

A *Taxing* Situation: Mutual Fund Distributions – What is the impact on your investments?

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Introduction

The passage of the \$787 billion Federal stimulus package in early-2009 ushered in a period of historic stimulus to counteract the worst economic downturn since the Great Depression. In total the government has allocated trillions of taxpayer dollars to combat the current economic crisis if you include other programs like Cash-for-Clunkers and the \$8,000 tax credit for first-time homebuyers. Moreover, the current debate on revamping the health care system is estimated to have a total cost of almost \$1 trillion dollars. While the economic impact of all this government spending is open for debate, we do know that the government will need to increase revenue to service its vastly expanded debt and manage the U.S. deficit. U.S. taxpayers will be paying

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for the stimulus effort and, potentially, the health care bill for many years, and possibly decades, to come. This almost certainly means higher taxes for many,

if not all, segments of the U.S. population. There is already speculation that the top two tax rates will revert to Clinton-era levels and itemized deductions will be limited for families with more than \$250,000 of income.

With the increasing likelihood of higher tax rates in the coming years, it is particularly important that taxable investors understand the impact of taxes on their investment programs. More specifically, investors must consider tax implications when evaluating mutual funds for their taxable accounts. Modest portfolio changes, like investing in municipal bonds instead of corporate bonds or utilizing more tax-efficient equity funds, can have a significant positive impact on an investor's after-tax return.

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Understanding Fund Distributions

In order for mutual funds to avoid paying corporate taxes they must distribute all of their yearly income and capital gains to shareholders¹. This tax arrangement is advantageous for mutual fund companies, but not necessarily for investors. Fortunately, like corporations, mutual funds can carry past losses forward for up to eight-years to offset future gains².

Mutual fund distributions come in various forms and originate from different sources. First, there are ordinary dividends, which are derived from the income or interest paid to the fund by portfolio holdings. Most ordinary dividends are categorized as either qualified or nonqualified and taxed at different rates. Qualified dividends are taxed at a lower rate, either 5% or 15% depending on the investor's tax bracket, while nonqualified dividends are taxed as ordinary income (maximum 35%). Nonqualified dividends can be from interest on bonds, dividends issued by foreign securities

where we do not have a tax treaty, REIT dividends, and dividends received on securities held for less than 61 days.

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from state taxes if the recipient is a resident of the issuer's jurisdiction. This makes municipal bonds particularly attractive for investors, especially those in the highest tax brackets. Most other income received on securities

held 61 days or more is classified as qualified dividends. Funds also distribute short-term gains, which are profits made on the sale of a security within 12-months of purchase. Short-term gains are taxed as ordinary income (maximum 35%) and lumped with ordinary dividends when shareholders receive their 1099-DIV form. Lastly, funds can distribute long-term capital gains, which are profits generated when selling securities that have been held more than 12-months. Like qualified dividends, long-term capital gain distributions receive preferential tax treatment and are taxed at 5% or 15% depending on the shareholder's tax-bracket³. Municipal bond capital gains are not exempt from taxation, but municipal bond mutual funds tend to be less active, offering less opportunity to generate gains.

The capital gains distributions just discussed relate to activity within the fund. Meanwhile, investors must

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^{1,2,3} United States Internal Revenue Code

also pay capital gains taxes if a gain is realized when they liquidate their fund shares. The net asset value (NAV) at the time of liquidation is compared to the NAV at the time of purchase to determine whether a gain was real-

ized. These gains are taxed in a manner consistent with sales of individual stocks within a taxable account. This is part of the tax code to ensure investors can not avoid taxation by simply liquidating their shares before the ex-

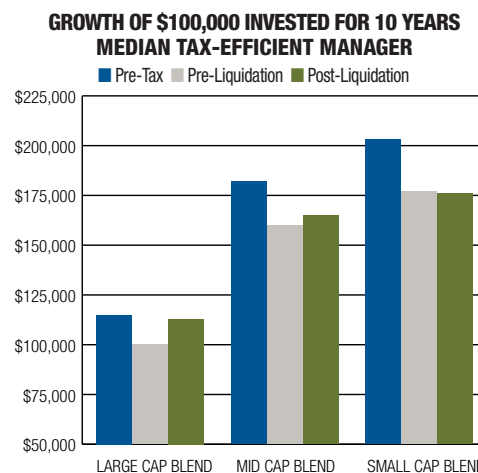
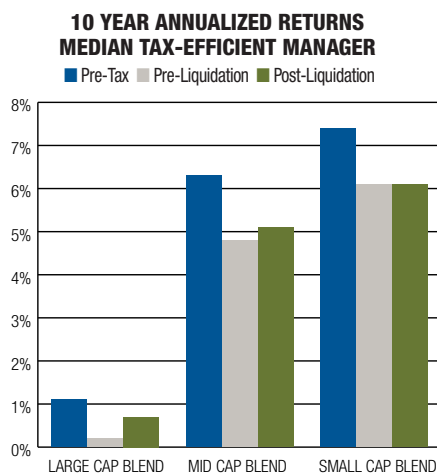
dividend date. Investors that liquidate before the ex-dividend date will not be responsible for the fund distributions they avoid yet will be responsible for the change in the fund's NAV due to the accumulation of unrealized gains.

