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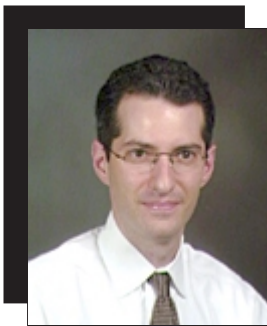
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By Steven M. Sheldon, CFA

About SMS Capital Management

SMS provides investment management services to individual investors desiring to preserve and build long-term wealth. As a fee-based firm, SMS has an independent, objective and sound approach to portfolio management. The firm is a Registered Investment Adviser.



About the Founder

Steven Sheldon has more than ten years of professional experience analyzing and managing investments. Prior to founding SMS, Mr. Sheldon worked as a senior member of a corporate principal investments group where he managed a \$100 million portfolio. Mr. Sheldon has an MBA from Tulane University and a BBA from The University of Texas. In addition, he is a CFA charterholder and a member of both the Association for Investment Management and Research (AIMR) and the Houston Society of Financial Analysts (HSFA).

Letting It Ride: Reinvesting Mutual Fund Distributions

If you bought a growth-oriented mutual fund during the late 1990's market boom by now you've surely made a couple of disturbing discoveries. First, despite the recent run up in the stock market, the current value of your fund may still be worth less than your original investment. Second, your tax basis (the amount used to calculate a realized gain or loss when the fund is sold) exceeds your original investment by a sizable margin, meaning your loss is actually more than you thought.

While the brutal bear market may explain your fund's disappointing performance over the past several years, the reason your tax basis (and loss) is so much higher than your original investment may be less obvious and require some explanation.

Investing On Autopilot

Upon initial investment, most mutual fund investors check a box on the fund application form that instructs the fund company to reinvest all distributions back into the fund, essentially "letting their earnings ride". Other options made available to mutual fund investors are to receive distributions in the form of a check or have the cash invested in another fund (money market account or another type of mutual fund offered by the fund family).

By law, mutual funds are non-tax-paying entities. As such, they are required to distribute at least 90% of the fund's realized income to its shareholders on at least an annual basis. When fund managers generate realized gains from trading activity (either short-term or long-term gains), collect dividends, or earn interest income on the securities held in the fund, the fund passes those earnings through to the fund shareholders in the form of distributions.

Buy High, Higher and Higher

During the 1990's bull market, most stock funds' Net Asset Values (NAV's reflect the price per share of the fund) rose significantly. As a result, fund shareholders kept reinvesting their annual distributions at increasingly higher prices, thereby increasing their taxable basis in the fund.

For example, an investor that purchased \$10,000 of the "Janus Fund" at the beginning of 1998 and elected to reinvest all distributions would have reinvested approximately \$6,000 (60% of the original investment) of distributions,



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almost entirely comprised of capital gains, over the next five years. However, given the fund's eventual decline, the value of the investor's total holdings (including the additional shares acquired through reinvestment) at the end of 2002 were approximately equal to the same \$10,000 original investment. Further, the investor would have paid taxes on the \$6,000 of distributions in the years in which the distributions were made (assuming the investment was in a taxable account). Since distributions retain their character at the individual taxpayer level, short-term capital gains and interest income generated by the fund are taxed at ordinary income tax rates for the investor (which can be as high as 35% under the new tax laws).

In the Janus Fund example, the investor's tax basis at the end of 2002 was \$16,000 (the initial \$10,000 investment plus the \$6,000 in taxable distributions), meaning that a sale of the total holdings at that time would have resulted in a \$6,000 realized loss. In summary, the investor made no money on the entire investment and is out an additional few thousand for taxes paid.

Everybody Does It

So why are investors so cavalier with distributions as if they were "doubling down" on a \$2 hand of Blackjack?

For starters, investors are probably unaware of the potential size of capital gains that can be generated during a bull market (particularly with funds with relatively high portfolio turnover), as was the case in our Janus Fund example. Secondly, reinvesting distributions is commonly thought of as a form of dollar-cost-averaging where the investor accumulates shares in a fund over a period of time, thereby lowering the risk of buying high in one lump-sum purchase.

For dollar-cost-averaging to be effective, however, fund purchases need to be systematic with regard to the dollar amount and frequency. By keeping the dollar amount of purchases fixed and regular, the object is to accumulate more shares when prices are low and fewer shares when they are high.

Unfortunately, most investors lack the discipline to make consistent purchases through both up and down markets. In fact, by nature retail fund investors are notoriously drawn to asset classes that are on the rise and shun those that are performing poorly. This innate bias leads them to make initial and follow-on investments in a highly-priced environment for a particular asset class. They are also just as likely to halt or avoid investing in funds that are not performing well. In our prior example, it is unlikely that the Janus Fund investor averaged



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down costs by making additional fund purchases right through the bear market lows. In fact, the investor probably sold all his shares and took the loss at the market bottom.

Further, mutual funds managers tend to lock in gains for their funds by selling stocks (creating distributable capital gains) when stock prices are going up. Therefore, more reinvestment takes place while stock market prices are elevated, further skewing the purchases to the high side.

In the long-term, reinvesting distributions may produce great returns, depending on your time horizon and the quality of the fund manager. Regardless, investors should be aware of the potential downfalls of simply “letting it ride.”

How Does SMS View Mutual Fund Distributions?

SMS views fund distributions as a form of **return on investment rather than as an automatic reinvestment**. With this distinction in mind, SMS consciously determines where to invest its clients’ distributions as if the funds were an entirely new investment.

SMS continuously weighs the risk/return profiles of particular asset classes against clients’ specific investment objectives and risk tolerances and makes investments and adjustments to portfolios accordingly.