Advertising Mutual Fund Returns: A Critical Analysis of a U.S. Securities and Exchange Commission Proposal to Change Advertising Law

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The Mutual Fund Tax Awareness Act of 1999 was introduced in the U.S. House of Representatives for the expressed purpose of requiring the U.S. Securities and Exchange Commission to change mutual fund disclosure and advertising law to better inform investors of the tax implications of various mutual funds. The Commission's proposed change in advertising law has inadequately addressed this congressional mandate and may lead investors to make poorer, not better, decisions.

Mutual funds have become the largest financial intermediary in the United States. The Investment Company Institute (1999), the primary industry association for mutual fund companies, estimates that 77.3 million people in the United States directly own shares of mutual funds. By pooling the assets of many investors for collective investment, mutual funds offer investors with relatively modest wealth unprecedented access to capital markets. Far from being an investment instrument of the wealthy, mutual funds are marketed to and purchased by a wide cross-section of the public (Geer 1997).

Mutual funds are advertised extensively through popular media outlets. In 1999, the mutual fund industry spent $324 million advertising its funds. This represents an increase of 75% over the $185 million that fund companies spent in 1995. The largest advertiser in the industry, Fidelity Inc., increased its advertising expenditure to slightly less than $40 million in 1999, an increase of 120% relative to its expenditures just a year earlier (*Mutual Fund Market News* 2000).

Mutual fund advertising is regulated by the Securities and Exchange Commission (SEC) through regulatory authority granted in the Securities Act of 1933 (15 U.S.C. 77a) and the Investment Company Act of 1940 (15 U.S.C. 80a-1). Recently, in no small part because of pressure from the U.S. House of Representatives, the SEC has turned its attention to amending advertising law to better disclose to investors the consequences of taxes in mutual fund returns.

Taxes impose a significant burden on mutual fund investors. Recent data indicate that over the past five years investors have surrendered approximately 15% of their mutual fund returns to taxes (*Wall Street Journal* 1999). In addition, two mutual funds that might otherwise appear quite similar can impose very different tax burdens on their investors because of relatively small differences in the way the funds are managed. For this reason, the U.S. House of Representatives undertook steps to increase investor awareness of this issue.

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A Brief Legislative History of the Mutual Fund Tax Awareness Act

The Mutual Fund Tax Awareness Act of 1999 (H.R. 1089, 106th Cong., 1st Sess., p. 1) was designed "to require the Securities and Exchange Commission to require the improved disclosure of after-tax returns regarding mutual fund performance, and for other purposes." The act envisions that improved disclosure about after-tax performance will further clarify mutual funds' marketing communications and lead to better investment decision making.

The SEC responded to the Mutual Fund Tax Awareness Act by proposing a rule that would amend the tax disclosure requirements imposed on the prospectuses of mutual funds and would similarly modify existing advertising rules (Release File No. S7-09-00).[1] I believe that modifying existing advertising law according to this rule would not serve the investing public well. The proposed rule contains serious omissions that will undermine its ability to be effective and could lead to investment decision making that is poorer, not better, than is currently observed. The rest of this article sets out a case for modifying the currently proposed change in advertising law.

How Mutual Funds Generate Taxes

To understand the shortcomings of the proposed advertising rule change, it is first necessary to understand how mutual funds generate taxes for investors. Mutual funds can generate taxable income to their investors in several ways. First, some of the assets held by the mutual fund may pay periodic dividends. Investors can elect to receive these dividends

[1]Advertising rules imposed by the SEC are contained in Rule 482 under the Securities Act of 1933. As a practical matter, the SEC allows the National Association of Securities Dealers to police the advertising practices of the industry.

Figure 1. Example of Taxable Distribution

A mutual fund currently owns two shares of the company Example.com. The shares were purchased by the fund at $5 per share and are currently selling for $10 per share. The fund has issued two shares of its own, owned by Investor A and Investor B. The current net asset value per share of the fund is thus $10 per share.