Do Fund Taxes Really Matter?

There are numerous issues to consider when discussing taxes and mutual funds, but perhaps the most important is how taxes impact an investor's after-tax return. The short answer is...a lot more than one might expect. A Lipper research report following 2008 distributions said U.S. equity funds on average lost approximately 113 basis points

(pre-liquidation) because of taxes, while taxable fixed income funds lost 228 basis points annually over the last ten years⁴. To further illustrate the impact of taxes, the charts below depict the differences in pre- versus post-tax returns and accumulated wealth for the median tax-efficient manager in three Morningstar Categories. Even

with the potential for funds to carry forward meaningful losses from 2008 and early-2009, investors must remember the tax laws that treat some fund distributions favorably will expire in 2010, income taxes are likely to rise, and carryforwards do not last forever.



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⁴ Lipper, April 2009 *Taxes in the Mutual Fund Industry - 2009*

Estimating 2009 year-end distributions is challenging, since markets declined by more than 50% between October 2007 and March 2009 before rebounding 70% over the last nine months. This is further complicated since some funds accumulated losses last year that may offset this year's gains. It is important to remember that even during a difficult 2008 when the "average" equity fund fell almost 40%, open-end mutual funds distributed \$408 billion to shareholders, resulting

in an additional \$15.8 billion in taxes⁵.

It might be surprising to some investors that mutual funds can generate taxable distributions during a down market, but 2008 was not the first time this has happened. For example, the S&P 500 Index returned -9.1% in 2000 as mutual funds distributed \$512 billion to shareholders⁶. Similarly, the S&P 500 generated negative returns during 2001 and 2002, yet mutual funds still distributed \$231 billion and \$131 billion, respectively.

The possible tax benefits of a decline in prices are often not reflected until markets appreciate and mutual funds are able to offset new gains with past losses. Taxes have a negative impact on investor returns in up, down, and lateral markets. Regardless of the expected market environment, managers, advisors, and investors need to address this issue because Americans pay billions each year on taxable fund distributions and will likely be doing so every April 15.

Getting Informed

The previous section reiterates that taxes cost investors money each year. Taxable investors should consider tax-efficient and tax-exempt funds in their diversified asset-allocation mix. This section highlights how to evaluate funds for a taxable account and that tax-efficient alternatives deserve consideration.

Consult with a (Tax) Professional

Advisors and their taxable clients should consult periodically with a tax

advisor to ensure that their portfolios are tailored to the client's specific tax situation. Tax discussions may be especially timely near year-end, because distributions usually occur during the fourth quarter and year-end tax selling can be used to offset gains in other accounts or investors may be able to generate additional losses to offset future gains. After an investor's tax return has been completed may also be a good time to re-

consider tax-efficient offerings since the impact of taxes will be evident.

When meeting with your clients, or their tax professional, an estimation of the investor's marginal tax rate is recommended. An individual's marginal tax rate is the amount taxed on the next dollar earned. While taxes are complicated, getting an estimate of the marginal tax rate is not. Income tax rates are pre-

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⁵ Lipper, April 2009 *Taxes in the Mutual Fund Industry* - 2009

⁶ FactSet

determined by the government, so with a reasonable income estimate an advisor can forecast the client's marginal tax rate. This rate is important because it determines how certain distributions will be taxed. Investors with higher marginal tax rates will see a greater gap between their pre- and after-tax returns. Individuals in higher tax brackets should be particularly diligent when making taxable investment decisions.

Research Your Investment Options

After meeting with a tax advisor and calculating the appropriate marginal tax rate, comprehensive research on the fund(s) being considered should be initiated. Mutual funds are required to distribute a plethora of information including holdings, investment fees, eligible investments, the investment process, and before and after-tax returns. Pertinent information can be found in the prospectus, statement of additional information, and annual reports or by speaking with a fund representative when necessary. Most of these documents are avail-

able at the fund company's website.

Comprehensive research should include a review of a fund's historical turnover rate. Low turnover is not a requirement of a tax-efficient fund, but provides insight on how frequently a fund is trading. Frequent trading may suggest shorter holding periods, leading to higher taxation. Interestingly, there is almost zero correlation between a Fund's post-liquidation tax-efficiency and trailing 12-month turnover, but a 2009 Lipper report advises taxable investors to consider turnover along with other fund characteristics when evaluating taxable investments⁷. Investors must also examine a fund's net realized and unrealized gains (losses). Net realized gains must be distributed to shareholders at year-end, while unrealized gains provide insight to future tax liabilities. Investing in a fund with accumulated gains is like acquiring a future tax liability, while diluting the gains for existing shareholders. Conversely, investing in a fund with embedded losses or past

losses that have been carried forward gives the fund manager greater short-term flexibility to generate gains and act in a less tax-efficient manner.

