Mutual Fund/Separate Account Tax Barometer December 2007

► Tax Implications and the Relative Attractiveness of Mutual Funds and Separate Account Strategies

The Tax Barometer can help investors decide—from a tax standpoint—which investment might best serve their needs—a separate account or a mutual fund. By illustrating the percentage of tax overhang in nine domestic-equity Morningstar mutual fund categories, the Tax Barometer helps investors to analyze their options.

The calculation, which is based on an asset-weighted average of each category's potential capital gain exposure, indicates how much of a mutual fund's portfolio is represented by unrealized (or undistributed) capital appreciation or loss. Funds with negative potential capital gain exposures have greater net losses than gains. In this case, some future gains will be offset by past losses, which can be advantageous for the funds' shareholders.

Better Served by Mutual Funds

Investors who have stuck with large- and mid-cap growth mutual funds through the bear market for those styles generally will realize some tax benefits from their position. Those who are bullish on growth stocks could also garner higher returns resulting from the realized and pending tax benefits in mutual funds.

Better Served by Separate Accounts

In contrast, and strictly from a tax perspective, investors considering a value or blend position in the market might be better served in a separate account than a similar mutual fund. This is illustraded in the shaded area of the Tax Barometer, below.

Summary

Tax-aware investors may find the Tax Barometer helpful when deciding between a separate account strategy and a mutual fund. It's important, however, for investors to consider the specific potential capital gains exposure of a mutual fund when making a decision.

As investing is an ongoing process, tax implications tend to shift as mutual fund performance varies, according to each investor's unique situation. It's also important to bear in mind that taxes are only one of several considerations in determining an investment's suitability. Depending on the situation, a separate account might prove a better option for an investor because of its customization features.

Domestic Equity Mutual Fund Tax Overhang

☐ Favorable capital gains exposure at this time

☐ Moderately unfavorable capital gains exposure

☐ Substantially unfavorable capital gains exposure

	Value	Blend	Growth
Large	16%	21%	13%
Mid	7%	17%	5%
Small	5%	12%	9%

This December 2007 Mutual Fund/Separate Account Tax Barometer shows that the average domestic mid-cap blend mutual fund has embedded gains representing 17% of its assets. In other words, a $1 billion AUM mid-cap blend stock fund has $170 million in gains to distribute. Especially for investors making an initial investment, a mid-cap blend separate account might be a worthwhile investment discussion at this time.

Average assets for one year ending December 30, 2007 used. Potential capital gains exposure as % of assets by Morningstar Domestic Equity Mutual Fund Category.