The key to avoiding mutual fund capital gains distributions

Some strategies work better than others, but low portfolio turnover is a good predictor of potential tax consequences

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By **Jeff Benjamin**

It's that time of year again when the leaves start falling, everything becomes pumpkin- flavored and mutual funds announce their dreaded **capital gains distributions.**

While the bulk of the cap gains distributions will be announced over the **next few weeks,** Christine Benz, director of personal finance at Morningstar, said there's no

"I wouldn't be surprised if this year is on par with recent years, which hasn't been great from a tax perspective," Ms. Benz said. "It's a confluence of quite good equity gains and an ongoing strong market, plus the redemptions out of active funds and into index funds and ETFs."

In other words, financial advisers will need to be on their toes again this year in order to help their clients navigate the annual tax bill that most actively managed funds result in, regardless of how long a fund has been owned or even if it produced positive returns.

"I keep a spreadsheet with the name of the fund, the capital gain distribution and the date it is being paid out," said Kashif Ahmed, president of American Private Wealth.

Since capital gains taxes only affect investors who hold funds in nonqualified accounts, Mr. Ahmed typically sells the fund positions out of the accounts of clients who own the funds outside their retirement accounts prior to the capital gains distribution date, which is usually in late December.

Understanding that most actively managed funds pay out capital gains distributions that are the result of portfolio trading activity, Mr. Ahmed will sometimes buy funds after the annual distribution has lowered the net asset value in proportion to the capital gain.

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the tax bill from a fund's distribution of gains.

If you sell prior to the distribution date, as Mr. Ahmed is prone to do, the client could be hit with a tax bill related to the fund's performance.

For that reason, Ms. Benz said some advisers will just **ride out the annual capital gains hit** and use the accompanying annual cost-basis adjustment as a kind of prepayment on the taxes that will be due on the fund's performance.

While actively managed funds are more prone to distribute capital gains, it's not a rule.

Of the more than 7,000 individual mutual funds tracked by Morningstar, a screen identified nearly 700 that had no capital gains distributions last year, as well as nearly 500 that didn't have capital gains over the past three years, and nearly 300 that had no cap gains over the past five years.

In most cases, the key ingredient was low portfolio turnover.

For example, the $30.4 billion DFA International Core Equity Fund (DFIEX), which hasn't distributed a capital gain over the past five years, has an annual turnover rate of 4%.

Emerging Markets Equity Fund (JMIEX) also hasn't distributed a capital gain in five years and has a 13% annual turnover rate.

Some of the funds that haven't distributed a capital gain in five years are designed for tax management, such as the $10.8 billion Vanguard Tax-Managed Capital Appreciation Fund (VTCIX), which boasts a 6% annual turnover rate.

"What's often commonly found among funds that don't pay capital gains distributions is a very low portfolio turnover rate," said Todd Rosenbluth, director of mutual fund and ETF research at CFRA.

There's no denying that active managers are being hurt by a general trend toward passive index funds and exchange-traded products, which are typically more tax-efficient in addition to being generally less expensive.

Consider, for example, that when the same Morningstar screen for funds that didn't distribute capital gains over the previous one-, three-, and five-year periods is expanded to include index funds, the one-year list expands from just under 700 to nearly 2,900.

The three-year list expands from nearly 500 to nearly 2,000. And the five-year list expands from nearly 300 to more than 1,300 funds.

said Mr. Rosenbluth.

Also, unlike redemptions, which typically result from something unpredictable like poor performance or a portfolio manager change, Mr. Rosenbluth said a low turnover rate is generally indicative of a predictable pattern.

"A lower turnover strategy reflects a portfolio manager's mindset on a longer-term outlook," he said.

However, as Ms. Benz explained, a low-turnover strategy is sometimes specific to a portfolio manager, which is why advisers should pay attention to manager turnover.

"The caveat is those things can turn on a dime, because a new manager can come on board and turn over the entire portfolio," she said.

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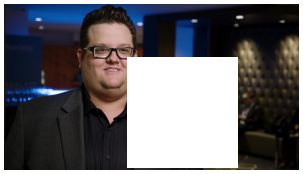

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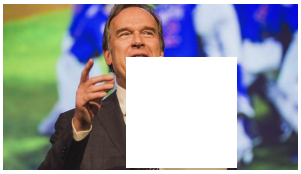

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