To Disclose or Not To Disclose After-Tax Returns of Mutual Funds

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PRÉCIS

Cet article présente les arguments favorables et défavorables à la publication des rendements après impôt des fonds communs de placement dans un contexte canadien. Plus précisément, l'auteur encourage la publication régulière et cohérente (uniforme) des rendements après impôt, de façon semblabe à la publication systématique des rendments avant impôt.

ABSTRACT

This article explores the arguments for and against the disclosure of after-tax returns of mutual funds in a Canadian context. Specifically, it argues for consistent (or uniform) and regular reporting of after-tax returns, similar to the ritual reporting of pre-tax returns.

KEYWORDS: MUTUAL FUNDS ■ PERFORMANCE ■ DISTRIBUTIONS ■ CAPITAL GAINS ■ PERSONAL FINANCE ■ TRUSTS

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BACKGROUND

Mutual funds managed by Canadian trusts or corporations are not currently required to disclose their after-tax investment returns. In contrast, mutual funds managed by US trusts have had to regularly report after-tax returns in a consistent and standardized manner since the Securities and Exchange Commission (SEC) legislated mandatory disclosure in April 2001. The Association for Investment Management and Research (AIMR) in the United States, in its mandate to look after the interests of the investing public, also advocates disclosure of after-tax returns: "it is important to promote a consistent, standard format for calculating and presenting after-tax

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results because it will prove very helpful to constituencies in evaluating potential investment firms to manage their funds."[1] While these disclosure issues have been discussed between regulators and industry groups in Canada,[2] there has not been much public discussion in the debate about disclosing after-tax returns of mutual funds. This article identifies the issues involved in assessing investors' needs and their interest in after-tax returns.

Recognizing a market demand from mutual fund investors, data vendors such as Morningstar already track and report tax efficiency ratios and tax-adjusted returns for three and five years using a standardized algorithm.[3] Measures such as tax efficiency ratios can be an alternative means of achieving transparency and may even be of greater interest to investors to the extent that they suggest future outcomes. Efficiency measures may alleviate the concern that there is too much emphasis on historical returns in mandated disclosure. However, Morningstar's plans to also report after-tax returns suggest investor demand for such disclosure. This article explores several arguments for not requiring mutual fund companies to disclose their after-tax returns and attempts to address these arguments.

The arguments in this article are applicable specifically to mutual funds that are set up as trusts. Corporate class mutual funds, in which approximately 3.38 percent of all mutual fund assets are held,[4] are subject to very similar arguments. However, these arguments are not transferable to all investment funds and consequently do not serve the current movement in Canada of treating all investment funds (as currently defined in the Securities Act (Ontario)) in a similar manner.

ARGUMENTS FOR AND AGAINST DISCLOSURE OF AFTER-TAX RETURNS

All disclosure is subject to a cost-benefit analysis before it is mandated for everyone. In the case of disclosure of after-tax returns, there are obvious benefits and costs to both the investors and the mutual fund companies. The obvious costs to the fund company include compliance costs—including expected litigation costs if disclosure is erroneous—which may or may not be passed on to the unitholders in the form of higher management fees. Disclosure of after-tax returns may also reveal the fund's proprietary investment strategy, which may remain opaque under the current regime of disclosing only pre-tax returns. Proprietary investment strategy could include the fund manager's bullish sentiment with respect to a particular sector, which may be manifested by a buy-and-hold strategy for that sector and may be revealed by the disclosure of after-tax returns that are reasonably similar to

1 "AIMR Releases Proposed After-Tax Standards for Public Comment" (2001) vol. 6, no. 4 *AIMR Advocate* 9.

2 For example, the Investment Funds Institute of Canada recently submitted its input on this issue to the Ontario Securities Commission's Capital Markets Branch.

