- Rather than purchasing actively managed tax-managed funds, I would favor tax-managed index funds, such as those offered by Bridgeway Funds, Charles Schwab Corp. and Vanguard.

But even these funds could struggle with unrealized gains. As a tax-managed index fund tries to avoid selling winners, it will tend to look less like its underlying index, so its annual results don't track the index precisely.

"In the short term, there will be more noise," Mr. Brennan concedes. "But in the long run, your pretax return should be close to the market and, if the tax strategies work effectively, you should be ahead of the game after taxes."

Moreover, Mr. Brennan notes that, if a tax-managed index fund gets in new cash from investors, it can use that money to keep its holdings in line with the fund's target index.

- Taxable investors should also check out exchange-traded index funds, which are listed on the stock market, just like a regular stock. Exchange-traded funds, or ETFs, can't be forced to realize capital gains by a rash of shareholder redemptions, so they are a good choice for tax-conscious investors.

**Still, because exchange-traded funds are so easy to buy and sell, investors need to be extra disciplined with these funds. If shareholders are too quick to sell, they could sabotage an otherwise tax-efficient strategy with their own impatience.**