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A White Paper

**An October 2008 Market Opportunity?
Minimizing Taxes by Avoiding Mutual Fund
Capital Gains Distributions**

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- **Mutual funds are tax inefficient**
- **Wealth managers have been waiting for the opportunity to convert mutual funds into individually managed securities**
- **The recent downdraft of the market has created both the opportunity and impetus to convert mutual fund assets to a tax efficient overlay management solution.**

About This Document

This document provides an analysis of mutual funds and the special circumstance of capital gains distributions. The paper shows how current market conditions are creating an opportunity to convert mutual fund assets to overlay, a more tax-efficient and cost-effective solution

For more information on Overlay Management, visit www.foliodynamix.com, or contact Shari Hensrud-Ellingson at (916) 288-6451.

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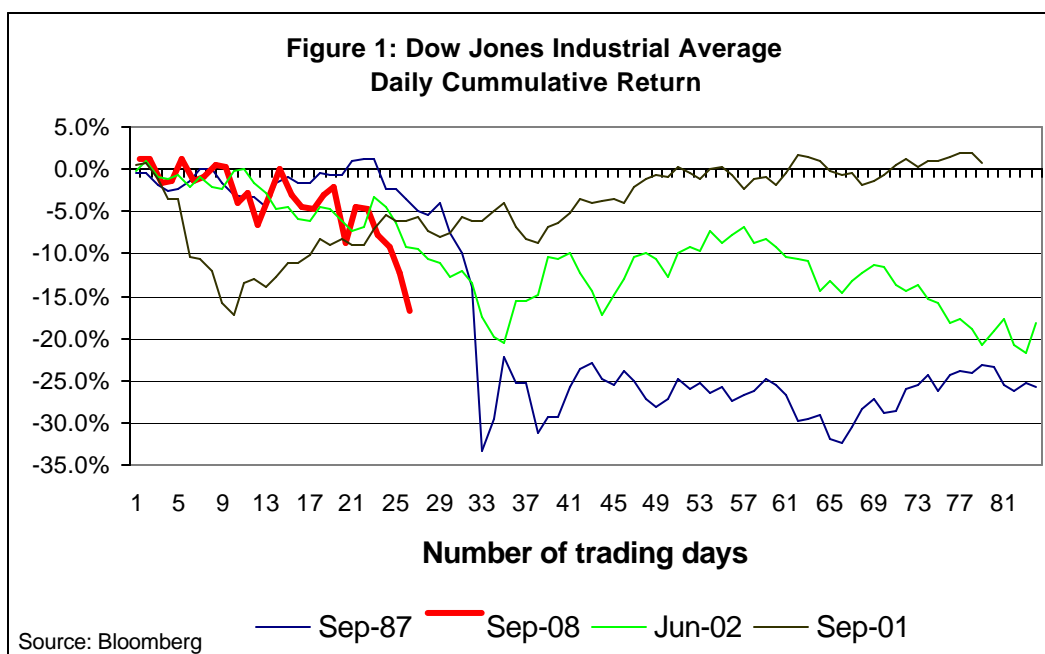
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An October 2008 Market Opportunity? Minimizing Taxes by Avoiding Mutual Fund Capital Gains Distributions

It is common knowledge that mutual funds are tax inefficient. A source of inefficiency is the periodic distribution of capital gains, which occur even in bear markets. History shows that mutual funds can, and do, pay out significant capital gains distributions creating the pain of higher taxes for investors. A driver of these high distributions in negative markets is unusually high redemptions resulting from panic selling. Due to the pooled structure of mutual funds, taxable fund investors face a unique problem where the redemptions of shares by other investors can have a direct impact on their after-tax returns. This paper illustrates the potential tax impact faced by today's mutual fund investors by reviewing capital gains distributions in other negative market environments. Also, this paper examines a near-term solution to the tax problem caused by high redemptions.