3 See Morningstar's Web site at http://www.morningstar.ca for further details.

4 http://www.ific.ca/eng/statistics.

pre-tax returns. While such transparency may be a benefit to some mutual funds and a cost to others, it would certainly benefit investors holding their funds in non-registered accounts. Investors benefit from after-tax disclosure by having a more appropriate compounding rate with which to estimate their asset accumulation in non-registered accounts. With greater transparency of mutual funds' tax strategy, investors would be able to allocate their savings to funds that actively seek to maximize after-tax returns.

In contrast to developments in the United States, the Canadian debate seems to have stalled with the argument that disclosure of after-tax returns need not be made mandatory since, in a competitive market, fund companies will find disclosure to be in their best interest if investors demand it. However, as is the case with other voluntary disclosure issues (such as proxy voting information currently provided by some "ethical" funds), inconsistent, irregular, or selective disclosure may lead to confusion among investors and thereby reduce the benefits of improved resource allocation decisions.

In a widely cited study, Jeffrey and Arnott show that most fund managers have a difficult time adding value relative to a passive investment strategy, even in the absence of tax considerations.[5] Higher pre-tax returns often require a more active management style with a higher turnover of investments inside the fund, resulting in higher fund distributions and corresponding lower after-tax returns. Mawani, Milevsky, and Panyagometh show that when the gap in pre-tax returns increases between funds that are ranked adjacently or in proximity (presumably as a result of a more active management style), the probability of after-tax ranking reversal also increases.[6] For example, when the gap in pre-tax returns increases from zero to one basis points to one to two basis points, the probability of ranking reversal increases from 46 percent to 66 percent.

Fund companies are concerned about the magnitude of disclosure if they are required to report 1-year, 5-year, and 10-year historical data on both a pre-tax and an after-tax basis. Such disclosure will have to include the assumptions, explanations, and disclaimers regarding the after-tax numbers. Furthermore, highlighting tax disclosure may cause investors to divert their attention from other factors, such as risk and diversification, that are critical in the evaluation of investments.

While the information overload argument put forward by some mutual fund companies seems appropriate, it is likely that the investing public will become more sophisticated over time and be able to filter and digest vast amounts of data. Investors in non-registered accounts may learn to ignore pre-tax returns altogether, while investors in sheltered or registered accounts would learn to ignore after-tax returns. Investors could also learn to evaluate risk or diversification simultaneously

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5 Robert H. Jeffrey and Robert D. Arnott, "Is Your Alpha Big Enough To Cover Its Taxes?" (1993) vol. 19, no. 3 *The Journal of Portfolio Management* 15-25.

6 Amin Mawani, Moshe Milevsky, and Kamphol Panyagometh, "The Impact of Personal Income Taxes on Returns and Rankings of Canadian Equity Mutual Funds" (2003) vol. 51, no. 2 *Canadian Tax Journal* 863-901.

with the tax efficiency of the mutual funds they are considering for investment. Taxes, as compared with risk, do have greater potential to erode pre-tax returns.

On the basis of industry consultations, the SEC in the United States estimated the ongoing compliance costs of reporting after-tax numbers to be approximately 18 hours per fund, although startup costs were expected to be much higher.[7] Both the SEC and AIMR found after-tax disclosure to be cost-beneficial in terms of investors' evaluation of funds, fostering efficiency, and promoting competition among mutual funds.[8] Competition among funds increases tax awareness, even among funds that do not claim to be tax-managed. Tarquinio reports that the gap in tax-adjusted returns between tax-managed and other mutual funds in the United States narrowed sharply during the March 2002-March 2003 period, in part owing to increased awareness among mutual fund investors as a result of the SEC's new disclosure rules.[9] However, some of the convergence may have been triggered by capital losses realized during the recent bear market. For example, the average annual after-tax return for the five years ended March 31, 2003 was –3.9 percent for tax-managed funds in the United States, as compared with –5.2 percent for other domestic equity funds over the same time period. (The average pre-tax return of the same tax-managed funds was -3.7 percent a year, as compared with -3.8 percent for other funds over the same time period.)

