On the Lookout for Tax Traps and Free Rides

Some funds' returns may look very different after taxes.

by Russel Kinnel

Let's take a look at funds' tax situations. Using annually reported data, we estimate a fund's potential capital gains exposure, or PCGE. The figure is a rough guess of how much a fund would distribute if it were to liquidate its whole portfolio. We update that figure based on appreciation and depreciation of the fund each month. You can find it on a fund's Tax analysis tab, and you can screen on it in the Premium Fund Screener.

It's rare for funds to distribute all of that level as few stock funds turn over their entire portfolio in a year. Still, those with large built-up gains, particularly with high turnover, are ones to be wary of in a taxable account. Conversely, funds with large negative capital gains exposure could have a nice tax benefit that will allow them to realize gains for years without distributing any to shareholders.

In contrast, hedge funds are not subject to the strict regulations that apply to mutual funds. Hedge funds are not required to register with the SEC, they are not legally required to publicly disclose performance and fee information, and their fees tend to be much larger than those charged by mutual funds. Hedge funds are available only to a limited number of "qualified" (read: "rich") investors, meaning investors with assets in the million-dollar range. Many hedge funds require investors to keep their money in the fund for at least one year.

Let's begin by looking on a category basis, so we have an idea of where the traps and opportunities lie. Overall, the environment is pretty benign, as the summer sell-off has given funds plenty of losses to harvest. I looked at stock funds with more than $1 billion in assets and found the median for the Morningstar Style Box categories. Both measures are intended to keep a few small funds with huge losses from skewing the figures. After all, you aren't likely to buy such funds.

At this point, there should be some good bargains in foreign-stock funds and a few worrisome funds in small- and mid-cap U.S. funds. (See the table.) Foreign large value has the lowest median PCGE with a figure of negative 11%. The other foreign style-box categories are between 4%-plus and negative 10%.

However, small blend, small growth, mid-blend, and mid-growth are all modestly north of 10%. That's not a big worry, but be sure to check any funds you are considering buying. Let's look at a few that jump out in both directions.

Category	PCGE	Category	PCGE
Foreign Large Blend	-10.23	Large Value	-6.38
Foreign Large Growth	2.27	Mid-Cap Blend	10.79
Foreign Large Value	-11.28	Mid-Cap Growth	13.10
Foreign Small/Mid-Growth	4.33	Mid-Cap Value	1.65
Foreign Small/Mid-Value	-4.56	Small Blend	12.08
Large Blend	4.59	Small Growth	12.33
Large Growth	5.93	Small Value	6.78

Data are through August 2011

Prominent Funds With Big PCGEs

In looking for warning signs, I look at PCGE along with turnover ratio. The typical stock fund runs around 70% turnover and so is likely to throw off a fair amount of gains in the portfolio.

- Baron Asset Retail (BARAX) is sporting a 51% PCGE, though its turnover ratio of 13% tells me that it won't likely distribute nearly that much. Looking back over the past decade, the fund has often paid out somewhere between 4% and 9% in capital gains, and that may happen again this year.
- T. Rowe Price New Horizons (PRNHX) will be an interesting one to watch. It has 40% PCGE and a 46% turnover ratio. Likewise, its cousin T. Rowe Price Media & Telecommunications (PRMTX) has a 36% PCGE and 42% turnover ratio.
- Artisan Mid Cap (ARTMX) has a 29% PCGE and a 63% turnover ratio. If you are in this closed fund, you might want to hold off on making additional investments until after the December distribution period.

Good Funds Set for a Free Ride

- American Funds Growth Fund of America (AGTHX) has a massive pile of capital losses that should spare it from paying out gains for a few years at least. All its recent redemptions will make the fund a tad more maneuverable and boost aftertax returns. Not bad. This is still a good fund with strong stock-pickers and low costs behind it, but its girth means it will usually have modest wins and losses versus the index.
- Vanguard European Stock Index (VEUSX) has a negative 73% PCGE. Yet another reward for being contrarian. Admittedly, Vanguard's index funds are ptretty tax-efficient vehicles anyway that have generally avoided making large capital gains payouts. Still, Europe is so cheap that not a lot has to go right for this to work. If you're really contrarian, you'll like the fact that it has plenty of financials. If you're cautious, though, be forewarned.
- Bogle Small Cap Growth's (BOGLX) negative 36% PCGE should come in handy, as John Bogle Jr. tends to run with high turnover. Since launching this fund and at his prior funds, Bogle Jr. has produced excellent returns. He has also closed this fund in the past at a low asset base. The fund also illustrates that the overall category tax trends don't mean every fund is in lock step.
- Litman Gregory Masters Value (MSVFX) has a negative 31% PCGE, and it's definitely worth a look. The fund boasts five all-star managers running four portfolios: Mason Hawkins of Longleaf Partners (LLPFX), Peter Langerman and Philippe Brugere-Trelat of Mutual Series, Bill Nygren of Oakmark Select, and Clyde McGregor of Oakmark Equity & Income. That's a great combination, and they'll be working tax-free for a while.

About the Author

Russel Kinnel is Morningstar's director of mutual fund research. He is also the editor of *Morningstar FundInvestor*, a monthly newsletter dedicated to helping investors pick great mutual funds, build winning portfolios, and monitor their funds for greater gains. (Click here for a free issue). Mr. Kinnel would like to hear from readers, but no financial-planning questions, please. Follow Russel on Twitter: @russkinnel.