

# What it's worth

Mutual funds advertise their pre-tax returns, but it's the post-tax number that really matters

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**WHEN YOU WERE HIRED FOR YOUR LAST JOB,** was the salary offer quoted to you on an after-tax basis? When you pick up groceries at the local supermarket, does the price tag include taxes? Chances are the answer to both of these questions is no. The same is true for many other numbers you experience in daily life, including the mutual-fund returns you see advertised in the local newspaper.

Now, an influential group in the fund industry is pushing for a new standard that would require companies to disclose and advertise both before- and after-tax investment returns. The Securities and Exchange Commission (SEC) recently imposed similar standards on U.S. companies, and the Ontario Securities Commission (OSC) might not be far behind.

Here's why you should pay attention to the after-tax return from your mutual fund. Currently, if a Canadian-based mutual fund claims to have earned 15% per annum over the last year, that number is before investors pay any income taxes. On an after-tax basis, your actual return will depend on the timing and classification of the gains (capital, interest or dividends) as well as your federal and provincial tax bracket. Bond and money-market funds are taxed more heavily, while equity and real-estate funds are taxed more lightly.

Now, if the investment funds are inside a tax-sheltered RRSP, as half of all Canadian mutual funds are, you don't have to worry much about the "before-" versus "after-" tax issue, since your income taxes will be deferred until retirement, at which point the entire pot will be treated as ordinary income.

However, for the 50% of funds held outside an RRSP, the difference can be substantial. When you invest in a mutual or segregated fund, if the manager sells stocks that have appreciated in value, or if the stocks paid any dividends, you'll face a tax liability at the end of the year, even if you didn't actually dispose of the fund units.

As you can see from the chart, based on an hypothetical example, two mutual funds can have the same before-tax rate of return, but the after-tax return will be quite different, depending on the amount of buying and selling (turnover) within the fund during the holding period and the classification of those gains.

For example, if the fund sold 100% of the stocks it holds each year, the after-tax return would drop, but if the fund didn't sell anything, there'd be no tax liability so the after-tax return would be higher. The greater the ratio between the after-tax and the before-tax investment return, the more tax-efficient the fund.

Preliminary research seems to indicate that the relative ranking of two funds can change dramatically once taxes are taken into account. Whereas one fund might perform much better than another on a pre-tax basis, once taxes are

paid, their relative performance might completely reverse itself. Fund A might be in the top quartile pre-tax, relative to Fund B, but in the bottom quartile post-tax.

Note that higher turnover does not always imply a lower after-tax rate of return. This is because some selling is actually good for investors. By getting rid of losing positions and investments, the fund manager can use losses to offset some gains and reduce the tax bill.

Also, a high tax-efficiency ratio can't make up for lousy stock picking. If your fund's before-tax investment return falls short of the rest of the herd, I don't care how tax-efficient it is; dump the fund.

I'll leave for another place and time the debate of whether or not mutual fund companies should be forced to disclose after-tax numbers. But right now, pay close attention to the tax implications of any mutual or investment fund you hold outside your RRSP. The gap between pre-tax and post-tax returns can be quite large. **E**



**A TAXING ISSUE** These funds all have the same published return of 15%, but depending on the amount of turnover, here's what you'll really get on a \$10,000 investment

Fraction of capital gain realized each year (%)	What does your money grow to after 15 years of investing?
0	\$63,527
20	\$60,340
40	\$57,354
60	\$54,558
80	\$51,940
100	\$49,488

\*Assuming a 15% constant investment return each year, and 25% tax rate on capital gains

Illustration by Jason Schneider