Another argument for not disclosing after-tax returns for mutual funds is that no other investment discloses, or is required to disclose, after-tax returns. Mutual fund companies could reasonably argue that disclosing after-tax numbers in an industry environment of pre-tax numbers could lead to a competitive disadvantage, as well as to potential confusion among investors. However, mutual fund managers do have more influence over the after-tax returns realized by their unitholders as compared with vendors of other investments, such as bonds and equities, and it may be reasonable to demand accountability for the control that fund managers have over that tax burden.[10] Mawani, Milevsky, and Panyagometh show that Canadian-managed equity and balanced mutual funds ranged in their tax efficiency from 25 percent to 100 percent, with an average tax efficiency of 85 percent.[11] If such a material tax

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7 Securities and Exchange Commission, "Final Rule: Disclosure of Mutual Fund After-Tax Returns," January 18, 2001 (release nos. 33-7941; 34-43857; IC-24832; file no. S7-09-00).

8 Association for Investment Management and Research, *Redrafting the After-Tax Provisions of the AIMR-PPS Standards* (Charlottesville, VA: Association for Investment Management and Research, 2000).

9 J. Alex Tarquinio, "Tougher Path for Tax-Managed Funds," *New York Times*, April 13, 2003.

10 A similar accountability argument could be made for managers of flowthrough vehicles such as income trusts.

11 Mawani et al., supra note 6, table A1, at 888-901. Tax efficiency can be measured by the ratio of pre-liquidation after-tax return to pre-tax return. The authors show that an investor in the highest tax bracket lost an average of 135 basis points (or 9.01% – 7.66%) to income taxes paid on the fund's annual distribution, resulting in an average tax efficiency of 85% (= 7.66%/9.01%). Furthermore, funds at all deciles lost at least 100 basis points to income taxes on annual distributions.

wedge is excluded from the fund manager's performance measure, the manager may remain indifferent between liquidating highly appreciated stocks and liquidating losing investments inside the fund—a situation that is clearly not congruent with the investors' objectives.

Another concern of the fund companies in disclosing after-tax returns may be that tax efficiency could potentially be impaired by net redemptions over which a fund manager may not have much control. Conversely, a growing fund may appear more tax-efficient since fund managers are not forced to make distributions to redeeming unitholders. The recent bear market has triggered significant redemptions in many funds, thereby increasing the resistance of fund companies to the disclosure of after-tax numbers. However, it could be argued that net redemptions do indeed signal the fund manager's performance to some extent, and therefore disclosure of tax efficiency can actually improve resource allocation decisions.

Furthermore, distributions triggering taxes to unitholders are also made by funds experiencing declines in their net asset values, since such fund managers still have to buy and sell shares on an ongoing basis. Taxes do reduce annual returns that are already negative, since investors still have to pay taxes on distributions, even if a fund declines in value for the year. For example, Trimark Canadian Endeavour fund distributed 5.7 percent of its net asset value despite a 4.3 percent drop in net asset value during 2002.

Mutual funds also argue that after-tax returns on any investment depend nontrivially on the investors' tax circumstances, and particularly the investors' horizons. However, investors' horizons also have a significant influence on their pre-tax returns, and certainly nobody argues against disclosing pre-tax returns on a consistent, periodic basis. The posted one-year pre-tax return of a particular mutual fund may be materially different for the unitholder who held the fund for only 360 days or 380 days instead of 365 days.

Another example of an investor's personal tax circumstances is possession of net capital losses. While an investor's net capital losses may enable her to shield capital gains distributions, she could also offset losses and gains personally by liquidating part of the investment portfolio. Universal distributions to all unitholders are not likely to facilitate individual tax planning relating to the offsetting of losses and gains. This argument is similar to the classic Modigliani and Miller theorems that shareholders or unitholders are often able to generate homemade leverage (by investing on margin) or homemade dividends (by liquidating part of their portfolio), and therefore corporations (or mutual fund companies) should not necessarily waste their resources in catering to such activities.[12]

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12 Franco Modigliani and Merton H. Miller, "The Cost of Capital, Corporate Finance and the Theory of Investment" (1958) vol. 48, no. 3 *The American Economic Review* 261-97; and Merton H. Miller and Franco Modigliani, "Dividend Policy, Growth and the Valuation of Shares" (1961) vol. 34, no. 4 *Journal of Business* 411-33.

