



# Investment Insights

Kevin Kennedy

## Loving The Losers

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In my previous column, I wrote about how mutual funds can be a great addition to many investor's portfolios. This week, I'd like to highlight a little-known advantage that exists for investors in many mutual funds today. As a result of two years of negative returns in the stock market, many mutual funds have capital loss carry-forwards that can shelter profits for years to come.

To understand how this can be advantageous, we first need to look at how mutual funds are treated from a tax standpoint. Let's consider a hypothetical fund called "XYZ Growth Fund" for this example. When the manager of the XYZ Growth Fund sells a stock in the portfolio, he or she may be selling that stock at a profit or loss. Tens or hundreds of such trades may take place in a given year within this hypothetical mutual fund. At the end of the mutual fund's tax year, the manager adds up all of the profits and losses and reports a realized capital gain or loss. If the net result of all of the transactions is a realized gain for the portfolio, the gain must be distributed to shareholders, and the shareholders must pay taxes on the gain (this is reported to shareholders on Form 1099). If the result is a loss, this loss is not distributed, but instead is held by the fund as a carry-forward loss. It can then be used in future years to offset realized gains in the portfolio, much like individuals can use capital losses to offset gains in their own investing.

Because of the negative returns the US markets have experienced over the past two years, many mutual funds have loss carry-forwards. In fact, according to Morningstar Inc., there are over 50 mutual funds as of 12/31/2001 that receive their highest rating, five stars, and have loss carry-forwards equal to 25% or more of the assets of the fund! New investors to these funds can take advantage of this by buying into these funds now knowing that the next 25% (or more) of realized gains the fund racks up will not be distributed to them because of the carry-forwards. Thus, any taxes that would normally be due on these gains is deferred, and money that normally might be needed to pay capital gains taxes can instead remain invested to grow and compound more.

Please note that this does not mean you will *never* pay taxes on the profits the fund generates—the profits of the fund are reflected in an increasing share price, and when you sell your shares of the fund you will pay taxes on that profit. What the loss carry-forward *does* do is defer taxes so that realized profits can stay in the fund and will not

have to be distributed to you and taxed. Thus, the money can stay in your account and compound even faster.

Also, be aware that you are looking at loss carry-forwards as a percentage of the assets in the fund, so if the fund experiences a large inflow of new investor money, the loss carry-forward is diluted by the larger asset base.

Sources like Morningstar Inc ([www.morningstar.com](http://www.morningstar.com)) or a current prospectus can tell you whether a fund you are interested in has loss carry-forwards. A word of caution—just because a fund has loss carry-forwards does not mean it offers a great investment opportunity, it may just be a poorly-managed fund that hasn't, and may never, turn a profit! But taking advantage of loss carry-forwards may be one way to use the downturn in the market to your advantage.

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