Real Money
Rob Rikoon

Making money in the markets is hard but keeping it in your pocket can be even harder. People have a right to know ahead of time how much of their hard earned money is going to end up in someone else's pocket. I'm talking about taxes and fees, two things people rarely know much about. There are a lot of investors who have had to pony up money this past month to Uncle Sam on mutual funds that lost money in calendar year 2000.

Imagine how indignant you would be if you got robbed or lost property in a fire and then had to pay the IRS for the privilege! Here is how this can happen. By law, mutual funds are required to report to the government for any trading they do during the year. As a result, every person who holds the mutual fund on December 31 gets their share of that year's entire tax bill, even if they bought it only a week before! Fund managers don't have to advertise their after-tax returns, so they really don't have an immediate need to care how their individual investors fare, as long as their published numbers look decent.

The effects of this injustice can be considerable. For someone in the top Federal and New Mexico State tax brackets, 39.6% and 8.5% respectively, owning a fund that trades stocks held for less than one year can subject the investor to paying out in taxes almost one half (39.6 plus 8.5 or 48.1%) of the amount distributed by the fund. This is because short-term capital gains are taxed as regular income. So, in addition to losing money on paper in a declining stock market, the unwitting shareholder has to pay cash, out of pocket, on money they have never seen.

Because of the stock market's run up from 1997 to 1999, many funds had huge undistributed capital gains at the start of year 2000. Anyone buying the fund in 2000 or 2001 has been subject to tax on those gains, even though they personally have not made any money. Investors have no control over when this kind of tax will be levied on them, but as the market goes down, nervous shareholders can and do decide to sell at the worst possible moment, thereby forcing the fund to liquidate positions, which in turn triggers the tax.

What can you do to offset this inherent disadvantage of mutual funds? Since many investor's accounts declined in value during the 1st quarter of 2001, look closely at your holdings to see if you can do something we call 'swapping' or 'tax harvesting'. This involves realizing current losses and stashing them away for use later in the year to offset the sale of other holdings that may have gains. Even if you don't have current gains, the losses can be used against your earned income, up to $3,000 per year. A friend of mine calls this "turning lemons into lemonade."

The question then becomes, what do you do with the cash or proceeds from these sales. We have seen some people just sit on the money, waiting for a "bottom." Even professionals can't spot the time when pessimism is finally overcome by optimism, so the risk of being out of the market is, to us, unacceptable. A better course of action is to find a suitable substitute for the fund or stock that has just been sold. The IRS rules say you can't immediately go out and re-buy what was just sold; it is necessary to wait at least 31 days.

However, you can immediately buy a similar type of security, such as using Juniper to replace Cisco, Ford for General Motors and the like. In this way, you maintain the same risk profile and participation in the market as before while insuring that you do not run afoul of the tax code. This is what "swapping" one security for another means. The performances of the stock sold and the new one bought at the same time should be "highly correlated," which means the 2 securities should move in the same direction, at the same time, in roughly the same amount so that the portfolio will perform roughly the same as if one owned the original holding.

In this way, you can avoid becoming a market time. The only one who loses in this move is the government! People who feel that their best choice is to continue using mutual funds should consider swapping out of funds with losses into index funds, such as the S & P 500. An even better choice would be "exchange traded funds" (ETF) such as the Dow 30, S & P 500, NASDAQ 30 or Russell 2000. ETF's never have the built in capital gains headaches described as inherent in most mutual funds. Index funds purport to have very few carry forward built in gains but we have seen mutual fund holders in indexes be slammed by large distributions caused by other shareholder's liquidations. Another big advantage of ETFs over mutual funds is their much lower expense charges.

Whether you use mutual funds, indexes, a private money manager, or a broker to choose investments, it is important to know what is considered to be a reasonable amount to be charged for asset or portfolio management services. Investors in broker sponsored managed fund programs get charged 1% for someone to pick the funds or managers, 1% or more by the mutual funds is levied by the fund or manager themselves, and there is usually another charge from the firm sponsoring the 'consultant' or advisor.

The issue of investment expenses is not well understood by many people nor is it articulated well by many financial companies. Sometimes, I think the many layers of fees are purposely buried in complex prospectus or complicated agreements because salespeople would be embarrassed by the truth. We see people who don't know any better paying excessively large fees for "managed account programs", also called 'separate' accounts or "wrap" accounts. They are advertised as an all-in-one fee, with no commissions, but this is not really the case.

Many financial firms tell consumers they are getting a great deal by paying these fees that range from 2.5% to 3% annual charge. Here is how it actually works: a local salesperson turns to their firm's stable of outside managers and then a complex marketing arrangement begins. The actual portfolio manager, who the client never gets to meet or talk to, usually only receives one half of 1%. Don't be fooled into thinking that these fees are fixed. By asking for a discount, we have seen the cost for these pre-packaged services reduced overnight from 3% down to 1.5%, but only if the threat of discontinuing the whole program is brought into the equation. If a salesperson tells you they have no power over the cost, look elsewhere for advice.

Brokerage or sponsoring firms makes a great deal of money on these pre-packaged accounts because the actual average annual cost of trading on a moderate risk account is usually quite low, around one tenth of one percent. Even the best managers rarely add 3% to a portfolio's return year after year so keep your eyes open. One way to protect yourself is to look for a <u>total</u> expense ratio of close to 1.5%. Relationships that involve a good deal of ancillary services, such as estate tax planning, budgeting, etc. warrant higher fees. Remember to ask for a full written disclosure of all fees to be paid and any penalties for changing your mind. It should be signed by the broker or advisor and on their company letterhead.

Maybe it's time for you to roll your sleeves up and get involved in doing your own analysis. Being aware of your after tax and after fee returns is essential. After all, that's what you get to spend. As the old Yiddish Proverb says, " With money in your pocket, you are wise and handsome and you sing well too!"

Rob Rikoon is the President of Rikoon-Carret Investment Advisors, located at 510 Don Gaspar, Tel (505)-989-3581. He will be hosting a round table discussion group on investment issues, on Thursday, May 17th at 3:30. It is free and open to the public.