KIM: Mutual funds set to distribute lumps of coal to taxable investors

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Fund investors endured harrowing plunges in 2015. Absent a year-end rally, returns will be disappointingly modest. Adding insult to injury, because mutual funds are required to "distribute" realized capital gains and income to shareholders at least annually, unwary investors who own or are considering buying shares in taxable accounts (i.e. ***not*** in 401-K or IRA accounts) could face an unpleasant surprise.

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

Regardless of the reason, the fund realizes a capital gain or loss based on the difference between the sale price and what the fund paid for the security.

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 gain, that amount is distributed to shareholders. If there is a net loss, that amount can be "carried forward" and used to offset gains in future years.

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

The downside of a six-plus year rally is many funds have exhausted their loss carry forwards. According to *The Wall Street Journal*, while funds distributed only about $37 billion in capital gains to taxable owners in 2012, this amount more than tripled to $132 billion in 2014.

A fund calculates its distribution by dividing the net capital gain by the number of shares outstanding on the "record date." If Fund A has $100 million in assets, a net capital gain of $10 million for 2015 and 1 million shares outstanding on the record date of December 28, 2015, its net asset value (NAV) is $100/share and will make a capital gains distribution of $10/share (which is 10% of NAV).

Importantly, you receive the same $10/share distribution ***whether you owned the shares one day or ten years as of December 28.***

Funds have started posting information regarding 2015 distributions on their websites. Beware of funds estimating distributions accounting for 10-30% or more of NAV. According to www.CapGainsValet.com (free), 99 of the 192 fund families it tracks have posted estimates, with 221 funds estimating distributions of 10-19% of NAV, 22 estimating distributions of 20-29% of NAV and 10 estimating distributions of a whopping 30% or more 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 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."

Also consider a fund's ***tax efficiency***. Funds 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 generates relatively little in realized gains versus an active trader (turnover rate > 100%) that creates a boatload of realized gains.

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