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Frank Pape,
Senior Director,
Portfolio Consulting
Group

Spooked by taxes?

On Halloween, most people think of vampires, ghosts and ghouls. As an investment professional, when I think of "spooky creatures" my mind actually goes straight to… Uncle Sam, and the investment implications of his power of taxation.

I think more investors should be spooked by taxes—and not just on Halloween, but every day of the year. Only those investors who are working with tax-savvy advisors may be spared the zombie-like state that often results from a lack of awareness about the amount of investment return eaten by taxes.

Let me explain.

The fear-factor of taxes on investment portfolios

For the five years ending September 30, 2017, the average U.S. equity fund (includes mutual funds, index funds and ETFs) surrendered 1.5% of its return to Federal taxes—***every year***. This represents a material reduction in investors' after-tax return—especially in an environment where returns are likely to be lower in the future. Some of those investors suffering from this tax drag may be your clients.

And U.S. equity returns aren't the only ones that are affected. As the table below illustrates, U.S. equities are currently leading the tax drag pack on a five-year annualized return basis, but U.S. fixed income and international developed equity aren't far behind. Emerging market equities are not immune either.

	U.S. Equity	Int'l. Developed Equity	Emerging Market Equity	U.S. Fixed Income
5 Year Annualized Reduction in return (tax drag)	-1.5%	-1.0%	-0.7%	-1.1%

Morningstar U.S. Equity Mutual Funds Universes, Morningstar Foreign Large Blend Universes, Morningstar Diversified Emerging Markets, Morningstar Taxable Bond Fund Universes. Source for tax drag: Morningstar tax cost ratio. See disclosures at end of piece for additional details. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

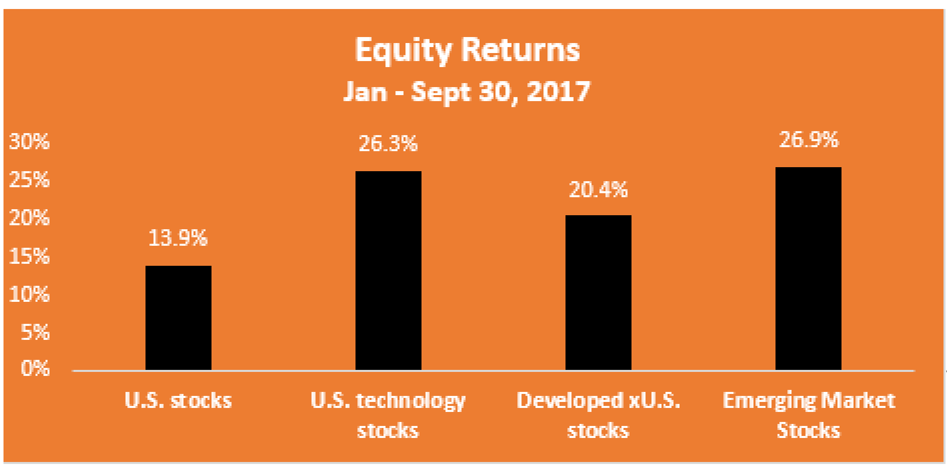
Why it matters right now: the countdown to year-end is on

As we enter the final two months of the calendar year, mutual fund companies will be making their 2017 estimated capital distributions publicly available to help advisors with end of year tax-planning for their clients.

Be prepared: Some of these distributions may be chilling.

Several factors will likely have contributed to that:

- Mutual funds are required to distribute at least 90% of their recognized gains to shareholders annually. For many funds, this occurs in December. These distributions are short-term and/or long-term capital gains. Short-term capital gains are taxed at a higher rate for investors in the 25% bracket or higher.
- The strong equity returns we've witnessed globally year to date as of September 30, 2017 (see table below), are likely to produce impressive gains in funds. Strong returns are of course a great outcome—but they typically have tax implications.
- Many U.S. equity funds have used up their built-up capital loss carryforwards following the post-Global Financial Crisis string of years with strong market returns. Internationally-oriented funds haven't benefited from strong performance in the same way, but 2010 tax code changes that are taking effect this year may impact many funds' ability to off-set recent gains.



Source: Russell. U.S. stocks—Russell 3000® Index; U.S technology stocks—Russell 3000 Index Technology Sector; Developed ex-U.S. Stocks—Russell Developed ex-U.S. Index; Emerging Market Stocks—Russell Emerging Markets Index. Index returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

How can you help prepare clients this year?

When trying to anticipate if a fund will have a large taxable distribution, consider if any of the following circumstances might apply:

- Did the fund experience a change in money managers during the year? In particular, if there was a change, does the new manager employ a different investment process?
- Did the fund undergo a mandate change (e.g., small cap to midcap)?
- Was the fund subject to unanticipated selling pressure?

All of these factors can lead to unintended turnover in the portfolio, which has the potential to create taxable events.

A fund that is intentionally managed in a tax-efficient manner has the potential to address these sorts of situations in an attempt to minimize their tax impact. The fund's prospectus, investment objective and even fund name will be helpful clues in that case: if a fund is designed to be tax-sensitive, that must be stated in all three of these.

Beware, though: Some non-tax managed funds have at times been able to produce attractive after-tax returns in the past. But don't assume that was achieved by design and will be replicated in future years. A certain degree of tax efficiency can be coincidental to the time and place. For example, as referenced earlier, many non-U.S. equity funds still have remaining capital loss carryforwards on their balance sheets from the 2008/2009 downturn. If any of these loss carryforwards have expired or have been used up this year, the attractive returns in the table above could be materially reduced by taxable distributions.

So make sure to double check that the fund's prospectus, investment objective and name explicitly state a tax-sensitive approach.

How can you help prepare clients in future years—especially considering potential tax code changes?

Your clients may be asking about potential implications of tax code changes and steps to consider in anticipation. As of this writing, it is hard to predict what the final changes may or may not look like. What we do know is that the tax treatment of investment income and gains is not likely to end up at 0%. So, keep your eye on the tax ball and heed the wise words of Will Rogers:

> **"The difference between death and taxes is death doesn't get worse every time Congress meets."**
>
> —Will Rogers

The bottom line

Make sure your clients are not among those suffering the consequences of undiagnosed and unmanaged tax drag. Helping your clients make smart decisions around taxes can make a meaningful difference in helping them reach their desired outcomes. After-tax return improvement is also one of the ways that advisors can help demonstrate their value and stand behind their fee in an increasingly fee-focused environment.

A little tax knowledge and a partnership with a tax-savvy asset manager can help drive a stake right through the heart of the vampire-induced drag on investor returns. Now **that** would be a **treat** for your clients!

Disclosures:

Tax drag calculation methodology: Included all U.S. equity, foreign large blend, diversified emerging markets and taxable bond fund universes, as reported by Morningstar Direct. Average of Morningstar's Tax Cost Ratio for universes as defined. The Morningstar categories are as reported by Morningstar and have not been modified. © 2017 Morningstar, Inc. All Rights Reserved.

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