George Sauter and Chris Ryon, portfolio managers, Vanguard Tax-Managed Balanced Fund

A Balanced Approach to Investing While Minimizing the Tax Consequences

One disadvantage to investing in mutual funds rather than individual stocks for taxable accounts is that there is less control over transactions that have tax consequences. Frequent selling of securities and returns in the form of dividends and income push up investors' annual tax bills, which cuts into bottom-line, aftertax rates of return.

As investors have become more aware of these disadvantages, a relatively new type of mutual fund has been developed—the tax-managed mutual fund. These funds attempt to minimize transactions and investments that generate higher annual tax bills, and they are the focus of Al Fredman's Mutual Funds column this month (for more on the characteristics of these funds, see his column starting on page 24). In general, these funds adopt a passive (index fund) investment approach that focuses on lower-yielding stocks, and municipal bonds when bonds are included in the portfolio; the passive approach has the advantage of keeping taxable transactions to a minimum, and at the same time expenses are kept low.

Among the tax-advantaged funds with the lowest cost and a high tax-efficiency is the Vanguard Tax-Managed Balanced Fund, which invests in a mix of stocks and municipal bonds. As with most tax-advantaged funds, it has only a short track record. Its three-year return is 17.6% compared to 19.2% for the average balanced fund (unadjusted for taxes); in 1997, it returned 16.5% compared to 18.8% for the average balanced fund. Currently, it has about $120 million in total assets.

In early January, portfolio managers George Sauter (who manages the stock portion) and Chris Ryon (who manages the municipal bond portion) discussed the fund with Maria Crawford Scott.

Could you give a basic description of the fund?

George Sauter: The objective is to invest half of it in equities and half in municipal bonds, creating a tax-advantaged situation.

The equity portion targets the Russell 1000 index, which covers the largest 1,000 firms by stock market capitalization. The one disadvantage to targeting the entire Russell 1000 is that you're going to have some yield from dividend payments. In today's environment, it is not as large as it may be in other environments, but the yield itself is not very tax-efficient. In fact, it is about as tax-inefficient as you can get. So what we try to do on the equity side is to get the Russell 1000 total return, but we try to do it with lower-yielding stocks. We use an optimizer model that focuses mostly on the lower-yielding stocks and that as a portfolio has the same risk and performance characteristics as the entire index. There is, as you would expect, a bit of a bias when you attempt to do that by purchasing lower-yielding stocks—you tend to get stocks that have more of a growth orientation, and you also have a smaller-cap bias. In any given year, we do have tracking error relative to the Russell 1000 index—some years we will somewhat underperform, and other years we will outperform it, but over time we think that it should average out.

How do your equity holdings differ from a small-cap portfolio?

George Sauter: We have similar industry weightings to the Russell 1000, and some small-cap stocks are actually high-yielding stocks. By trying to keep the industry weights similar to the 1000 index, it looks more like a large-cap fund than a small-cap fund. In fact, we do own most of the larger-cap names, but we simply underweight them in our portfolio. And we have managed to get the dividend yield down quite low—on the order of about 0.2%.

How do you manage gains and losses?

George Sauter: What we do is periodically go through the portfolio and sell off any positions that are at a loss—we call it harvesting our losses. And we will use those to offset any realized capital gains that are forced upon us—for instance, if a company is merged out of existence. So far, we have not had to distribute any capital gains during the life of the portfolio.

In a way, I suppose, down markets are helpful to the portfolio from a tax standpoint?

George Sauter: Yes. Absolutely. It is very tax-efficient. From a capital gains standpoint, we're able to realize some losses, and we look at those as a kind of asset that we

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The Vanguard Tax-Managed Balanced fund is part of the Vanguard family of funds, P.O. Box 2600, Valley Forge, PA 19482; 800/662-7447; www.vanguard.com.

can carry forward, since you are allowed to carry those forward for seven years. We just keep stockpiling them to use to offset any future gains that might be forced upon us.

