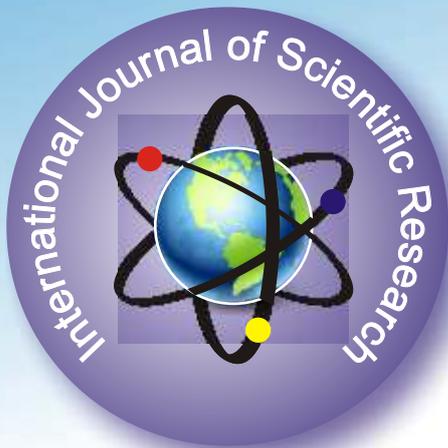


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Tax-advantaged Mutual Funds V/s. Rest of the Population

* Dr. Deepak H. Tekwani

June, 2012

Abstract

Mutual funds are considered as one of the best available investments as compare to others they are very cost efficient and also easy to invest in, thus by pooling money together in a mutual fund, investors can purchase stocks or bonds with much lower trading costs than if they tried to do it on their own. But the biggest advantage to mutual fund is diversification, by minimizing risk and maximizing returns. Mutual funds have shown a tremendous growth in India during the past decade.

These funds have allowed many unsophisticated investors easier access to the capital markets that were previously unavailable. These investments have grown tremendously and continue to make up a significant portion of the financial portfolios of many individuals. Given their increasing significance, this study will examine some of the information provided to investors and how that information is utilized by investors in making their investment decisions. More specifically, tax information provided by mutual funds can significantly impact the returns of individuals. This paper will examine the effects of taxes on mutual funds which affects the after tax returns of the investors.

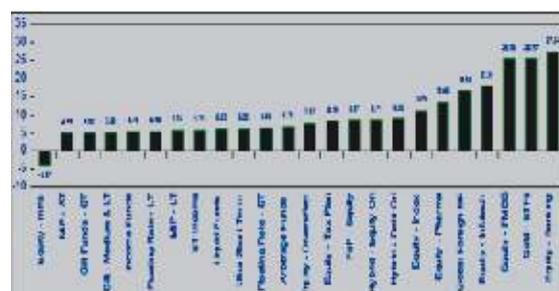
Keywords : NAV, Tax-Managed Mutual Fund, Churning ratio, After-tax return

Introduction

Mutual funds are required by law to distribute their earnings yearly and these distributions result in taxable income to investors. The distributions are taxed either as ordinary income and/or capital gains based on the trading strategy of the fund manager, not the holding period of the investor. This creates significant taxable income, which can significantly reduce the net return earned by mutual fund investors.

This paper deals strictly with open-end funds that can be easily bought and sold in an open market. These shares can be bought and sold at any time and the shareholder does not have to wait for a buyer. Open-end shares are sold back to the fund for their NAV and the mutual fund may have to sell some of its holdings to pay the shareholder. There are many choices available to open-end mutual funds that influence the risk and return of the fund. Funds can invest in stocks, bonds, and even money market funds.

Performance of MF categories during FY 11:



Tax-Managed Funds

In the late 1990's some funds in the mutual fund industry organized tax-managed funds to help alleviate the high tax costs associated with holding mutual fund shares. The stated

goal of the typical tax-managed fund is to decrease the tax costs to the shareholders thereby maintaining a high after-tax rate of return. Although these funds cannot totally alleviate the tax burden, they can decrease the burden it by decreasing the level of churning, holding growth as opposed to income stocks, and selling their holdings at losses or long-term gains before selling the shares of stock that were held only short-term. Another available option is to sell stocks with the highest cost basis first. Schwab has two funds that keep track of the stock's cost basis rather than averaging the cost basis for each position (which is done in many other mutual funds). This knowledge allows them to sell those shares with the highest cost basis first when the decision is made to sell.

Year on Year changes on MF investors' folios:

Financial Year	Equity Oriented Schemes			Financial Year	Debt oriented Schemes		
	No. of Folios	Change (in numbers)	Change (in %)		No. of Folios	Change (in numbers)	Change (in %)
2004 - 05	9,041,075	1,007,507	12.54	2004 - 05	3,245,694	-571,236	-14.96
2005 - 06	17,238,776	8,197,701	90.67	2005 - 06	2,966,669	-339,225	-11.41
2006 - 07	25,376,347	8,137,571	47.21	2006 - 07	3,161,699	235,820	8.77
2007 - 08	37,766,259	12,389,912	48.82	2007 - 08	2,989,743	-171,946	-5.44
2008 - 09	41,131,623	3,365,364	8.91	2008 - 09	3,299,198	339,451	10.35
2009 - 10	41,118,795	-12,828	-0.03	2009 - 10	3,738,602	439,408	11.33
2010 - 11	39,290,289	-1,828,496	-4.45	2010 - 11	4,537,405	798,793	21.09

Financial Year	Grand Total		
	No. of Folios	Change (in numbers)	Change (in %)
2004 - 05	13,845,792	798,032	5.45
2005 - 06	21,788,215	7,942,923	57.37
2006 - 07	30,366,707	8,578,492	39.37
2007 - 08	43,796,378	13,429,371	41.22
2008 - 09	47,951,517	4,155,139	9.52
2009 - 10	40,174,920	-7,776,597	-18.44
2010 - 11	47,233,262	7,058,342	17.15

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Development of Hypotheses

The hypotheses relates to that is testable via archival empirical markets data. The empirical data looks at the equivalence of the returns that are earned with a tax-managed fund versus a nontax-managed fund.

In examining the archival data, the first question to be asked is whether after-tax returns of tax favorable funds are comparable with the after-tax returns of the overall fund population. An investor would not consider investing in tax efficient funds if the returns on these investments were well below the remainder of the mutual fund population. Without a suitable alternative, the tax situation surrounding mutual funds would have to be accepted.