The amount of realized and/or unrealized gains in existing funds may be the result of recent changes in the fund's asset base. Fund flows are important because they can impact the fund's ability to maximize tax-efficiency. A rising asset pool dilutes the existing gains and accumulates new share lots. Conversely, a decrease in the assets in the fund may force the realization of gains and concentrate future distributions across a diminishing share base. A smaller asset base also limits the number of share lots, which may hinder tax-management in the future. This is an important point because some equity funds experienced large redemptions during 2008 and the first quarter of 2009.

Customer service is often a valuable resource for information that may not be readily available through fund publications or the internet.

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⁷ Lipper, April 2009 *Taxes in the Mutual Fund Industry* - 2009

Fund representatives can provide helpful information, such as the fund company's accounting technique. Meanwhile, historical returns, which can be found in a fund's prospectus, are a great measurement of past

after-tax performance. Managers are now required to publish pre-tax and after-tax returns, which provide historical evidence on the fund's tax-efficiency. A large gap between pre-tax and after-tax returns suggests tax

inefficiency, but must be viewed from a relative perspective. Higher taxation can be offset by stronger returns, so when comparing two funds, an investor should consider after-tax returns.

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Tax-Efficient Investment Options

Tax-efficient funds combine various tax-management tools to limit the negative effect taxes have on investor returns. The portfolio managers that oversee tax-efficient funds strive to maximize after-tax returns by exhibiting smart turnover, harvesting losses, offsetting past gains, limiting short-term gains, and using favorable accounting techniques. Tax-efficiency does not supersede portfolio man-

agement when making investment decisions within a tax-efficient fund. Rather, before implementing portfolio changes, tax-conscious managers usually consider the tax-implications before taking action. A concerted effort to consider taxes can have a significant impact on after-tax returns. Research shows tax-conscious equity funds retain an additional 60 to 90 basis points of pre-tax return

compared to inefficient peers⁸.

Tax-efficient equity funds can be paired with a municipal bond fund to create a portfolio that is less susceptible to the yearly drag of taxes. Recent data suggest that taxes have a greater absolute and relative impact on fixed income funds because bond interest is usually taxed at one's marginal tax rate – which can be as high

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⁸ Morningstar Direct and FactSet

as 35% – and interest is a key component of total return for fixed income vehicles. Municipal bond interest is exempt from federal taxes and possibly state taxes. Municipal bonds are also less prone to default and have higher recovery rates than many other fixed income securities. As a

result, municipal bonds offer good principal protection and are a great source of tax-exempt income. Due to the tax-exemption, municipal bonds tend to have lower coupon rates than corporate bonds. Nevertheless, the ability to generate tax-free income can make a big difference for inves-

tors, particularly those in the highest tax brackets. Municipal bond funds are also appealing because they offer easy access to quality, active management and a diverse portfolio of tax-exempt bonds that may not otherwise be easily and inexpensively available to a retail investor.

Summary

The tax implications for mutual fund distributions can be very confusing, but should not be ignored when determining asset allocations for a taxable portfolio. Now is an excellent time to review your asset allocation and conduct due diligence on the underlying mutual funds. A thorough evaluation of a fund's tax-efficiency can be accomplished by proactively using the numerous resources available to shareholders. During the evaluation process, remember painful losses experienced during 2008 may be used advantageously to offset future gains, a fund's tax-efficiency must be measured rela-

tive to peers, and the client's entire portfolio should be considered when making any investment decision.

A taxable investor's fixed income allocation also deserves attention. Municipal bond funds should be a consideration for an investor's fixed income allocation because municipal bond funds are tax-efficient and offer attractive income for income-conscious investors. Retail investors do not have the access or expertise to personally manage a portfolio of municipal bonds and markets are too sophisticated to maximize total return through a buy-and-hold approach. An easy alternative is to invest in a

municipal bond fund. Municipal bond funds offer relatively inexpensive access to a diverse portfolio, managed by a quality investment team with extensive experience navigating the municipal bond marketplace.

Lastly, taxes are important in all markets. Taxable investors should consider taxes when making investment decisions throughout the year. Similarly, fund managers should also consider tax implications when making investment decisions to protect their investors. Excess returns from solid stock selection are not guaranteed, but the benefits of a tax-efficient

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portfolio are, so fund managers should at least take notice. Research shows tax-conscious funds retain an additional 60 to 90 basis points of pre-tax returns compared to inefficient peers⁹. However, the fund manager's primary focus is to generate positive

returns and achieve fund objectives. Therefore, the responsibility falls on the financial advisor and/or investor to make sure their taxable investments are the right fit and, if generating a big tax bite, they are being compensated with higher returns.

With federal income tax rates certain to increase, investors and financial advisors must reevaluate their taxable portfolios to ensure they are positioned to maximize after-tax return.

⁹ Morningstar Direct and FactSet

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