MUTUAL FUNDS AND TAXES

JCB - Apr 12, 2006

The February 25, 2006 issue of the Wall Street Journal carried an op-ed piece by Eugene Fama and and Ken French (here, for subscribers). Their article inspired me to submit a letter to the editor, which was, for better or worse, never published by the Journal. I'm pleased to have the opportunity to share it with you here:

To the Editor of the Wall Street Journal:

While I greatly respect the major contributions that Professors Fama and French have made to modern portfolio theory, I take strong exception to their recommendation to change the tax code so that mutual fund investors pay taxes only as gains are realized when they sell their shares, rather than be subject to taxes paid as their funds realize gains on their underlying portfolios. (â€œKeep it Simple,â€ February 25, 2006.)

First, their proposed system is in fact far more complex. Now, fund shareholders receive from each fund they own a single tax statement providing the information required on the tax return. Under the new system, investors would have to report the amount and date of each share purchase, worry about wash sales, and post multiple gains (or losses) on their returns. What is more, the conversion from the old system to the new would require the complex recreation of prior data of perhaps hundreds of individual purchases and liquidations in each account. Finally, relying on the accuracy of cost information from investors when they sell their holdings of individual stocks has already proven difficult for the Internal Revenue Service to enforce; in the case of mutual funds, it would be even more difficult.

Second, their article completely ignores the fact that traditional open-end funds can easily provide the same tax deferral as do exchange-traded funds. So far, all (or virtually all) ETFs are index funds, providing returns that parallel those of the underlying market indexes, and are barely, if at all, more tax-efficient than regular index funds, many of which are operated at extremely low cost, yet free of the brokerage commissions on purchasing ETFs. Neither Vanguardâ€™s 500 Index Fund and Total Stock Market Index Fund, for example, have paid capital gains distributions since 1999, with annual distributions averaging less than 0.5 percent of asset value during the preceding five years.

The authors also ignore the availability of *tax-managed* traditional funds for taxable investors. Again, Vanguardâ€™s five tax-managed funds, in nearly 50 cumulative years of operation, have yet to realize a single capital gain distribution, all the while providing superior pre-tax returns, and truly stunning after-tax returns (outpacing, on average, 92 percent of their peers over the past decade).

The real problem is not with the tax code, but (unrecognized by the authors) with the mutual fund managers themselves. They turn over their fund portfolios at a stunning average rate of 91 percent per yearâ€"a holding period of barely 13-months for the average stock in their portfolios, reflecting a trading strategy that is far more akin to short-term speculation than long-term investing.

Unsurprisingly, because of all those execution costs, high fund turnover is clearly associated with low fund performance. During the past decade, for example, the highest-turnover quartile of funds (165 percent annually) provided an annual *pre-tax* return of just 9.8 percent, while the lowest-turnover quartile (13 percent) returned 11.5 percent, an advantage of 1.7 percent per yearâ€"a cumulative extra profit of nearly 30 percent. What is more, the high-turnover quartile of funds took nearly 30 percent *more* risk (standard deviation of 20.6 percent vs. 16.2 percent).

Looking at risk-adjusted returns, then, the low-turnover funds earned 11.6 percent per year compared to just 8.9 percent for their high-turnover cousins. Result: $10,000 invested ten years ago grew by $20,000 vs. $13,300â€"a 50 percent enhancement in profit even before taxes are considered. After taxes, the enhancement in cumulative profit approached 100 percent, a difference that is truly astonishing.

Like the mutual fund industry that is now vigorously campaigning to change the tax law, Professors Fama and French simply ignore the economic realities described in this letter. It is not the tax code that needs changing; it is the â€œshort-termismâ€ exhibited by the vast majority of mutual fund managers, and the short-sightedness of mutual fund shareholders who refuse, out of naivetÃ© or even ignorance, to look after their own economic interests. â€œThe fault, dear Brutus, is not in our tax code, but in ourselves.â€

John C. Bogle

COMMENTS

salevin - May 21, 2008

Amen. We recently discussed The Battle for the Soul of Capitalism in the TigerTomes book group (http://www.tigertomes.com) and capital gains taxation came up in the following:

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Back in the late '90s, there was a modification to the tax code to reward long term buy-and-hold investors with a 2% reduction in the top capital gains tax rate for new investments held for five years or more. The Bush tax cuts wiped that incentive out, rewarding instead 100% portfolio turnover per year. (Those changes also shafted folks like me who took advantage of the option to irrevocably redate some existing holdings as of 1/2/2001 by paying capital gains at the 20% rate at that time in order to start a 5 year clock running on those same investments.) While tax rates should not be the single factor driving investment decisions, they do have a powerful sway over both institutional and individual investors. Should the Bush tax cuts be allowed to sunset and replaced by a stronger version of the 5 year break, say a 5% reduction to 15% after five years, I would confidently predict that average portfolio turnover would drop to a modest fraction of its current stratospheric level. Let's go even further, say 10% for 10 year holdings and 5% for 20 year holdings. According to current administration vogue, such cuts would increase government revenues, and accelerate them in the out years when Social Security will most need them, while at the same time rewarding long term savings and stable investment.

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