MUTUAL FUNDS

Most managers downplay tax efficiency because they are rewarded on pretax numbers, but a few exceptions exist—including index funds and special tax-managed funds.

Tax-Conscious Funds: For Investors, It's the Leftovers That Count

By Albert J. Fredman

Many individuals have not worried much about tax considerations because they earned extraordinarily high returns during the bull markets of the 1980s and 1990s. Nevertheless, minimizing taxable distributions can noticeably boost the aftertax returns of mutual fund investors, particularly those in the highest brackets. As a group, mutual funds are not very tax friendly because they must distribute yearly at least 98% of their net investment income and net realized capital gains.

Suppose ABC Fund sells its shares of XYZ Corp. for $100. If the stock had a $40 cost basis, a $60 gain is distributed, assuming no offsetting losses. If the gain is short-term, it is taxable at federal rates ranging up to 39.6%. Conversely, if XYZ was not sold, ABC Fund's net asset value would reflect the stock's unrealized appreciation. In this latter instance, there is no tax liability on the growth in net asset value until the investor sells the appreciated shares. Thus, fund investors relinquish control over the timing of capital gains realization to their portfolio managers.

Distributions have been larger with the hefty returns spun off by many stock funds during recent bull market years. However, not all investors who enjoyed generous returns have been saddled with large tax bills, because some funds distribute far less than others. In fact, fund performance rankings can change markedly when tax-adjusted returns are used, especially over long periods.

Most managers primarily focus on pretax results and downplay tax efficiency because they are rewarded on pretax numbers. A few exceptions exist. For instance, managers who have a substantial amount of their money in a fund may strive to minimize portfolio turnover. In addition, index funds often are highly tax-efficient, and there is a small but growing number of tax-managed funds, which are examined in this column.

Gauging Tax Efficiency

A simple way to determine how tax-efficient a stock fund has been is to chart its net asset value. Successful funds that retain appreciated stocks can enjoy dramatic growth in net asset value. For instance, the tax-efficient Vanguard 500 began August 31, 1976, with a $14.15 net asset value, which had grown to $90.07 by December 31, 1997. Conversely, tax-inefficient funds that realize and distribute large capital gains or pay relatively high income dividends may exhibit only slight growth in net asset value.

A better way of gauging tax efficiency is to compare a fund's tax-adjusted and pretax returns. Fund trackers such as AAII, Morningstar, and Value Line supply this information in various formats. In "The Individual Investor's Guide to Low-Load Mutual Funds," AAII provides yearly pretax and tax-adjusted returns for the last 10 years or the life of the fund, whichever is shorter. Morningstar calculates three-, five-, and 10-year annualized tax-adjusted returns.

A fund's tax-adjusted return can be divided by its pretax gain to determine its relative tax efficiency. Suppose ABC High-Yield Bond Fund had 1997 tax-adjusted and pretax returns of 6% and 10%, respectively. Dividing the former by the latter yields a 60% tax efficiency. Subtracting 60% from 100% tells you that 40% of the return was consumed by taxes.

Table 1 contains average annual pretax and tax-adjusted returns, including tax efficiencies, for several stock and balanced funds over a recent 10-year period, as calculated by Morningstar. A typical tax efficiency for an equity fund would be about 80% to 85%. The maximum tax-efficiency reading is 100%, which some municipal bond funds may achieve although the number would fall below 100% if capital gains were paid out. At the other extreme, tax efficiencies below 50% are seen on non-municipal bond funds that pay large income dividends. Of course, your own pretax and aftertax results

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Table 1.
Tax Efficiency of Selected Funds*

Fund (Objective)	Pretax Return (%)	Tax-Adjusted Return (%)	Tax Efficiency (%)
Vanguard Index 500 (growth & income)	14.52	13.17	91
American Century 20th Century Ultra (agg. growth)	18.57	16.45	89
Fidelity Contrafund (growth)	19.04	17.04	89
Strong Opportunity (growth)	13.67	11.53	84
Janus (growth)	16.29	13.49	83
Dodge & Cox Balanced (balanced)	13.07	10.74	82
PBHG Growth (growth)	17.80	14.60	82
T. Rowe Price Equity Income (equity-inc)	14.80	11.94	81
Fidelity Magellan (growth)	15.60	12.42	80
Safeco Equity (growth & income)	15.92	12.47	78
Fidelity Puritan (balanced)	12.93	9.67	75
Pennsylvania Mutual (small company)	11.98	8.69	73
Vanguard Windsor (growth & income)	14.20	10.30	73
Lindner Dividend (balanced)	12.07	8.73	72

**Average annual total returns for 10 years through 9/30/97.*

Source: Morningstar, Inc.

depend on when you make your investments and redemptions and on your personal tax circumstances.