While a tax wedge (or the difference between pre-tax return and pre-liquidation after-tax return) may not offer investors a precise measure of their personal tax burden, it does offer some measure of relative tax efficiency. Furthermore, to the extent that investors select funds on the basis of ranking, they should at least be aware that a relative ranking on a pre-tax return measure is significantly different from a relative ranking on a post-tax return measure. Mawani, Milevsky, and Panyagometh show that funds ranked in proximity on a pre-tax basis have approximately a 46 percent probability of having their ranking reversed when the ranking is done on an after-tax basis.[13] Furthermore, the average absolute value of the change between pre-tax return rankings and pre-liquidation after-tax return rankings was 28 in a sample of 343 Canadian-managed equity and balanced mutual funds.

After-tax returns do depend critically on the holding period selected, since annual fund distributions are not uniform across the year. Most mutual fund trusts calculate and distribute capital gains only at year-end, since it is difficult to determine the net annual gains or losses earlier. Therefore, after-tax returns could change significantly by the inclusion or exclusion of the month of distribution. However, pre-tax returns are subject to the same sensitivity, given the vagaries of the stock market.

Similarly, fund companies could argue that one-year after-tax returns are not necessarily predictive of long-term tax efficiency, since pre-tax and after-tax returns are almost identical over a one-year horizon. However, in this business, one-year pre-tax returns also are not generally indicative of long-term investment performance.

Approximately 46 percent of investments in mutual funds are held inside registered accounts[14] (such as registered retirement savings plans [RRSPs] and registered education savings plans). Disclosure of after-tax returns is irrelevant for these investments since the income earned is not subject to tax until withdrawn. However, the remaining 54 percent of investments in mutual funds are held in non-registered accounts that attract tax on an annual basis. This is a substantial market segment for which after-tax returns are more relevant than pre-tax returns. If after-tax reporting were to become mandatory, it is conceivable that funds may have to be divided into registered and non-registered to ensure that management fees related to the preparation of after-tax returns are not passed on to registered unitholders. Alternatively, investors holding funds in registered accounts would also have to pay higher management fees for reporting of standardized after-tax returns. The need for two parallel funds (registered and non-registered) may be realistic, since otherwise registered investors may perceive their fund managers to be sacrificing pre-tax returns in order to optimize after-tax returns. For example, Dimensional Fund Associates in the United States offers two parallel funds for precisely this purpose. However, such parallel funds impose significant costs that can be justified only by a critical mass clientele for each of the funds.

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13 Mawani et al., supra note 6, at 880, figure 5.

14 As of December 2001. See Investor Economics, *Insight Index Funds Report*, February 11, 2002.

If investors demand after-tax metrics, it could be argued that firms within the competitive mutual fund industry would find it in their best interest to provide such information voluntarily, as evidenced by the disclosure practices of several firms. This argument is similar to other voluntary disclosure issues, such as the proxy voting information currently provided by some "ethical" funds. However, non-uniform and sporadic voluntary disclosure increases investors' information-processing costs, potentially requiring a costly and unbiased financial intermediary (other than the vendor) to interpret the results. Furthermore, non-uniform and irregular disclosure makes it difficult for investors to evaluate funds relative to each other, thereby making it easier for tax-inefficient funds to hide behind their customized, but not very meaningful, disclosure. The results reported by Mawani, Milevsky, and Panyagometh in respect of changes in relative performance ranking between pre-tax and after-tax returns are feasible only with a single, universal disclosure methodology uniformly applied at the same periodic intervals to all mutual funds of the same type.[15] Furthermore, the wedge between pre-tax returns and pre-liquidation after-tax returns exceeded 100 basis points for funds at all deciles. In this context, non-uniform and non-regular or selective disclosure of the material impact of taxes may lead to greater confusion among investors and thereby reduce the benefits of improved resource allocation decisions. Therefore, even if a few mutual fund companies decide to disclose after-tax returns voluntarily, the mutual fund industry should adopt a standardized method for computing those returns.

