



Investment Insights

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Loving The Losers

As we embark on a new year, many investors are reviewing their results for 2002, and deciding on changes to make in their investment portfolios. An interesting and potentially beneficial situation exists in many mutual funds that you may want to use to your advantage as you look for new investment ideas. As a result of three 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 three years, many mutual funds have loss carry-forwards. Some of the best sectors to look for these funds include growth funds, which have suffered the most from the bear market. There are many four- and five-star Morningstar-rated funds that have racked up sizeable losses due to the overall decline in the stock market. New investors to these funds can take advantage of this by buying into these funds now knowing that a substantial part of the realized gains the fund racks up may 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) 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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