Stock funds are likely to be more tax-efficient going forward because of the capital gains tax cut from a 28% to a 20% maximum, according to Russel Kinnel, Morningstar's equity editor. The majority of large gains realized by mutual funds are long-term, so they would meet the 18-month minimum holding period threshold for capital gains treatment.

Determinants of Tax Efficiency

Four factors work together to determine a fund's potential tax efficiency, namely:

- Portfolio performance and net new cash inflows.
- The portfolio's yield, or income return.
- Portfolio turnover and the portion of turnover that results in realized gains.
- The fund's age and the percentage of its assets represented by unrealized capital gains.

Net New Cash Flows: A fund that receives lots of new shareholder money could be highly tax-efficient because its per-share distributions are spread over a much larger shareholder base. Suppose a $200 million small-cap growth fund realizes $10 million in net capital gains and also receives $100 million in net new cash during a year. The $10 million capital gain now can be spread over $300 million of assets, cutting the distribution to earlier investors but not their percentage returns. Those who invested just prior to distribution time also share in the taxable payout, benefiting long-term shareholders. Conversely, a fund that hasn't attracted new money or one that is closed to new investors would be less tax-efficient, other things being equal.

Funds that have attracted consistently high cash inflows in favorable markets normally have been stellar performers. Obviously, a fund's future returns and net cash inflows are difficult to predict. For this reason, factors such as a portfolio's yield and turnover are more useful when evaluating probable tax efficiency.

Income Distributions: A fund's yield, known as the "ratio of net investment income to average net assets," is the most straightforward and telling indicator of tax efficiency. Income dividends are paid regularly and are taxed at the individual's highest rate—which currently ranges up to 39.6%—rather than at the 20% maximum long-term capital gains rate. Thus, funds that distribute income regularly such as growth and income, equity-income, balanced, and bond portfolios tend to be relatively tax-inefficient. A high-yield bond fund would be especially tax-inefficient.

If income is an integral component of a fund's strategy, holding tax-free bonds is the only way to minimize taxable distributions. Several tax-managed balanced funds are following the strategy of investing in a mix of municipal bonds and low-yielding stocks. But a large stake in tax-free bonds is usually not appropriate for growth-oriented investors.

The Turnover Rate: The larger the percentage of a fund's holdings sold annually, the higher its portfolio turnover rate. A fund with a 100% turnover holds onto its stocks for about a year on average, a 50% rate implies a two-year horizon, and so on. The turnover for the average equity fund ranges from 80% to 90%. Yearly turnover rates are contained in the financial highlights table found in a fund's prospectus and in its annual and semi-annual reports.

Funds with rock-bottom rates tend to be more tax-efficient, particularly index funds with minuscule ratios of 5% or so. In fact, research indicates that the turnover rate needs to be 10% or less if you really want tax-efficient benefits. The difference between, say, a 100% turnover and a 50% turnover on a fund is not that significant, as far as tax efficiency goes.

But turnover may vary widely from year to year because trading activity can increase for various reasons. A new manager may decide to revamp a portfolio to conform to his or her choices, as in the case of Fidelity Magellan when Robert Stansky took the helm in 1996. In other instances, managers who trade infrequently may have sizable amounts of unrealized appreciation. When they do

sell stocks, their capital gains distributions will be high, especially if the fund is older and has done well.

You can even find high-turnover funds that are very tax-efficient and low-turnover portfolios that are surprisingly tax-inefficient. A low-turnover stock fund could be more income-oriented, making the portfolio less tax-efficient from that perspective. A high-turnover aggressive growth fund may cut losses quickly on picks that don't pan out, while retaining its winners. In addition to checking the annual turnover, you can scrutinize yearly capital gains distributions (also in the financial highlights table) to see if a fund has regularly paid out a large percentage of its net asset value.

That said, owning funds with relatively low turnovers still makes sense. These portfolios might not always be more tax-efficient, but they will have lower transaction costs and a longer-term orientation.

Capital Gains Exposure: A fund that has been tax-efficient in the past will not necessarily be tax-efficient going forward. The extent of a fund's unrealized capital gains is worth knowing. Morningstar's "potential capital gains exposure" number expresses a portfolio's unrealized gains as a percentage of assets. Unrealized capital gains simply are paper profits that could become tax liabilities when the holdings are sold. The larger this number, the greater your potential tax bill. A relatively small number of funds have readings exceeding 50%. However, some managers hold onto stocks with large embedded gains for years. But if a change occurs in the fund's management or objectives, or there are widespread redemptions in a severe bear market, an increase in liquidations could lead to sizable distributions.

