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*“The Smarter Way to Invest”*

## Mutual Fund Investors Brace for Huge Tax Bill

By Richard D. Romey

In 1773, a group of brave Bostonians dumped tea into Boston Harbor to protest taxation without representation. They risked life and limb to fight unfair and excessive taxation. Despite their actions, millions of investors today calmly sip their tea (or coffee) read their mutual fund reports and quietly accept excessive taxation each year and never give it a second thought.

According to the Investment Company Institute, a mutual fund industry research firm, U.S. mutual fund investors could pay over \$20 billion in taxes this year due to capital gains distributions by funds. Unlike other investments, a mutual fund is a pass-through investment vehicle. All earnings – capital gains and dividends – must be distributed to the shareholder. The shareholder is responsible for paying taxes on the earnings, whether they’re reinvesting those earnings or not.

Mutual fund capital gains distributions are expected to exceed \$200 billion this year, making 2006 the third-highest year for distributions, surpassed only by \$238 billion in 1999 and \$326 billion in 2000.

What does this mean to you? If you own a mutual fund in a taxable account your after-tax return may be substantially less than you think. Some experts suggest that the average investor loses over 2 percentage points per year due to taxes. For example, if you own a mutual fund in a taxable account that averaged 7% per year over the last five years your return after taxes may only be 5% per year.

The reason mutual funds tend to be so tax inefficient is that fund managers have no incentive to limit capital gains. They’re interested in performance at any cost. If that means selling securities and realizing huge capital gains, so be it. After all, they’re not the ones paying the taxes, you are! Ironically, even if you buy shares of a mutual fund *after* the fund has realized a gain but before the gain is paid, you’re still liable for the taxes.

Mutual fund capital gains distributions can be a problem even in years when the market is down. In 2000, when the market registered substantial losses, many long-term mutual fund investors took a double beating. They lost money as the price per share of their mutual funds dropped and had to pay taxes on gains generated in the fund’s port-

folio. What a great investment: lose money and pay taxes!

What can investors do to minimize their potential tax liability? The best way is to use a more tax efficient investment product, such as exchange-traded funds (ETFs). An ETF is essentially a basket of securities that can be bought or sold on an exchange like shares of stocks. Like index mutual funds, ETFs are designed to track a specific market index or benchmark. Unlike mutual funds, ETFs are bought or sold on an exchange during regular market hours.

The unique way ETFs are structured makes them very tax efficient. This was evident in December of 2005 when the largest family of ETFs (the iShares) announced for the fourth consecutive year zero year-end capital gains distributions for all 101 iShares. In contrast, mutual funds passed through record levels of taxable capital gains over this same period. As a result, ETF investors paid less in taxes and kept more of what they earned.

Unfortunately, to protest the excessive taxes associated with mutual funds you really can’t dump tea into Boston Harbor, but you can dump your tax inefficient mutual funds. Send a message to the mutual fund industry and move your money to tax efficient exchange-traded funds.

### **About the Author**

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