In the choice of tax rates to compute after-tax returns, the literature has ranged from the highest federal rate, excluding state and municipal taxes,[16] to an arbitrary 35 percent.[17] The US disclosure requirements also ignore alternative minimum tax (AMT) and phaseouts (or "stealth" tax rates).[18] Mawani, Milevsky, and Panyagometh use the highest personal combined (federal and provincial) marginal tax rate in Canada adjusted for year and type of income (interest, dividend, or realized capital gains), thereby providing a worst-case scenario of the tax wedge.[19] However, the change in rankings (pre-tax returns versus after-tax pre-liquidation returns) documented is not qualitatively different when the top-bracket tax rate is substituted with the medium-bracket tax rate (starting with the federal rate of 22 percent and adjusting for provincial income taxes, year, and type of income).

Although wealthier individuals are more likely than less-wealthy individuals to own stock directly, it is likely that top-bracket taxpayers do own most of the mutual-fund

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15 Mawani et al., supra note 6.

16 Securities and Exchange Commission, supra note 7, at 13.

17 William Lewis Randolph, "The Impact of Mutual Fund Distributions on After-Tax Returns" (1994) vol. 3, no. 2 *Financial Services Review* 127-41.

18 Stealth tax rates are discussed in Alan Macnaughton, Thomas Matthews, and Jeffrey Pittman, "'Stealth Tax Rates': Effective Versus Statutory Personal Marginal Tax Rates" (1998) vol. 46, no. 5 *Canadian Tax Journal* 1029-66.

19 Mawani et al., supra note 6, at 872.

wealth. "Top bracket" and "rich" are not synonymous since the top-bracket threshold is fairly low in Canada. Moreover, lower-bracket taxpayers probably do not invest much outside their RRSPs, given that only 35 percent of all eligible tax filers contributed to their RRSPs in 1995.[20] Therefore, the investors who pay tax on their mutual fund returns are likely top-bracket taxpayers.

Mutual fund companies could also argue that calculations of after-tax returns using historical tax rates could be misleading if there are frequent changes in tax law or tax rates. For example, capital gains inclusion rates changed from 75 percent to 66.67 percent on February 28, 2000, and then from 66.67 percent to 50 percent on October 17, 2000. After-tax returns calculated on the basis of historical rates may not be indicative of future after-tax returns, since the latter may be computed using new tax rates.

A question related to the disclosure issue is whether mutual fund managers explicitly consider changes in tax rates or tax law in their holding period decisions. For example, did the drop in the capital gains inclusion rate (from 75 percent to 50 percent in 2000) prompt fund managers to hold more capital-gains-yielding investments, and thereby distribute more capital gains, at the expense of dividend-paying stocks and dividend distributions?

For example, consider a fund earning a 13 percent pre-tax return consisting entirely of interest and foreign dividends, and another fund earning 10 percent entirely from annually realized capital gains. Under a 75 percent inclusion rate and an assumed 50 percent marginal tax rate, the first fund earns 6.5 percent after tax while the second earns 6.25 percent. Under a 50 percent inclusion rate and the same 50 percent marginal tax rate, the first fund still earns 6.5 percent after tax, but the second fund now earns 7.5 percent after tax, and the rankings are reversed. Thus, composition of the distributions matters. Forward-looking tax rates could be used in an after-tax algorithm only if the composition of returns (distributions) by income type were held constant.

After-tax returns based on historical tax rates can still serve their relative ranking objective if all mutual funds uniformly disclose the composition of the distributions, using the same historical rate at the same periodic intervals. The after-tax return metric serves well as a measure of relative ranking, even though it may fare poorly as a measure of the unitholder's consumption power. In the case of pre-tax returns, mutual fund companies do correctly advise or warn the investing public that past returns may not necessarily predict future returns. After-tax returns could be disclosed to investors with a similar caveat.