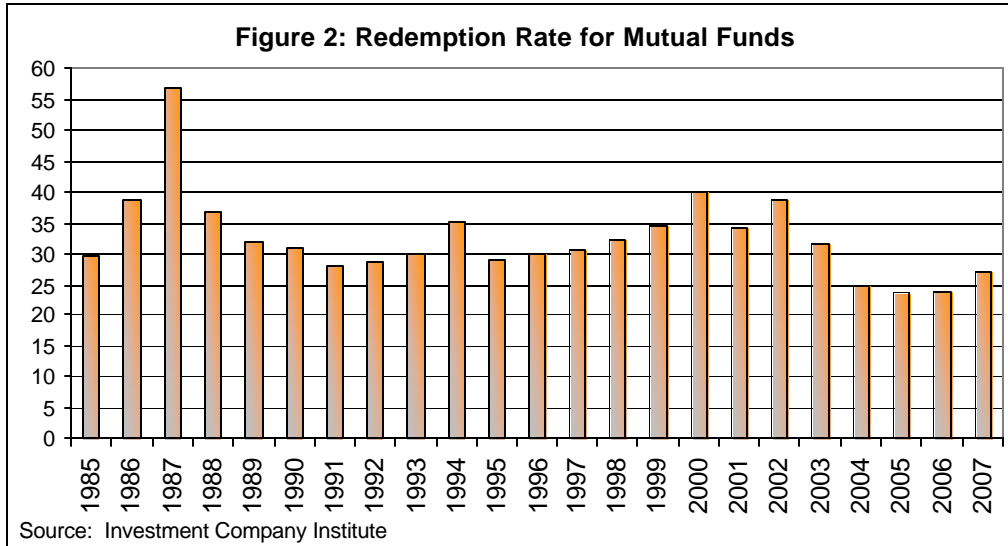
Redemption and Capital Gains Distributions in Down Markets

Figure 1 compares the recent performance of the Dow Jones Industrial Index to similar time periods in history. Clearly, 2008 is not the first time markets have spiraled downward thereby forcing mutual fund managers to meet high redemptions by liquidating positions with imbedded gains. Some of the more memorable markets are those that occurred in October 1987, after 9/11 in 2001, and then again the summer of 2002.



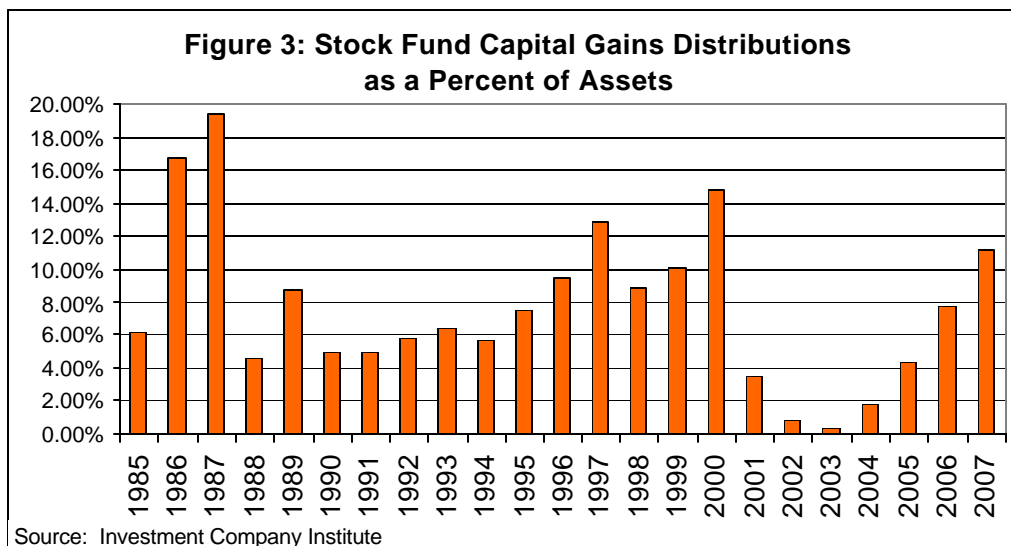
The chart demonstrates the similarity of current markets to 1987 and 2002, albeit 2002 was not as severe as 1987. While it is possible that 2008 will also not follow 1987 in severity, the impact for taxable investors was significant and could be again.

The historical rate of redemption for mutual funds was highest in and around 1987 followed by 2000 and 2002. (Figure 2)



In July 2002 mutual fund investors apparently hit their psychological limit on losses and withdrew a record \$53 billion from stock mutual funds (1.7% of assets) —significantly higher than the \$29 billion they had pulled out after September 11, 2001 (0.9% of assets). However, as a percent of assets these levels still do not meet the rate in October 1987 where net asset flow was -\$16 billion or 3.1% of assets.

Not surprisingly, these high redemptions left existing shareholders with an unwanted tax liability. The capital gains distributions reached historical highs in 1987 at almost 20% of assets for stock funds. (See Figure 3). The results for 2001 and 2002 were not as severe.



