


## Fund outflows mean tax hit for investors

### Shareholders could get 'January surprise' of big tax bill, portfolio losses

By [Sam Mamudi](#), MarketWatch  
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**NEW YORK (MarketWatch) -- Mutual fund investors, facing large losses due to the market downturn, may also be hit this year with a high tax bill as redemptions create capital gains for their funds.**

As spooked investors pull their cash from stock funds -- more than \$110 billion so far this year, according to TrimTabs Investment Research -- managers are forced to sell assets to pay them out. Often, the quickest way to raise cash is by selling high-valued stock, which creates capital gains liabilities for the fund that investors must pay at year's end.



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"It's going to be the January surprise for a lot of people," said Larry Glazer, founder of investment advisory firm Mayflower Advisors. "You could have a loss [on your fund investments] and significant capital gains distributions in the same year."

The problem is made worse by the fact that funds have had high returns in the past few years, and have tried to mitigate capital gains hits by off-setting those gains with losses they suffered earlier this decade. But those off-sets have been largely used up this year, further increasing the chances of a tax charge.

"We're headed for a 2000-like double-whammy," said Tom Roseen, senior analyst at research firm Lipper. In 2000, stock funds on average lost 0.7%, but investors faced a tax bill of at least \$31.3 billion, according to Lipper. That year, the fund industry had total assets of about \$6 trillion; today, that figure is close to \$12 trillion.

Stock funds are down an average 17.6% this year as of September 25, according to Lipper.

#### Moving out

Poor performance and fears about the market have seen investors leave stock funds and move into what they see as safer holdings, such as money market funds, Treasury bills and cash.

The problem is also created by fund rotations, as investors reacted to market performance and shifted from value funds and into core and growth strategies, said Roseen. They also dumped small-cap funds for larger-cap funds.

The issue may not be as bad as some fear, however.

"I'm not sure how big a deal it's going to be," said Adam Bold, president of the Mutual Fund Store. He said that many redemptions come when the Dow Jones Industrial Average is at a low, which means fund managers often aren't selling high, which cuts the chance of realizing capital gains.

"A lot of managers will also at the same time sell positions in which they have losses to off-set any capital gains," said Bold.

"I would love to see the industry do that, but I just don't know if they will," said Roseen. Not everyone does this, he said, as 2000's large tax bill proved.

### **What to do**

No one will know what's going to happen for about another six weeks. Mutual funds' financial year ends on October 31, at which point they'll calculate their capital gains. Distributions will be announced in mid-November and made in December. Bold suggested investors sell up before the distributions are announced.

Glazer said that the situation is "another feather in the cap of ETFs" -- because of their structure, ETFs don't realize capital gains when investors pull out. He suggested investors switch into ETFs before the distribution dates. If an investor is considering new investments in a mutual fund, "you need to have a conversation," about the capital gains liability, said Glazer, who recommended holding off such investments until January 1.

Roseen said that one thing investors can do is look at the tax-loss carry forward in a fund's report to see if there is any loss that can be used to off-set this year's gains. He also said they should look at their income statement to see if they have any so-called tax overhangs -- a clue to unrealized gains that that have the potential of being realized at year's end.

One note of reassurance, though, is that this year's performance figures are so bad that there simply won't be any capital gains.

"The tax issue is either going to turn out to be nothing, or it's going to be like 2000 again," said Roseen.