An advantage to investing in a relatively new fund is that it starts off with no unrealized gains. New funds run by managers with established track records are the best bet. New small-stock or micro-cap funds can be particularly attractive because they often perform best when their asset base is small, assuming small stocks are in an uptrend.

Loss Carryforwards: Some funds have capital-loss carryforwards so their potential capital gains exposure is negative. Funds carry net realized losses forward to offset future realized gains, giving investors a nice tax shelter until the losses are used up. High-yield bond fund investors benefited from their tax-loss carryforwards when the junk bond market recovered from its 1989–1990 debacle.

Of course, funds with poor histories could be badly managed. And if a poor-performing sector or market is to blame, the dismal performance can persist for years, as in the case of Japan's extended bear market. Table 2 shows the negative capital gains exposure of several Japanese stock funds at this writing. Investors will receive a tax benefit when Japan's market finally makes a sustainable comeback.

Table 2.
Loss Carryforwards of Selected Japanese Stock Funds

Fund	Capital Gains Exposure (% of assets)
Fidelity Japan	–31
Fidelity Japan Small Companies	–58
Japan	–28
T. Rowe Price Japan	–16
Warburg Pincus Japan OTC—Common	–39

Source: Morningstar, Inc.

Funds that Use HIFO: Tax-smart individuals often use the "specific identification" method when selling a portion of their position in a mutual fund or a stock. With this method, those shares with the highest cost basis are identified and sold first, to minimize a taxable gain or widen a loss. (Of course, the individual needs written documentation from the fund company or broker in case the IRS makes an audit.) The specific identification method is often more desirable than the first-in, first-out method, which assumes the earliest shares acquired are sold first. That's because the earlier shares may have been acquired at lower prices.

There appears to be momentum within the fund industry to also apply the specific identification method, which has been dubbed highest in, first out (or "HIFO"). The tiny universe of tax-managed funds adhere to this approach, but more funds that are not tax managed also are following HIFO. There's no need to change the way stocks are sold—only the accounting for gains. Using HIFO can make any fund—even an index fund—a bit more tax-efficient.

How Tax-Managed Funds Work

Well-run tax-managed funds offer the most dependable way of achieving tax efficiency. These portfolios focus on tax-adjusted rather than pretax returns. Relative to other funds, their returns rank higher after an individual's taxes are considered than before taxes. They normally have tax efficiencies ranging from 90% to 100%, as opposed to the 80% to 85% range for the typical stock fund. Some tax-managed funds target a market index, but they don't track the benchmark as closely as a traditional index fund would. This gives them the flexibility to be even more tax-efficient than a plain-vanilla index fund.

Tax-conscious funds do several things to meet their objectives. Specifically, they can:

- Minimize income distributions by owning stocks that pay skimpy divi-

Table 3.
Selected Tax-Managed Funds

Fund	Start Date	Total Net Assets ($ Mil)**	Yield (%)	Turnover Rate (%)	Exp. Ratio (%)
T. Rowe Price Tax-Efficient Balanced	6/97	13.8	—	—	1.00
Schwab S&P 500 Index Investor Shares*	5/96	875.4	0.66	—	0.49
Schwab 1000 Investor Shares*	4/91	2,651.4	1.03	2	0.49
Schwab Int'l Index Investor Shares*	9/93	342.7	1.27	5	0.69
Schwab Small-Cap Index Investor Shares*	12/93	407.0	0.35	23	0.59
USAA Growth and Tax Strategy	1/89	202.0	3.22	194	0.74
Vanguard Tax-Managed Balanced	9/94	110.2	2.49	5	0.20
Vanguard Tax-Managed Capital Appreciation	9/94	852.9	0.56	12	0.20
Vanguard Tax-Managed Growth & Income	9/94	499.6	1.47	7	0.20

**Schwab Select Shares funds require a $50,000 minimum investment and have lower expense ratios.*
***As of 9/30/97; 12/31/97 for T. Rowe Price Tax-Efficient Balanced.*

Source: Morningstar, Inc.; T. Rowe Price Tax-Efficient Balanced data from T. Rowe Price Associates, Inc.

dends or holding tax-exempt bonds within a balanced portfolio.