2008 Redemptions on the Rise: Will Capital Gains Distributions Follow?

Bringing the analysis forward to 2008, as of August 31, the year-to-date net flow to stock mutual funds is -\$68 billion or 1.5% of assets and redemptions are at almost 30% of assets. Additionally, many investors really pushed the panic button in September. [TrimTabs](#) reported \$75 billion fled U.S. mutual funds during the month. About two-thirds of the outflow came from equity funds and the rest from bond funds. Early signs indicate October may see even more outflows than prior months. The implication is investors could once again experience significant capital gains distributions from mutual fund companies.

If for example, an investor holds 100,000 shares of a fund with a current NAV of \$10 and the fund declares a 20% of NAV capital gain, the result is \$200,000 in taxable capital gains. If the cost basis is greater than \$10 per share, the decision is clear. Avoid the capital gains tax and realize a loss. If the cost basis is lower than \$10 per share, it could still be prudent to liquidate and avoid the capital gains distribution.

Avoiding the Pain: A Window of Opportunity

The current negative market conditions and pending distributions create a rare opportunity to cost-effectively convert mutual fund clients to individually managed securities accounts through overlay. The benefits of overlay are well documented and include, but are not limited to, tax alpha and lower expenses. Parametric Portfolio Associates has demonstrated through simulation, the excess return from overlay management could be as high as 0.6%. [Stein, 2003]. It has also been illustrated that converting from mutual funds to overlay management investors can save 0.9% in expenses and fees. [Martin, 2006] However, high cost basis is often a barrier, preventing existing mutual fund clients from experiencing these benefits.

Today's negative market has removed much of the cost basis barrier. Furthermore, mutual fund investors can avoid capital gains distributions by selling prior to the mutual fund's year end capital gains record date. October 31st marks the fiscal year end for many mutual funds and hence also marks the beginning of year end capital gains distributions. Thus, the window of opportunity is very short.

With the removal of the cost basis barrier, and with the avoidance of a significant tax bill from capital gains distributions, mutual fund clients should consider liquidating their mutual fund shares and investing them in an overlay solution. By doing so today, the costs to clients may realize a relatively short payback period of 3 – 4 years, or less, created by the tax management alpha and the lower expenses of overlay compared to mutual funds. (See Figure 4.)

Figure 4: Simple Payback Period for Different Holding Periods¹

Horizon # of Years	Initial Investment	Current Market Value	Unrealized Gain	Tax on Gain	Tax Avoided on CG Dist	Total Net Tax	Payback Tax Alpha	Payback Tax Alpha & Fees
10	\$1,000	\$1,073.44	7.34%	1.10%	0.30%	0.80%	1.34	0.53
9	\$1,000	\$797.41	-20.26%	-3.04%	0.30%	-3.34%	0.00	0.00
8	\$1,000	\$750.10	-24.99%	-3.75%	0.30%	-4.05%	0.00	0.00
7	\$1,000	\$986.48	-1.35%	-0.20%	0.30%	-0.50%	0.00	0.00
6	\$1,000	\$1,345.88	34.59%	5.19%	0.30%	4.89%	8.15	3.26
5	\$1,000	\$1,021.79	2.18%	0.33%	0.30%	0.03%	0.05	0.02
4	\$1,000	\$925.43	-7.46%	-1.12%	0.30%	-1.42%	0.00	0.00
3	\$1,000	\$887.03	-11.30%	-1.69%	0.30%	-1.99%	0.00	0.00
2	\$1,000	\$783.13	-21.69%	-3.25%	0.30%	-3.55%	0.00	0.00
1	\$1,000	\$678.54	-32.15%	-4.82%	0.30%	-5.12%	0.00	0.00

Conclusion

Life teaches that negative experiences often contain positive opportunities for the future. However, it is difficult for most people to identify opportunities amid a crisis. Today's market volatility is creating unrest among investors. Clients are struck with fear and are struggling to see anything positive in the current environment. As wealth managers, we should help our clients capitalize on the existing opportunities, despite our clients' pull to give into the panic. One such opportunity is to convert mutual fund clients to individually managed securities accounts through overlay. By doing so, clients may avoid incurring capital gains distributions from redemptions. This opportunity is brief, and must be acted upon quickly before the fiscal year end of mutual funds. Furthermore, clients will gain future benefits that include higher after-tax returns and an overall improved client experience. Finding opportunities like these amid today's market environment will not only benefit your clients, but will also benefit your wealth management firm through very strong and loyal client relationships and may even lead to asset growth.

Endnotes

1. Calculation: Market values represent the growth of an investment in the Dow Jones Industrial Index ending October 6, 2008. Capital gains tax rate is set at 15% and the capital gains distribution is assumed to be 2%. Tax alpha is 0.6% and expense reduction is set at 0.9%

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