Finally, mutual fund companies could argue that additional disclosure of after-tax returns will add to the management expense fees that will have to be passed on to unitholders. If such disclosure were universally mandated by securities regulators, as is the US practice, no single fund would be at a comparative disadvantage as a

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20 Investment Funds Institute of Canada, *Gimme Shelter: Registered vs. Non-Registered Investing*, 1998 IFIC Personal Finance Series (Toronto: Investment Funds Institute of Canada, 1998).

result of the costs of such disclosure. The issue of additional disclosure should not focus solely on the costs of disclosure, but also focus on the benefits.

CONCLUDING REMARKS

This article has provided a non-exhaustive set of arguments for and against the disclosure of after-tax returns of mutual funds on a standardized (uniform) and regular (periodic) basis in a Canadian context. Individual investors holding mutual fund units outside their registered accounts are clearly interested in after-tax returns in their pursuit of maximizing long-term wealth accumulation.

Pre-tax rankings do not take into account the holding period or turnover of assets inside the fund, and therefore the taxable distributions made to investors. Different investment strategies (including, but not restricted to, holding period decisions) generate different tax liabilities, and therefore different after-tax returns and rankings. To the extent that taxes on distributions are reasonably within the control of fund managers, investors should monitor their funds' tax implications in much the same way that they monitor the funds' risk and diversification characteristics. Erosion of pre-tax returns caused by taxes on distribution easily exceeds management fees and brokerage commissions.

Such after-tax returns and rankings can be significantly and materially different from pre-tax returns and rankings. As shown by Mawani, Milevsky, and Panyagometh, an investor with the highest marginal tax rate in Canada lost approximately 135 basis points of the average pre-tax return to income taxes paid on the fund's annual distributions in the 1992-2001 period, resulting in an average tax efficiency of 85 percent.[21] The 343 funds analyzed ranged in their tax efficiency from 25 percent to 100 percent. Furthermore, the results showed that funds ranked adjacently on a pre-tax basis had almost a 50 percent probability of having their ranking reversed when the ranking was done on an after-tax basis. These results suggest tremendous potential for improvement in investors' resource allocation decisions, particularly if investors have access to consistently and regularly reported after-tax returns.

Any single algorithm to calculate after-tax returns may not be acceptable to all constituents, and all measures suggested in the literature have difficulties. However, lack of agreement on an algorithm should not imply that nothing be done. The mutual fund industry should help its clients to measure after-tax returns and educate them about the potential shortcomings of any measure.

As discussed earlier, Mawani, Milevsky, and Panyagometh's results reflecting the changes in relative performance ranking between pre-tax and after-tax returns depend on a single algorithm uniformly applied at the same periodic intervals to all mutual funds in the sample.[22] To the extent that non-uniform and non-regular or selective disclosure creates confusion for investors, the benefits of improved resource

21 Mawani et al., supra note 6, at 880.

22 Ibid.

allocation decisions are reduced. Thus, it is suggested that, even in the case of voluntary disclosure, the industry should adopt a standardized method for computing after-tax returns.

Some fund companies might argue that certain mutual funds attract only registered investments, and therefore disclosure mandated by securities regulators would impose a cost without any corresponding benefit. One option is for the industry to mandate the format of disclosure, but not require disclosure. That is, if funds report after-tax performance, it must be done regularly and in a standard format. Funds should have the option to not provide any after-tax data. If taxes matter to them, investors could choose to avoid investing in non-disclosing funds. Funds that wish to attract only registered investments would not be affected by such a disclosure regime, since they would not be subject to any incremental costs and therefore would experience no competitive disadvantage. If such funds decided to pursue the larger market of non-registered investors, the disclosure regime would motivate them to provide after-tax information in a format that would facilitate comparison with peer funds. Fund companies would also need to ensure that the fund manager's compensation is appropriately aligned to the performance measure (pre-tax or after-tax) advertised by the fund.