How Tax-Efficient Is Your Mutual Fund?

A few basic metrics can guide you.

by Morningstar.com

Tax frenzy may reach a fever pitch in April, but it's a mistake to only consider your tax bill around tax time. Whether you're just starting out or are a longtime investor looking to make changes to your portfolio, understanding a fund's tax efficiency can mean more money in your pocket in the long run. Below we'll take a look at some basic metrics that will help you gauge how tax-friendly a fund is.

What Taxes Are You Paying?

Fund investors are at a disadvantage when it comes to taxes. Stock investors pay taxes on an investment only if they have pocketed dividends or income or have sold the fund for a profit. Exchange-traded funds that track broad swaths of the market have also been quite tax-efficient over time.

But investors in conventional mutual funds can get stuck with a tax bill on their mutual fund holdings, even if they've lost money since they've held the fund. Like all investors, fund investors have to pay taxes on dividends from stocks and interest from bonds, and they also have to pay taxes on all fund distributions, including capital gains, which occur when a fund manager sells an underlying holding for more than its purchase price. (Read my colleague Russ Kinnel's take on the injustice of the mutual fund tax code here.)

So, what's the best way to gauge how hard a fund will be hit by taxes? High turnover can be a signal that a fund might not be tax-efficient. That's not the only thing to look at, though. Pull up a fund on Morningstar.com and click on the Tax tab on the navigation bar at the top of the page to get a glimpse of a fund's tax profile.

Tax-Adjusted Return

One of the quickest ways to understand a fund's tax implications is to compare its pretax return with its tax-adjusted return. The tax-adjusted return accounts for a fund's capital gains, dividends, and interest during the period, but it doesn't include tax consequences from selling the fund in the future. Note that Morningstar.com uses the highest federal tax rate when dealing with short-term capital gains, interest income, and non-qualified dividends (currently 35%) and the 15% rate for long-term capital gains and qualified dividends. (Those rates are slated to go higher in 2013.)

State and local taxes aren't included in the calculation because they vary across the country. The tax-adjusted return also factors in sales charges that you pay from buying the fund, so you can get a sense of how much money you're losing to fees and taxes when comparing it with the pretax return.

Meanwhile, the "% rank in category" helps you see how a fund's tax-adjusted return stacks up against its peers. It works in the same way as the category rank for total returns: a ranking of 1 is most desirable and means that the fund's tax-adjusted return is at the top of the category, and 100 means it's at the bottom. It's worth noting that a fund can have a good tax-adjusted return not because it's been tax-efficient but simply because it has a high pretax return. However, you'll want to be careful about funds with big gaps between their pretax and tax-adjusted returns.

Morningstar.com provides tax-adjusted returns for several time periods, including three-, five-, and 10-year periods. Although longer time periods are generally more meaningful when it comes to evaluating funds' performances and characteristics, in some cases it might be useful to look at the shorter time periods. For example, many funds have very low or even negative returns during the past five years, making the tax statistics less valuable simply because capital gains have been few and far between, and funds have had capital losses to offset their meager gains.

Tax-Cost Ratio

Another useful metric is tax-cost ratio, which measures how much a fund's annualized return is reduced by the taxes investors pay on distributions. Morningstar calculates the tax cost ratio in-house on a monthly basis, using load-adjusted and tax-adjusted returns for different time periods.

Think of tax-cost ratio as you would an expense ratio: The lower it is, the easier a fund is on the wallet if you own it in a taxable account. A tax-cost ratio of zero means that the fund didn't pay out any taxable distributions for the period. That's not to say that you should buy a fund just because its tax-cost ratio is low or zero, however. It could have plenty of other things wrong with it, such as poor management, a bad record, or high fees.

On the flip side, many good funds pay out distributions, so you shouldn't necessarily avoid a fund just because it has a tax-cost ratio. Just be careful to keep funds with high tax-cost ratios in nontaxable accounts such as 401(k) s and IRAs.

Potential Capital Gains Exposure

Whereas tax-adjusted returns and tax-cost ratios look at funds' tax efficiency in the past, a fund's potential capital gains exposure helps you gauge how big of a future tax bill you could possibly face. It measures how much a fund's underlying holdings have appreciated in value, adding up capital gains that haven't yet been distributed to the fund's shareholders and dividing that number by the fund's total net assets.

A positive PCGE means some of the fund's investments have gone up in value and could cost shareholders come tax time if the manager sells any of those securities and distributes the gains to shareholders. A negative PCGE means the fund's underlying holdings have lost money, so taxes shouldn't be an immediate concern.

PCGE is especially important for investors looking to buy a new fund. If a fund has a high PCGE, investors can get stuck paying taxes on capital gains that occurred before they were even shareholders. On the other hand, funds with negative PCGEs may be tax-efficient because the losses can offset future gains.

It's helpful to look at a fund's turnover alongside its PCGE. A fund with high turnover (generally more than 100%) could chew through its tax losses pretty quickly, lessening the tax benefit.

About the Author

Morningstar.com offers coverage of more than 1,700 stocks, 1,700 mutual funds, and 300 ETFs, plus market news, economic analysis, portfolio-planning insights, and investment commentary.