- Minimize turnover, particularly if realized gains would result.
- Tweak the portfolio to offset a realized gain by taking a loss on another position.
- Increase selling during market downturns to accumulate losses for future use.
- Sell the highest cost shares when liquidating a part of a stock position so as to minimize a gain or maximize a loss.
- Hold onto stocks with substantial gains, even if those positions have little or no upside potential.
- Impose redemption fees to discourage short-term trading, which could force a fund to unload shares to meet redemptions and realize and distribute gains. For instance, Vanguard charges a 2% redemption fee for shares of its tax-managed portfolios held less than one year and 1% for redemptions within one to five years. The money from the fees goes back into the portfolios and helps to cover redemption-related transaction costs, including tax expenses.
- Finally, if the fund does not attempt to replicate a benchmark, it may increase cash holdings as a cushion for redemptions if the financial markets appear skittish. However, this practice probably is used to a limited extent—if at all—because the cash holdings would earn income, reducing the fund's tax efficiency.

A tax-managed fund may not always fare that well on a pretax basis, but if you're in a sufficiently high bracket, its tax-adjusted returns should be greater than those of its less tax-efficient peers. These funds obviously are designed for taxable accounts, not tax-deferred retirement plans.

Sorting Out the Funds

Table 3 profiles several tax-managed funds. The Schwab 1000 and Schwab Small-Cap Index funds attempt to match the performance of the 1,000 largest and the second 1,000 largest domestic firms, respectively. The Schwab 1000, one of the oldest of the no-load tax-managed group, had a 96% average tax efficiency over the five years ended September 1996, according to Morningstar. The Schwab 1000 has never paid a capital-gains distribution. Schwab International Index fund tracks the performance of Schwab's proprietary index of 350 large-cap foreign corporations.

All four Schwab index funds remain fully invested; no effort is made to time the market. Schwab's international portfolio may have as much as 1% in cash, but the other three portfolios would have at the most 0.5% in cash. The primary goal of these funds is to track their benchmarks as closely as possible; tax efficiency is a secondary goal. All Schwab index funds are available in both Select Shares and Investor Shares. The Select Shares funds require a $50,000 minimum initial investment but charge lower expenses.

Vanguard Tax-Managed Growth & Income targets the Standard & Poor's 500, and Vanguard Tax-Managed Capital Appreciation invests in a sample of low-yielding stocks from the Russell 1000, which tracks the 1,000 largest domestic companies. Vanguard Tax-Managed Balanced allocates 50% to 55% of its assets to an actively managed mix of intermediate-term municipal bonds, with the remainder invested in a passive compilation of Russell 1000 stocks. Like traditional index funds, these Vanguard portfolios are fully invested at all times.

Introduced last June, the T. Rowe Price Tax-Efficient Balanced fund holds about 50% of its assets in tax-free munis of various maturities and the balance in stocks that pay low dividends. It plans to keep its turnover rate low, but it does not index its stock holdings.

USAA Growth and Tax Strategy was started in 1989 as USAA Balanced Portfolio. Its name was changed in 1995, but it follows the same strategy of holding a mix of intermediate- to long-term municipals and large growth-oriented stocks that pay below-average dividends. Its stock position is not indexed.

An advantage of mixing munis with stocks is that the two markets often move independently. Tax-conscious managers can use losses from one asset class to offset gains from the other, enhancing tax efficiency. Like a regular balanced fund, its tax-managed counterpart provides an all-in-one vehicle for those who want simplicity. But you don't have single-state municipal bond exposure, so most of your income would normally be subject to state and local taxes. Thus, investing in both a single-state municipal bond fund and a tax-

conscious stock fund may work better for people with high tax brackets living in states with relatively high tax rates.

Table 4 shows yearly pretax and tax-adjusted returns of selected tax-managed funds with at least three full years of performance history as reported by AAII.

Traditional Index Funds

Traditional index funds also may be highly tax-efficient, even though they are not labeled "tax managed." The typical index fund follows a buy-and-hold strategy, as evidenced by the very low portfolio turnover rates on these investments—often less than 5% or 10%. Thus, they distribute little, if any, capital gains.

A true index fund will sell stocks in only two situations:

- To remove the occasional stock that has been dropped from an index.
- To raise cash to meet redemptions during market downturns.

Index funds outperform most actively managed funds with their low costs and fully invested portfolios. Their tax efficiency is an added plus. Index funds do vary in tax efficiency, however. Vanguard Index Trust 500's huge net cash inflows over the years have contributed significantly to its high tax efficiency, which averaged 91% over the 10 years ended September 30, 1997. Others with more stable portfolios may be less tax-efficient. Beware of so-called "enhanced" index funds that do a fair amount of buying and selling to try and beat their target benchmarks, making them less tax-efficient.

Because index funds remain fully invested to track their benchmarks as closely as possible, critics point out that indexed portfolios could be hit harder in a severe bear market than managed funds if investors cash out en masse. Their managers may be forced to realize and distribute large gains on low-cost positions that have been held for years. This also may be true of the index funds that take a few extra steps to be tax smart.

