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Understanding Mutual Fund Yield

Clients often tell us that they want to buy investments with high yields so they can create better cash flows. This makes sense since a high-yield investment should be able to generate more income per dollar of principal. However, when you are evaluating the open-end mutual funds we use in our managed portfolios, many clients misinterpret what is yield and what is actually just a return on embedded gains.

Open-end mutual funds (as distinguished from closed-end funds) are allowed to continually issue new shares so new investors can be admitted at any time. Unlike individual stocks and closed-end funds, where there must be one share sold for each share bought, open-end funds have a virtually limitless supply of shares they can issue to keep growing their investment pool. When it comes to understanding a fund or stock's yield, the limitless shares available to open-end funds impact how various distributions should be viewed.

Individual stocks and closed-end funds are valued on a "real time" basis each day as a result of competitive bidding between willing buyers and sellers. Values are based on the perceived values set by buyers and sellers. In contrast to this process, open-end mutual funds are valued only once each trading day after the New York Stock Exchange has closed, based on the value of the underlying securities owned. Open-end fund values are computed mathematically with absolutely no subjective judgments allowed in the pricing process. The mathematical nature of open-end fund valuation means that distributions automatically lower share values in open-end funds.

	Actively Managed Open-End Fund	Low Trading Open-End Fund
Initial share price	$10.00	$10.00
Original shares issued at $10 per share	10,000,000	10,000,000
Initial fund value	$100,000,000	$100,000,000
Year one dividends earned and accumulated	$1,000,000	$1,000,000
Realized capital gains accumulated for year	$10,000,000	0
Unrealized capital gains for year	0	$10,000,000
Total year end fund value before distributions	$111,000,000	$111,000,000
Year end distributions	$11,000,000	$1,000,000
Fund value after distributions	$100,000,000	$110,000,000
Value per share post distributions	$10.00	$11.00
Distributions reinvested (capital gains only)	$10,000,000	None
New shares issued	1,000,000	None
Total shares outstanding after reinvestment	11,000,000	10,000,000
Fund security values after reinvestment	$110,000,000	$110,000,000

Another factor to consider is how actively traded an open-end fund is. Actively-traded or managed funds can potentially have very different distributions from a fund that does not trade as much, such as an index fund or an asset class fund. As a hypothetical example, in the chart above, both open-end mutual funds begin the year with 10 million shares valued at $10 per share. The funds have identical investment performance for the year, including dividends and growth in value. However, the Actively Managed Fund has realized all its gains from selling shares while the Low Trading Fund has not sold any shares. What will be the tax effect of these facts on the shareholders for each fund?

Shareholders for both funds will pay tax on their $0.10 per share ordinary dividend. Actively Managed Fund shareholders will also recognize a $1.00 per share capital gain despite the fact they reinvested these capital gains to purchase additional shares of the fund. The Low Trading Fund shareholders do not declare any capital gains since their unrealized appreciation is deferred from taxes. So all shareholders have the same ending value for their holdings, but Actively Managed shareholders have a big tax bill that will put them at a disadvantage to the Low Trading shareholders.

Immediately after the capital gain reinvestments are completed, one shareholder of each fund needs to liquidate $20,000 of their fund holdings. Each shareholder account was valued at $110,000 before this sale. Continuing with this hypothetical example, the chart below shows the potentially divergent results.

Once again, the before-tax cash flows are identical for our two investors. However, the Actively Managed shareholder has no untaxed gains remaining, so no tax is due. Our Low Trading shareholder must begin to pay some capital gains tax. However, the gains on the unsold shares remain deferred until the Low Trading shareholder actual triggers a sale. Clearly our Low Trading shareholder has lost nothing economically, but has gained a clear tax advantage over the Actively Managed shareholder.

Closed-end funds and stocks do not follow these strict mathematical rules of valuation. As a result, it is difficult to say whether capital gain distributions and/or dividends should be classified as investment yield when analyzing closed-end funds or stocks.

With open-end funds, however, we believe that capital gain distributions should not be classified as yield, but rather as a tax burden. If you are seeking cash flows from open-end mutual funds, it is better to choose a low trading fund over an actively trading fund despite the expectation of lower capital gain distributions. You can create the cash flows you need from selling share and be able to defer more of your capital gains.

If you want more information on mutual fund distributions, please email Marlene Bass at mbass@loringward.com for a white paper discussion of mutual fund yields.

	Actively Managed Open-End Fund	Low Trading Open-End Fund
Market value per share	$10.00	$11.00
Shares owned (valued at $110,000)	11,000.000	10,000.000
Shares sold to raise $20,000 needed	2,000.000	1,818.182
Cost basis shares sold (first-in, first-out basis	$20,000	$18,182
Taxable capital gain realized	None	$1,818
Shares owned after sale to raise capital	9,000.000	8,181.818
Unrealized gain on shares still owned	None	$8,182
Market value of remaining shares owned	$90,000	$90,000