TUVE INVESTMENTS INC.

What Makes for a Tax-Efficient Mutual Fund?

Ben Franklin said that there are two things that are certain in life – death and taxes. The inevitability of taxes is certainly true when it comes to investing in mutual funds. Most investors know that if they sell shares of an appreciated mutual fund, they will be taxed on their profits. What often comes as a surprise, however, is a tax bill resulting from mutual funds you buy and hold. That's because by law, mutual funds are required to pass along all realized profits on investments, along with income, to their shareholders in the form of interest, dividends, or capital gains. So, if you're investing in mutual funds in a taxable account, you'll have to pay taxes on those distributions. Of course, in tax-deferred accounts such as 401(k)s and traditional IRAs, taxes are not a day-to-day concern. Rather, all your withdrawals will eventually be taxed as ordinary income.

Just how much of your funds' gains can you lose to Uncle Sam? Roger Ibbotson's study shows that taxes swallow roughly two percentage points of an equity funds' annualized pretax returns for investors in the highest tax bracket. And over the long-term, that's nothing to sneeze at.

Investing in tax-efficient funds for taxable accounts can whenever possible help keep more of what you earn in your own pocket. How do you determine a mutual fund's tax efficiency? First of all, there are "tax-managed" funds explicitly designed to minimize taxable distributions. However, these funds share a number of characteristics you can find in a variety of other funds – and employ strategies you can use on your own to enhance the tax efficiency of your portfolio.

At the most basic level, taxes are a result of the securities a fund invests in. For example, funds that invest in municipal securities are one of the most tax-efficient due to the federal, and perhaps state, tax exemption of that interest income. On the other end of the spectrum, equity funds that seek capital appreciation or high current interest income often distribute large capital gains or dividends to shareholders.

A fund's investing style also affects your tax obligations. Because a buy-and-hold strategy results in lower portfolio turnover than the frequent buying and selling of securities, index funds are more tax-efficient than actively traded funds. To avoid tax surprises, check the fund's turnover rate before investing. Found in the prospectus, the turnover rate measures the frequency with which the fund buys and sells securities during a year. Clearly, a high turnover rate in a strong market increases the likelihood that a fund will realize and distribute gains.

Again, some funds, especially those marketed as tax-managed funds, are managed to minimize taxes. In addition to minimizing turnover, these fund managers may sell portfolio losers to offset fund gains or sell shares with the highest tax-cost basis when less than an entire position is sold. Of course, this tax loss harvesting is a strategy you can put to work in your own portfolio to minimize your taxes from fund distributions.

Also, remember that funds make capital gain distributions once a year. If you buy shares in a mutual fund right before its distribution, you are buying a potential tax liability. Ideally, you will want to avoid paying taxes on growth you did not participate in. Most such distributions occur near the end of the calendar year, but check on any fund you are considering just to be sure.

For a quantitative measure of tax efficiency, you can check out Morningstar Inc.'s Tax Cost Ratio at www.morningstar.com to determine how effective fund management has been in keeping taxes under control. The Tax Cost Ratio compares a fund's load-adjusted, pretax return to its tax-adjusted return. The resulting number represents the percentage of an investor's assets that are lost to taxes. It's important to note, however, that unlike the expense ratio, the Tax Cost Ratio is not deducted from a fund's published returns. Also important, is the fact that Morningstar calculates this statistic assuming that an investor is in the highest tax bracket.

Naturally, the best way to use the Tax Cost Ratio is to compare one fund's ratio with that of another fund in its peer group. That is, compare a large-cap equity fund with a large-cap equity fund and small-cap value with small-cap value.

Finally, although it is important to understand how taxes can erode your returns, tax efficiency should never be the primary consideration when investing in a mutual fund. Rather, look for solid management; a strong, long-term track record; and a risk profile that suits your long-term investment strategy. Superior tax efficiency can never outweigh such negative fund characteristics as poor management, an unsound investment strategy, or high expenses. However, if two funds you are considering are roughly equal, you'll probably want to select the more tax-efficient fund for your taxable account.

Remember, it's impossible to avoid taxes all together. Rather your goal should be to understand what you are being taxed on and to earn the best after-tax returns across your total portfolio.

As with any investment, please consult your financial advisor to see what is appropriate for your situation. Mutual funds are subject to market fluctuation and loss of principal is possible.

For more information on this topic call 1-800-373-8883 or visit www.tuveinvestments.com.