There are some counter arguments, however. First, redemption fees, such as those imposed by Vanguard on its tax-managed funds, could be a deterrent to selling. Second, the manager could sell the highest cost shares first in a market decline to realize some losses to offset gains on other positions that may also have to be sold. Finally, indexing attracts more sophisticated investors who would be less likely to panic and sell during a market rout.

Diamonds and Spiders

Diamonds and Spiders are, respectively, Dow Jones industrial average and Standard & Poor's 500 index portfolios that trade like stocks on the American Stock Exchange (trading symbols DIA and SPY). Spiders, which were introduced in 1993, have become the most actively traded stock on the Amex with assets of $5.4 billion at this writing. Diamonds were launched in January and also are expected to be highly popular.

Each vehicle essentially represents ownership in a unit investment trust that holds stocks in the respective index. Because cash redemptions are not possible with Diamonds or Spiders, they are even more tax-efficient than traditional index funds. The only time shares are bought and sold within the portfolio is if the composition of the underlying index changes. Of course, just like any other tax-efficient investment, Diamonds and Spiders must be bought and held to derive the maximum benefit from their tax efficiency. Total yearly expenses are at a rock-bottom 0.18% for Diamonds and 0.1845% for Spiders. Call 1-800-THE-AMEX for a prospectus and more information on Diamonds and Spiders.

Estate Planning Considerations

Tax-managed portfolios and index funds also can be useful for estate planning purposes. At the time of an investor's death, mutual funds and other securities that make up the deceased individual's estate are eligible for a tax-free "step-up" in basis, which can be very attractive for a shareholder's heirs. Suppose the cost basis of an index fund is $50,000, and

Table 4.
Pretax and Tax-Adjusted Returns of Selected Tax-Managed Funds

		Annual Total Returns (%)			
Fund		**1997**	**1996**	**1995**	**1994**
Schwab 1000	Pretax	31.9	21.5	36.6	–0.2
	Tax-adj.	31.3	20.9	35.8	–1.1
Schwab International Index	Pretax	7.3	9.1	14.2	3.8
	Tax-adj.	6.8	8.5	13.7	3.3
Schwab Small-Cap Index	Pretax	25.6	15.4	27.6	–3.1
	Tax-adj.	25.4	15.2	27.3	–3.3
Vanguard Tax-Managed Balanced	Pretax	16.5	12.2	24.5	—
	Tax-adj.	16.5	12.2	24.5	—
Vanguard Tax-Managed Cap. Apprec.	Pretax	27.2	20.9	34.3	—
	Tax-adj.	26.9	20.5	33.9	—
Vanguard Tax-Managed Growth & Inc.	Pretax	33.3	23.0	37.5	—
	Tax-adj.	32.6	22.1	36.4	—

Source: American Association of Individual Investors

its fair market value is $200,000 at the time of death. Using the step-up in basis, the new basis is $200,000. So, the investor's estate and heirs could escape from paying taxes on $150,000 worth of unrealized gains. The heirs would have the option of establishing the value of the basis as of either the date of death or six months thereafter. The higher of the two is normally the better choice. The opportunity to reduce potential taxes makes the step-up in basis a very attractive provision.

The automatic tax-deferral feature of tax-managed funds and index funds is highly beneficial if you want to incorporate the tax-free step-up strategy into your estate plan. If you decide not to leave your appreciated investments to any beneficiaries, you still will benefit by postponing the day of reckoning with the IRS through the build up of unrealized gains. Incidentally, balances in variable annuities, individual retirement accounts, and other tax-sheltered retirement plans don't qualify for any tax-free step-up in basis.

Conclusion

With lower rates on long-term capital gains, tax-smart mutual fund investing makes more sense than ever. However, the tax efficiency of a traditional mutual fund can change for various reasons. Therefore, tax efficiency is probably best viewed as a tiebreaker when choosing among traditional funds. More important is the ability of a fund's management to perform well relative to the competition.

That said, many individuals—particularly those in the highest tax brackets—want both tax efficiency and growth. The most dependable vehicles for achieving tax efficiency with equities are found within the small group of tax-managed stock funds. Certain index funds with minuscule portfolio turnover rates and modest net income distributions also are tax-efficient.

Yet there is no ironclad guarantee that a tax-managed fund will always be tax-efficient. Tax-efficient performance might be difficult to achieve in a bear market where a fund is forced to sell large amounts of appreciated stocks to meet redemptions.

In the end, the most tax-efficient approach lies within your own control—it consists of having the patience and discipline to be a buy-and-hold investor, since selling will trigger taxes no matter how tax-efficient a fund is.