

Sell your Mutual Funds NOW!

Reduce your 2008 tax liability and lower your future investment expenses by liquidating mutual funds and replacing them with low-cost ETF portfolios.

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Similar to mutual funds, Exchange-Traded Funds (ETFs) are a diversified portfolio of individual stocks or other securities. As the name implies, ETFs are funds (baskets of stocks) that can be traded on a stock exchange, just as an individual stock does. However, ETFs are structured differently than mutual funds and, therefore, offer a number of unique advantages over mutual funds. These include:

- **MANAGEMENT EXPENSE:** ETFs are historically unmanaged and, thus, avoid management expenses. Unmanaged means that they are created to closely match the exact securities and the respective positions size of each security to a particular index. Because this saves ongoing research and management costs, ETFs' expense ratios are typically lower than the cost of professional money managers or managed mutual funds.

There is a broad range of ETFs that allows investors to access just about any market in any part of the world. ETFs track large stock indexes like the Dow Jones Industrial Average or the Standard and Poors 500. There are ETFs that allow you to invest in various sectors of the economy (healthcare or financials), the stock markets of various continents or countries around the world (Europe and Asia or countries such as Brazil and China), and/or commodities such as corn and gold. In all cases, the ETFs are based on an index of securities and because the holdings that make up the index rarely change, there is rarely a change in the holdings of the ETF. This typically makes the expenses within these ETFs very low. ETFs will only incur a 0.10%-0.70% (10-70 basis points) annual administration expense, depending on the index.* Contrast this with a managed equity mutual fund, which may have as much as a 1%-2% (100-200 basis points) management fee.

[Note: In addition, ETFs don't charge investors marketing, distribution and accounting expenses; only mutual funds charge investors 12b-1 fees, upfront or back-end loads.]

- **COMMISSIONS:** The portfolio managers of actively managed mutual funds are continually buying and selling stocks/bonds and other investment securities within their funds. When new money flows into a fund (when investors buy shares of the fund), or when money flows out of the fund (when investors redeem or sell shares of the fund), a mutual fund manager buys or sells securities to maintain the overall investment

position of the fund. Additionally, a mutual fund manager may decide to sell one security and buy a new security that he or she feels offers greater profit potential. In either of the above cases, when the mutual fund manager buys or sell securities, there are commission costs with these transactions. In total, the commissions a mutual fund pays can add another 0.50%-1.5% (50-150 bps) annually in costs to a managed mutual fund.

An ETF does not incur commissions to buy and/or sell securities within the fund like a mutual fund does. Most ETFs are index funds and don't require changes to the portfolio. The important point I'm trying to make here is that, in general, ETFs only make changes to the portfolio on rare occasions when there is a change to the index and, therefore, they avoid the transaction costs of a managed mutual fund.

ETF shares are created when financial institutions deposit large baskets of individual shares of stocks in-kind into the fund. In exchange the institution receives ETF shares from the fund. At this point, individual investors begin to buy and/or sell those ETF shares to each other on securities exchanges. The ETF's outstanding shares are reduced when financial institutions purchase large baskets of individual shares of stocks in-kind from the fund. These baskets of stock are purchased when the institution redeems ETF shares they own back to the fund. These large baskets vary in size, as determined by each individual ETF, from 25,000 to 200,000 shares, and are called "creation units."

- **TAX ADVANTAGES:** Since there are rarely changes within the index an ETF is based upon, there are generally few, if any, capital gains payouts to shareholders of ETFs. ETF investors generally only realize capital gains when they sell their ETF shares to other investors at a price above their cost basis.

On the other hand, whenever a mutual fund sells securities in its portfolio, either to reallocate its portfolio, accommodate new purchases, or to fund shareholder redemptions, under U.S. law, any net realized gains must be passed through to the remaining shareholders. Those who have just recently purchased their mutual fund shares could end up paying taxes before they have any returns. This tax liability paid by investors in mutual funds can be 0.5%-1.5% (50-150 bps) or more of invested assets each year.

Take action now: Write off losses and avoid year-end taxes: **

Generally, mutual funds have enjoyed net contributions into their funds for the last 5 years. During this time, most mutual funds have built up significant unrealized gains within their portfolios as a result of the bull market. Since the market topped in late 2007, most mutual funds have experienced significant net outflows (redemptions) of capital as investors sold shares. The

high level of redemptions has forced mutual fund managers to sell shares of stocks at a profit and, thus, generate capital gains that will have to be distributed to all remaining shareholders by the end of the year.

Where do things stand now? If you bought a mutual fund in the past several years and you still own it today, it's likely that those shares are worth less than what you paid for them. If you continue to hold those funds until year-end, outside of a retirement account, capital gains taxes will be allocated to you as a result of other shareholders selling their mutual fund shares, as mentioned above. Most funds accumulate and calculate their realized gains based upon an October-October fiscal year and make the capital gains payment in December. A particularly important investment strategy that must be acted upon soon to avoid those taxes is to liquidate your shares in taxable investment accounts before your mutual fund makes its capital gain distribution for 2008 (IRAs and other non-taxable accounts generally don't incur taxes on capital gain distributions until the distribution takes place). In addition, if your funds are showing a loss, you'll need to sell them to recognize the loss and possibly generate a tax write-off, which may be used up to five years against other taxable gains.

Therefore, I'm advising clients to sell most equity mutual funds held in taxable accounts before the funds declare and pay their capital gains distributions for 2008. This capital gain distribution can happen anytime; however, mutual funds generally declare these distributions in December each year (check with your fund to confirm). It's important to mention that if you sell your mutual funds and stay invested in cash, you won't be in a position to participate in any potential market recovery. On the other hand, if you purchase a different mutual fund, you likely face capital gains taxes from the new fund. Therefore, this is an excellent time to make the switch to ETFs. You not only receive the tax benefits mentioned from liquidating your mutual funds, but you also remain in a position to profit from any market recovery. And, in the long run, your investments will be in a lower-cost, more efficient ETF portfolio that keeps you in a position to recover any losses you may have incurred when the markets recover.

I'd like to conclude by providing you with an excellent resource that can help you quantify your mutual fund expenses: www.personalfund.com. This resource helps investors discover all relevant expenses related to their mutual funds, which can be 2%-3% or more (annually) of your fund investment.

Vernon Sumnicht is founder of Sumnicht & Associates, LLC, an SEC registered investment advisor based in Appleton, WI, and founder of iSectors[®], a series of investment strategies that create and offer diversified ETF portfolios for independent investment advisors and their clients. To reach Vern, or learn more about iSectors ETF strategies, visit www.iSectors.com or email him at www.vern@sumnicht.com

1. Active vs. Passive Management, By: [Rex A. Siquefield](#), October 1995

*Note: In 2008, the U.S. Securities and Exchange Commission began to authorize the creation of actively managed ETFs.

**Note: This information is not intended to be tax advice. Check with your tax or financial advisor before making any changes to your investment portfolio. This paper is provided for information purposes only. The tax savings information provided here applies to taxable accounts only. If you are holding mutual funds or ETFs in an IRA or other tax-qualified account, you generally won't pay taxes on gains until you take distributions from your account.

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