BUSINESS

ARBOR OUTLOOK

Mutual funds, taxes and Irving Berlin

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Author's Note: This is the first in a two-part series on mutual funds.

"Dressed in their best, they're a happy mob ... If you care to join them, just hurry along." — from "Follow the Crowd" as written by Irving Berlin

Imagine you and four friends pool funds and purchase a beach house rental property with the intention of holding it for a long time. And let's say that in the following years, each of your friends decides to sell his interest in the property to someone outside the original group.

You still own the same percentage of the property; the other portion of ownership has simply changed hands. But here's the kicker. What if every time one of your friends sells his share, you have to pay some capital gains taxes on the growth in value of your proportional interest in the property? Yikes.

Essentially, that's the tax arrangement that investors accept when they purchase mutual funds. These funds are required to "cash out" investors who want their money back at the end of every day. If a large portion of a fund's owners want to withdraw their money from a fund, the fund manager is forced to sell investments in the fund to make the cash available.

This can potentially trigger a large capital gains tax liability for investors if long term, highly appreciated holdings had to be liquidated.

Ironically, "a rush to the exit" usually occurs in sudden market downturns. So precisely when investors are feeling the pain of declining asset values, they may also receive a surprise tax bill. Other owners in the mutual fund wanted out, and the manager may have had no choice but to sell securities to raise cash.

For this reason, the mutual fund "wrapper" is now considered one of the least efficient investment vehicles when considering taxation.

Mutual funds are an investment vehicle comprised of a pool of funds owned by multiple investors, just like you and your friends' fictional rental house.

These funds are simply the vehicle through which investors can buy a variety of securities, like stocks, bonds, real estate, commodities and more.

One is careful not to offer blanket statements regarding a particular type of investment's appropriateness for any investor without knowing that person's age, financial goals, investment experience, risk tolerance, and more. It may indeed be appropriate to purchase a mutual fund if that's the best way for an investor to access or participate in a desired financial strategy or market sector. Investors for whom taxes might not be a big issue enjoy access to professionally managed securities or strategies by buying into a mutual fund. So for these and other investors, mutual funds may be a prudent choice.

For investors of more substantial means, though, more often than not, it's cheaper and more tax efficient to simply purchase individual securities.

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