Mutual fund distributions a risk you *can* avoid

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Corrections bear markets and recessions are parts of the normal investing landscape and can't be avoided. ***If you're invested in stocks, this is what you signed-up for, whether you realize it or not***.

However, there is an important risk that ***can*** be avoided; buying in front of a large (>10% of NAV) mutual fund capital gains distribution.

A mutual fund is a "pooled" investment vehicle that owns a portfolio of individual stocks. Shareholders of the fund own proportional interests in the fund and are treated identically.

Taxable (i.e. non-retirement account) fund shareholders incur capital gains taxes two ways. First, as with any security, a capital gain occurs when shares are sold for more than what they cost. Second, funds sell securities throughout the year and must distribute realized net capital gains at least annually. If there is a net capital loss, it can be carried forward to offset future gains.

Funds sell securities for a number of reasons, including needing to pay withdrawing shareholders. Morningstar estimates investors have pulled nearly $240 billion from actively-managed U.S. equity funds in the past year, almost a ***half a trillion*** over the past two. Ouch!

With stock prices up and withdrawals high, funds will be distributing boatloads of capital gains by the end of the year, unfortunately spread over a smaller number of shares.

A fund calculates its distribution by dividing the net capital gain by the number of shares outstanding on the "record date." Assume Fund A has $100 million in assets, a net capital gain of $10 million for 2017 and 1 million shares outstanding on the record date of December 28, 2017.

Fund A will make a capital gains distribution of $10/share ($10 million gain/1 million shares), or 10% of its $100 Net Asset Value (NAV--$100 million assets/1 million shares). Fund A's NAV will immediately drop (don't worry!) from $100 to $90 (($100 million assets - $10 million capital gain distributed)/1 million shares).

Shareholders can elect to receive the distribution in cash or reinvest the amount in additional shares. So, if a shareholder owns 1000 shares worth $100,000 on the record date, she can either take a check for $10,000 (reducing the value of her investment to $90,000) or reinvest the $10,000 in additional shares (leaving the value of her investment constant at $100,000 and increasing her cost basis by $10,000, which reduces the capital gain when she sells).

Importantly, she receives the same $10/share taxable distribution ***whether she owned the shares one day or ten years as of December 28.*** In sum, while the distribution is a nonevent from an investment point of view, it can be a very big deal for taxes.

Taxable shareholders should generally avoid buying shares of a fund in front of a large distribution. As Morningstar's Christine Benz said, "The last thing you want to do is buy into a fund and pay taxes on a distribution that you did not enjoy in any way, shape or form."

Most funds post estimates of upcoming distributions on their websites. Alternatively, about one-third of the 247 fund firms in CapGainsValet's https://www.capgainsvalet.com/ free database have posted estimates, with 169 funds estimating distributions of 10-19% of NAV, 16 funds 20-29% of NAV and 5 funds a whopping 30% plus of NAV.

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