H1: Average after-tax returns of funds that are actively tax managed are not statistically different from the average after-tax return of the overall fund population

Research Methodology

Empirical Test:

The empirical test will utilize historical data on the after-tax returns of the funds along with historical churning or turnover rates. The data to be employed in the study will be taken from Morningstar India for Mutual Funds. Year to date data along with three year average data will be utilized. The sample contains 127 observations for tax-managed funds with year to date return figures and 59 observations for tax-managed funds with three year average returns.

Results of the Analysis

Data from Morningstar India was used to test the hypothesis that "Average after-tax returns of funds that are actively tax managed are not statistically different from the average after-tax return of the overall fund population." Birla life has a category of funds that are classified as tax-managed and the tax-adjusted returns of these funds were tested using least squares regression against the returns of the fund population. This is similar to a comparison of means t-test but allows for control of other variables if necessary. The final results for both tests are identical in comparing the average returns of both samples and determining if they are statistically different.

A total list of 7047 funds was compiled from the fund database (137 of which are tax managed & 6910 are not). For the most part, these are Indian stock funds although a portion of the funds have partial bond investments in addition to their stock holdings. The tax managed funds mainly had zero bond holdings with only one fund having bond holdings of less than 1%. 5,300 funds that were not tax managed had zero bond holdings, while 615 funds had bond holdings that did not exceed 5% of their total portfolio, 350 funds had bond holdings between 5% and 20%, and only 200 funds had bond holdings between 20% and 49%. Of the funds in the sample there were some funds with missing data. Therefore, the sample sizes for the various regressions, ranged from 4366 to 6657. The variance in the amount of observations was mainly due to funds being in existence for a period of less than three years. The database also was missing some return data and turnover data for specific funds, therefore those funds were deleted from the sample. The regression equation that included the year-to-date data had the larger sample of 6,537 observations for the total funds and 127

observations for the tax-managed funds. The regression equation with the three year average data had the lower sample size of 4,307 observations for the total funds and 59 observations for the tax-managed sample. This discrepancy is mainly due to the limited life of a portion of the funds; many of the funds were not in existence at the start of the three year period.

Conclusion and Discussion

The empirical results provide support for the importance of tax-managed funds to investors that want high net returns. The tax adjusted returns for both year-to-date and a three year average were not found to be statistically different from the entire fund population. In addition, the year-to-date after-tax returns were found to be higher (marginally significant) for tax-managed funds than the remaining fund population. The composition of the tax-managed funds was examined further, and was found to have significantly lower turnover ratios than the rest of the fund population. This study also found that funds with lower turnover had statistically significant higher after-tax returns both for year-to-date returns and three year average returns. Investors choosing to maximize their after-tax returns should select funds with a low turnover and tax-managed funds due to their having a greater likelihood of keeping turnover low.

The empirical results provided evidence that low turnover was found in funds that had high after-tax returns. The experimental results though found that investors did not utilize the turnover rate in their decision making process. In addition, distribution information that would be important to investors if they had not been given after-tax returns, were not found to be utilized by investors in their investment decisions.

The study results provide evidence that the tax-adjusted returns for tax-managed funds are not significantly different from the overall fund population. In addition, funds with the tax-managed quality of low turnover have significantly higher tax-adjusted returns than the overall fund population. These results provide incentives for investors to put more of their taxable monies into tax-managed or tax-beneficial funds. The increased trading or turnover of fund managers does not seem to be beneficial to the net returns of investors. This evidence gives investors incentive to place funds in funds with low turnover and high after-tax returns.

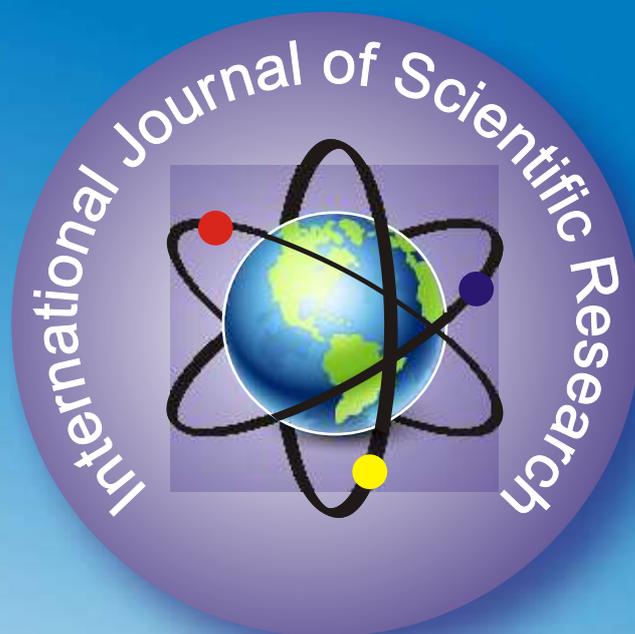
Findings & Suggestions

The clarity of a single, transparent, pre-calculated fee figure would be more beneficial to potential investors in their investment decisions.

This study provides evidence that funds with low turnover have significantly improved after-tax returns and investors find those after-tax returns have greater benefit than pre-tax returns in their investment decisions. It follows that investors would choose to place their taxable dollars into tax-managed mutual funds or mutual funds that have the tax-beneficial quality of low turnover. This should be a signal to mutual fund management to change their fund strategies to decrease the turnover or the stocks in their portfolios and try to manage the trading of their stocks to improve the after-tax returns of the fund. In addition, mutual funds should look to the trends of tax-advantaged trading and provide more tax-managed funds for investors. Another differentiation that can be made by fund managers is between funds for tax-free investing versus taxable investing.

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