KIM: Fund investors: Beware of year-end taxable distributions.

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U.S. mutual funds are required to “distribute” realized capital gains and income to shareholders at least annually, making this is a tricky time of the year for investors to buy shares in taxable accounts (i.e. ***not*** in 401-K or IRA accounts).

Fund managers sell securities for a variety of reasons, including the security reaching the manager’s price target, to raise cash to pay departing fund shareholders or because a new fund manager wants to reconfigure the portfolio.

Regardless of the reason, the fund realizes a capital gain or loss based on the sale price and what the fund paid for the security (i.e. the fund’s “cost basis”). If the security was held more than a year, the gain or loss is considered “long-term.” Less than a year is considered “short-term.”

Many funds elect to make their required annual distributions at year-end. A fund will net its realized capital gains and losses. If there is a net realized gain, that amount is distributed to shareholders. If there is a net realized loss, that amount can be “carried forward” and used to offset gains in future years.

Most U.S. stock funds realized substantial net capital losses during the financial crisis, which shielded gains in 2009 and beyond. The upshot is fund investors have generally enjoyed the best of both worlds since the bottom; strong performance, with little in the way of capital gain distributions.

Unfortunately, many funds have exhausted their loss carry forwards and will be distributing realized capital gains in 2014s.

A fund calculates its capital gains distribution by dividing the total dollar amount of net gain by the number of shares outstanding on the “record date.” If Fund A has a net capital gain of $10 million for 2014 and 1 million shares outstanding on the record date of December 30, 2014, it will make a capital gains distribution of $10 per share (and its “net asset value (or NAV)” will immediately drop by the same amount).

Here’s where it gets tricky for taxable shareholders; you receive the same distribution per share ***whether you have owned the shares one day or ten years.***

Most funds post estimated distribution amounts and record dates on their websites. For example, according to Morningstar, BlackRock Small Cap Growth Equity (CSGEX) estimates distributing gains of a whopping 25-27% of NAV, while Putnam Voyager (PVOYX) and Multi-Cap Growth (PNOPX) both estimate distributing gains of 11-13% of NAV. ***Taxable shareholders should generally avoid buying shares of a fund in front of a distribution.*** As Christine Benz, Morningstar’s Director of Personal Finance and fellow Illinois alum says, “The last thing you want to do is buy into a fund and pay taxes on a distribution that you did not enjoy in any way, shape or form.”

Taxable shareholders should also consider a fund’s ***tax efficiency***. Funds are required to disclose their “portfolio turnover rate,” which measures its level of trading activity. Given similar performance, you’d ***much*** rather own shares in a fund that buys and holds securities (turnover rate < 25%) and thus generates relatively little in realized gains versus an active trader (turnover rate > 100%) that creates a boatload of short-term gains (taxed as ordinary income).

Don’t let the Grinch leave you an unexpected year-end lump of coal.

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