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Taxes matter in fund investing, even when there’s no bill

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NEW YORK — Most of us don’t worry about taxes when it comes to mutual funds.

We don’t need to because we invest in them through a 401(k), IRA or another account designed to delay taxes until after retirement. More than half of all money invested in mutual funds is in tax-deferred accounts. That makes it easy to ignore whether other shareholders in the same fund are getting a big tax bill just because they’re holding it in a taxable account.

Even so, it can pay to consider a mutual fund’s tax history, regardless of whether your money is in a taxable or tax-deferred account. That’s because funds that keep tax bills down tend to have better returns, even before taxes are taken into account.

“There’s a lot of effort in the industry on picking stocks and timing the market, but that is extremely difficult to do persistently,” says Clemens Sialm, a professor at the University of Texas at Austin. “Often, it’s much easier to create value by managing your trading costs and managing taxes.”

Sialm co-authored a study that found that the U.S. stock funds that give the smallest tax bills to their shareholders routinely beat those that generate the biggest tax bills. The difference in annual returns is up to nearly 1 percentage point, and the margin is even wider after taking taxes into account. It’s the latest piece of research to suggest keeping costs low can lead to better returns in fund investing.

The issue centers on the capital-gains distributions that mutual funds pass along to their investors each year, whether they withdraw money or not. Toward the end of each year, funds pass along the gains from buying and selling stocks, along with dividends received. If the fund is in a taxable account, the tax rate on the income can be as high as 39.6 percent. That applies to gains made from stocks held less than a year and rose from 35 percent in 2013.

Sialm and his co-author, a professor at the Nanyang Business School in Singapore, looked at how U.S. stock funds performed between 1990 and 2012 and split them into five groups, based on the size of tax bills they imposed on shareholders.

Funds that pay out the smallest taxable distributions one year tend to remain in that group in future years, and the same goes for funds that lead to the biggest tax bills for shareholders.

That's because some funds make it a primary goal to limit tax bills. Among other moves, these tax-managed funds try to hold onto stocks for longer than a year before selling them. That way, the gains count as long-term rather than short-term and qualify for lower tax rates.

Others funds are tax-efficient as a byproduct of their approach. Index funds are in this group. Because index funds try to match the performance of the Standard & Poor's 500 or another index, they're not buying and selling as often as a fund run by a stock picker. By trading less often, index funds have fewer taxable distributions.

The most tax-efficient funds had annual returns that were somewhere between 0.51 and 0.97 percentage points better than the least efficient funds, the researchers found. That may not sound like much, but compounded over time, it can enable someone to retire years earlier.

As for what's causing the difference, Sialm says he's confident that a big reason is the cost of higher trading activity cutting into returns. Other factors may also be involved, such as the possibility that tax-efficient managers may be better stock pickers, but Sialm says the evidence isn't as strong for them.

Finding a tax-efficient fund matters more in some segments of the market. When a small-cap fund manager sees a stock skyrocket, for example, that's good for the portfolio. But it can also mean the stock graduates to mid-cap stock status, which could force the manager to sell.

In contrast, a large-cap fund doesn't have to unload Apple if its stock keeps rising, says Michael Buek, portfolio manager at Vanguard.

To limit distributions at his Tax-Managed Small-Cap fund, Buek aggressively sells stocks when there's been a notable drop in in price. That lets him lock in losses to offset gains made from selling winning stocks. After selling, he'll wait 30 days before buying back the stock again. That's the minimum time required for investors to be able to count the loss.

That buying and selling means the Vanguard Tax-Managed Small-Cap fund's return will deviate from its benchmark, the S&P 600 index, and produces slightly higher trading costs than an index fund. But its trading costs are still well below that of an actively managed small-cap fund.

Buek says he's surprised tax-managed funds haven't gotten more attention given the recent increase in capital-gains tax rates. He attributes some of that to the strong growth of index funds, which are tax-efficient already.

When looking to buy, Sialm suggests investors consider a fund's expense ratio and then its tax efficiency. A fund's web page will often show its history of capital-gains distributions and how big they were. Sites like Morningstar also show a fund's returns before- and after-tax returns, demonstrating their efficiency.

"It's typically not the information that's emphasized, but investors can find it," Sialm says.