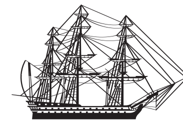


Vanguard®

How Big a Drag are Taxes on Fund Performance?

INVESTOR | education

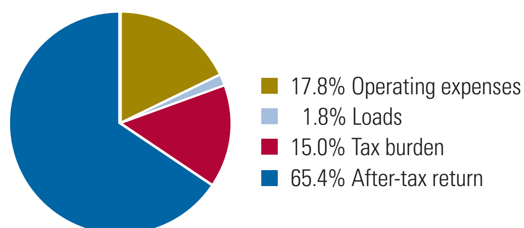
The volatility in the financial markets lately has led many investors to focus on costs, especially mutual fund expense ratios. While operating costs are important, investors might be losing sight of a culprit that can do as much or more damage to a portfolio.

According to Lipper data for the ten-year period through 2007, taxes ate away 15% of the gross return (the total return before all loads, costs, and taxes are taken into account) of the average U.S. diversified equity fund. The tax bite was much worse for the average U.S. taxable bond fund, eating away over 40% of the gross return—almost double the effect of operating expenses and loads combined.

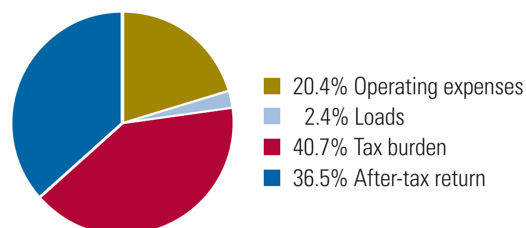
These results were during a period when the 2000–2002 bear market in stocks, tax-loss carry-forwards, and favorable tax-code changes mitigated the tax burden. As tax-loss carryforwards are exhausted, taxes will likely become an even greater burden for investors in stock funds. The likelihood is higher if Congress does not extend the currently favorable tax rates on capital gains and qualified dividend income past their scheduled sunset date of year-end 2010.

Breakdown of gross returns, ten years through 2007

Average U.S. diversified equity fund



Average U.S. taxable bond fund



Calculations are based on the highest individual federal income tax and capital gains tax rates in effect at the times of the distributions. Investors in lower income tax brackets would have a lower tax burden. The data assume that an investor held the funds in a taxable account, reinvested distributions, and did not sell any shares. Selling shares would have provided a lower or higher after-tax return, depending on whether the sale resulted in a capital gain or a capital loss that qualified for a tax deduction. Operating expenses include management fees, administrative fees, and any marketing and distribution fees. Expenses do not take into account loads (sales fees charged on the purchase or sale of some mutual fund shares), redemption fees, or purchase or transaction fees. *The performance data shown represent past performance, which is not a guarantee of future results.*

Source: Derived from data in the Lipper study, *Taxes in the Mutual Fund Industry—2008.*

What you can do

1. Focus on maximizing after-tax returns. Advertising and the financial media widely tout funds' total returns, which take operating costs into account but not taxes. Two similar funds can deliver drastically different returns after taxes. Investors should be conscious of taxes, but they should not fixate on them. Low taxes on a low return still means a low net return. Instead, investors should focus on maximizing after-tax returns.

2. Implement an asset location strategy. Investors can exert considerable control over tax ramifications simply by how they allocate their investments between taxable accounts and retirement (tax-advantaged) accounts.
   - Keep tax-efficient investments—such as broad-market stock index funds, exchange-traded funds (ETFs), tax-managed funds, and municipal bonds (for investors in the higher income tax brackets)—within taxable accounts.
   - Keep tax-inefficient investments—such as most actively managed stock funds, taxable bonds, real estate investment trusts (REITs), and certain commodities such as gold and silver—in retirement accounts.

3. Be conscious of costs and taxes when making transactions. If you're repositioning assets between accounts or among asset classes, there might be trading costs and tax consequences. Weigh those costs against the expected benefits.

Each individual's tax and financial circumstances are unique. Before taking any action, talk with your financial advisor or tax consultant on ways to improve your portfolio's after-tax returns.

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For more information on mutual funds or ETFs, contact your financial advisor to obtain prospectuses and product descriptions. Investment objectives, risks, charges, expenses, and other important information are contained in these documents; read and consider them carefully before investing.

Investors must buy or sell ETF shares in the secondary market with the assistance of a stockbroker. In doing so, the investor will incur brokerage commissions and pay more than net asset value when buying and receive less than net asset value when selling.

Mutual funds and ETFs are subject to risk, which may result in the loss of principal. Investments in bond funds are subject to interest rate, inflation, and credit risk. It is possible that tax-managed funds will not meet their objective of being tax-efficient.

Investment Products: Not FDIC Insured • No Bank Guarantee • May Lose Value

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