The other portion of the fund is in municipals—primarily for the tax advantage?

George Sauter: Yes. The primary advantage of using munis instead of corporates is the tax advantage. Obviously bonds themselves are terribly tax-inefficient as investments because essentially almost all of the return is taxable at ordinary income tax rates. Using muni bonds, we avoid that problem.

Balanced funds typically invest slightly more in equities—why do you maintain a 50%/50% equity to municipal bonds balance?

George Sauter: Actually, at the end of each quarter we have to make absolutely certain that we are at 50%, because if a fund invests in municipals but doesn't have at least 50% in munis, the muni yield is not tax-free. That's an IRS regulation for mutual funds investing in municipals.

Obviously for an individual who wanted a different balance between stocks and municipals, they are better off creating their own "balanced" fund by investing in, say, our tax-advantaged growth fund and a municipal bond fund.

Shareholders who sell fund shares cause the fund to sell shares, possibly forcing realized gains. Do you have redemption fees to discourage short-term trading?

George Sauter: Yes. There are two things that can cause us to realize a capital gain: Number one is a company being merged out of existence, and number two would be investors selling out of the fund and forcing us to sell off some of our holdings. In order to ensure that investors are long-term oriented, we do charge a transaction fee—if you redeem in the first year, it's 2%; if you redeem in years two through five, it's 1%. The fee is paid to the fund to reimburse the other investors who might be negatively impacted by the seller's actions.

How are the municipal bonds managed?

Chris Ryon: The municipal side of the fund is managed like an intermediate fund—it has the same general characteristics and objectives as our intermediate-term portfolio, with an average maturity target of around seven years.

Is there a particular index you track?

Chris Ryon: No. It is managed with the same constraints as our intermediate -term portfolio, but there is not much trading because I don't want to incur capital gains.

How do you decide which bonds to purchase?

Chris Ryon: I look for the portion of the yield curve [yields for similar bonds of different maturities] that I find to be the most attractive, that will provide what I believe to be the best total return. Once I've found that portion of the yield curve, I look to see what is the cheapest sector.

What would cause you to sell a bond?

Chris Ryon: It would be a combination of things. First of all, if there were a credit reason to get out of it, certainly I would sell the bond at that point in time regardless of whether I have a capital gain or loss in the security. After that, I'd look at a combination of how the bond is trading, whether its characteristics are over-priced or undervalued, but always keeping an eye toward whether the security has a capital gain attached to it or not.

Why do you target intermediate-term bonds?

Chris Ryon: The intermediate portion of the municipal market is very attractive in terms of the total returns that they generate, particularly when you compare it to the long end of the market [long-term maturities]. For instance, if you look at the Lehman Brother's municipal bond indexes, you get about 85% to 90% of the long-term yield, with only about 70% to 80% of the maturity risk. So, in terms of yield per unit of risk, it is a very attractive portion of the market. And that is also true in terms of total return generated per unit of risk—you get about 90% of the total return, with about 75% to 80% of the risk. Those are rough numbers.

What would be the disadvantage of investing in the fund?

George Sauter: The major disadvantage would be for an investor who is not in a high tax bracket. In other words, if munis don't make sense to you, clearly this fund doesn't make sense to you. The other disadvantage is the fact that it is a 50/50 weighting, and some investors may prefer a different balance.

At what tax bracket are municipal returns better than taxables on an aftertax basis?

Chris Ryon: That's going to be dependent upon where they are investing along the yield curve, and right now municipal bonds are cheap compared to historical averages. For maturities five years and longer at this point in time, an investor in a 28% bracket would do better with municipal bonds on an aftertax basis. For instance, general obligation bonds maturing in five years are yielding 75% of the Treasury equivalent; an investor in the 28% tax bracket will break even right at 72%. If you go to 10-year maturities, they are trading at 78½% of Treasuries, so it is even more compelling.