

## Fund Screen

# Avoiding a Taxing Situation

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January 20, 2006

**OVER THE PAST FEW YEARS**, mutual-fund investors have enjoyed a blissful vacation from one of the major downers of fund investing: capital-gains taxes. Unfortunately, that holiday is now coming to an end.

You can thank the lingering effects of the 2000-2002 bear market that the reprieve lasted for as long as it did. Even as their portfolios recovered in grand fashion in 2003, fund managers were able to offset gains with losses carried forward from the lean years. Total capital-gains distributions in 2003 were a paltry \$14 billion, according to the Investment Company Institute (ICI), an industry trade group. In 2004, distributions climbed to \$55 billion, but were still a far cry from 2000, when the bill for late-'90s excess came due in the form of a whopping \$326 billion in distributions.

But three straight years of market gains have eaten away at the generous carry-forward reserve. With the final tally still to be counted, ICI expects the 2005 bill to be twice that of the 2004 bill. And if the market performs well in 2006, this trend is just getting started.

And so, we present the SmartMoney.com Tax-Friendly screen. Our criteria is based in large part on Lipper's tax efficiency ratings, which essentially measure how much of a fund's total gains are left when the tax bill comes due. The greater the percentage that's left, the better the ranking. The top 20% of funds receive a ranking of 1, the next 20% get a 2, and so on.

Because tax efficiency without solid returns will leave you unencumbered yet poor, our screen also includes a total returns requirement. The combination should theoretically reduce your tax bill while still steering you toward a successful fund.

Of course, all of Lipper's rankings measure a fund against other funds in that fund's classification, and some classifications are less tax efficient than others. As a result, there's a fair amount of variation among funds with tax efficiency scores of 1.

Also, these rankings are not forward-looking. They measure a fund's tax efficiency in years gone by. In some of those years, the fund may have benefited from special circumstances unlikely to be repeated—such as

### A CAPITAL GAINS RECAP

Each year mutual funds pass along realized gains to current investors in the form of an annual (or semiannual, or quarterly) capital-gains distribution. This distribution is taxed at standard capital gains rates. Losses, of course, are not taxed, and when they occur in abundance, they may be carried over into future years in order to offset future gains. And keep in mind, for tax-advantaged accounts, like IRAs and 401(k)s, all of this is moot.

unusually high carry-forward losses or abnormally low turnover.

“In the last three years even some notoriously tax inefficient funds become tax efficient,” warns Tom Roseen, a Lipper senior research analyst.

That’s not to say that a fund that is tax efficient today will be tax inefficient tomorrow. But it bears repeating that the funds on this list don’t guarantee a lifetime of tiny tax bills.

What this all means is that tax efficient investing requires a little extra homework. Lipper’s Roseen suggests a number of assignments: First, scan the fund’s paperwork for low turnover and keywords like tax-loss harvesting. Then look at the fund’s tax-loss carry-forward and unrealized capital gains figures.

Finally, call the fund and ask if they have tax efficiency in mind. If you hear a lot of shuffling paperwork and throat-clearing, hang up and move on.

## THE CRITERIA

This week, we used our fund screener to find funds with the enviable combination of low tax bills and high returns. We required that each fund on our list score a 1 (on a scale of 1 to 5, 1 being the best) in the Lipper rankings for tax efficiency and total returns. We screened only for no-load funds, and demanded expense ratios in the bottom half of the fund’s respective classification. Finally, we eliminated those funds that are closed to new investors, carry a minimum initial investment in excess of \$5,000, or have less than \$50 million in total net assets. Sixteen funds made the cut.

CAPITAL CLASS					
Fund	Fund Classification	Annualized 3-Year Return(%)	Expense Ratio (%)	Total Net Assets (\$ millions)	
T Rowe Price Int:Em Euro (TREM)	Emerging Markets	56.61	1.75	1059.30	
Alpine Eq:US RE;Y (EUEYX)	Real Estate	40.75	1.31	540.10	
Baron iOpportunity Fd (BIOFX)	Midcap Growth	33.84	1.50	161.00	
RS Inv:Internet Age (RIAFX)	Science & Tech	32.16	1.70	85.50	
Bridgeway:U-Sm Co Mkt (BRSIX)	Small-Cap Core	31.09	0.73	758.40	
Stratton:Small-Cap Val (STSCX)	Small-Cap Value	29.76	1.47	356.40	
James Adv:Small Cap (JASCX)	Small-Cap Value	29.71	1.50	80.50	
New Century:International (NCFPX)	International Multicap Core	27.64	1.50	78.30	
Marsico Inv Fd:Intl Op (MIOFX)	International Multicap Growth	26.51	1.60	311.90	
→ Muhlenkamp Fund (MUHLX)	Multicap Value	26.16	1.14	3082.50	
Marsico Inv Fd:21st Ce (MXXIX)	Multicap Growth	25.41	1.39	441.70	
T Rowe Price Gbl Tech (PRGTX)	Science & Tech	22.86	1.50	122.20	
Heartland:Sel Val (HRSVX)	Multicap Value	22.40	1.33	154.70	
Schwab Cap:Tech;Inv (SWTFX)	Science & Tech	21.76	1.02	62.70	
Chesapeake Core Growth (CHCGX)	Large-Cap Growth	17.12	1.41	641.60	
Loomis Sayles:GB;Rtl (LSGLX)	Global Income	8.19	1.00	500.00	

Source: Lipper data as of Jan. 17, 2006