MUTUAL FUND CONFUSION

If you are like most individual investors, you invest at least a portion of your financial assets in mutual funds. Mutual funds can be an efficient way for individual investors to gain access to professional management, gain broad diversification and automatically reinvest on a dollar cost average basis. However, mutual funds can also be confusing in their effect on your taxes and on your statements, requiring a deeper understanding to avoid confusion or misplaced disappointment.

Regarding taxes, which are not a factor in retirement accounts like an IRA or 401(k), you may find you have taxable income, sometimes substantial taxable income, at the same time as your mutual fund position shows little or no gain or even a decline. This can be especially frustrating in a year where the market, and thus your account is sharply down. How can this be? As mutual funds pay dividends that are typically systematically reinvested in additional shares, these dividends are taxable income, but income that you don't see in cash. Instead, you gain more shares in the mutual fund. If the value of these shares declines in value, your account will show a decline in value at the same time you get a tax bill for the dividends. It is not unusual for a mutual fund to make a special dividend toward the end of the year to distribute gains realized during the year on securities transactions. Again, this creates a taxable event where you don't see any cash to cover your tax bill and can create an unpleasant surprise at tax time. While there is not much you can do as long as you are using mutual funds and reinvesting dividends, understanding can be helpful. Some things you can do is to concentrate the more tax efficient investments in your taxable accounts and the less tax efficient investments in your tax deferred accounts, such as IRA's.

The second issue that may cause confusion is where a mutual fund position may show on the statement as a loss, when quite the opposite is the case when you crunch the numbers on a total return basis. To illustrate this consider the following hypothetical example. The original investment was made several years ago for $20,000. It is now worth $26,000 but shows a loss on the statement of $12,000. How can this be? When the past returns on the mutual fund are reviewed, there is nothing in the performance that explains a net loss in value. You can see how this can be very confusing. The original shares cost about $20 per share. Over time dividends were reinvested at prices in the low $20s and then a special dividend was paid at about $3.50 a share. At that time the price per share dropped by $3.50 a share to reflect the dividend paid, as you would expect if the cash dividend is taken out of the share price and paid to the shareholder. However, that does not affect the cost of the original shares purchased prior at $20-23 a share, so those all appear on the statement as a loss even though the total mutual fund position value is greater than the original investment. Further complicating things in this example is another special dividend paid a year later for $10 a share. Again, the value of the shares declined by $10 per share to reflect the dividend payout, but the original cost of prior shares still reflects their actual purchase price in the low $20 range. Thus, on this hypothetical investor's statements the cumulative loss appears to be substantial even though the current value is actually well above the original investment. You can see how misleading this can be, especially multiplied over a large number of individual mutual fund holdings. In a case like this example it takes a bit of research and an understanding of fund valuation to piece together how this came about. If in this hypothetical example the position was held in an IRA, there would be no additional tax consequences. Circling back to our first topic, if this example played out in a taxable account there would also have been taxes to pay on the dividends and capital gains distributions as they were paid and reinvested.

We all strive for clarity and no surprises with our investments. Unfortunately, along with the benefits of mutual fund investing to the retail investor come complications. Having a good understanding of both the tax and reporting nuances of mutual fund investing will help to avoid surprises and alleviate confusion.

Investing involves risk. Depending on the types of investments, there may be varying degrees of risk. Investors should be prepared to bear loss, including total loss of principal.

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