Investor B decides to sell his or her share in the mutual fund. To generate the cash to pay Investor B, the mutual fund must sell one share of Example.com. Selling this share generates a $10 – $5 = $5 capital gain at the fund level. This capital gain is distributed to the remaining shareholder, Investor A. The net asset value of the mutual fund drops to $5 per share. Investor A chooses to reinvest the distribution. With the $5 distribution, he or she purchases an additional share of the mutual fund. Investor A now holds two shares of the fund valued at $5 per share.

Investor A must now pay .20 × $5 = $1 in capital gains taxes. This effectively leaves $9 instead of the pre–capital gains distribution $10 in assets.

directly or to reinvest the proceeds in additional shares of the fund. In either case, current tax law treats dividends as ordinary income. Thus, investors will pay the same marginal tax rate on these mutual fund distributions as they would on income obtained from noninvestment sources. Second, a mutual fund can generate capital gains taxes at either the individual or the fund level. Individual-level capital gains taxes occur when investors sell shares in a mutual fund for a greater price per share than that at which they purchased them. For example, if an investor buys 100 shares in fund XYZ for $8 and sells the shares later for $10, he or she would be taxed on the $200 capital gain received.

More important for this discussion are capital gains taxes created at the fund level. As a mutual fund buys and sells assets, it creates taxes for itself just as an individual investor would. The taxes that a mutual fund generates through these purchases and sales are, by law, passed through to individual investors through what is commonly called a "taxable distribution." Unlike the individual-level taxes described previously, these fund-level taxes occur not because of any action taken by the investor but rather by actions taken by the manager of the mutual fund. The investor has virtually no control over the taxable distributions of a fund. These two types of capital gains taxes, individual- and fund-level, are best understood through the simple example in Figure 1.

As is evident from Figure 1, existing shareholders are penalized when the fund makes a capital gains distribution. These distributions at the fund level have the effect of accelerating the taxes imposed on current investors. It is true that, sooner or later, Investor A would have to pay taxes on his or her gain. At some point in the future, Investor A will sell the shares and incur taxes at the individual level. Capital gains distributions force current investors to pay their taxes sooner rather than later. Because future interest, or returns, will be lost on the money the investor pays in taxes, accelerating these taxes drives the net return to existing investors lower. This is the basic logic behind the advantages of tax-deferred 401(k) or 403(b) retirement savings. Deferring taxes generally raises net return to the investor.[2]

The Role of the Mutual Fund Manager in Determining Taxable Distributions

The simple example in Figure 1 characterizes a situation in which the fund manager has little choice but to make a taxable distribution. In many situations, however, mutual fund managers have considerable control over the amount of taxable distributions their investors will face. Fund managers, to a large degree, control the turnover rate of their funds. That is, they control decisions to buy and sell the assets that are held in the fund. Each time a manager sells an appreciated asset a taxable distribution is created. If managers wish to minimize taxable distributions to current investors, they can simply hold (not sell) assets for a long time. Thus, managers who buy and sell assets frequently (high turnover) generally place their current investors at a tax disadvantage relative to managers who trade assets less actively. The high turnover rates of some funds, and the resulting tax burdens they place on their investors, gained the attention of federal legislators.

The SEC has responded to this congressional mandate by proposing a change in the way mutual fund prospectuses are written and by changing advertising law (SEC S7-09-00). In short, the proposal requires mutual fund companies to display their after-tax returns in their prospectuses and further

[2]Many academics reading this article will have some or all of their retirement savings invested in TIAA-CREF funds. This is an example of a 403(b) tax-deferred retirement plan. Many who work for industry have access to similarly structured 401(k) plans.

requires that all advertising containing information on after-tax returns be formatted in a way spelled out by the proposal. The method for computing annual after-tax returns is contained in the proposal.

The Dangers of Embedded Tax Liabilities

The previous argument is simple enough. High turnover accelerates the tax liabilities of current investors, which leads to reduced net returns. The government is concerned about this issue and has proposed advertising rule changes that are intended to highlight annual after-tax returns. It is hoped that highlighting these returns will cause investors to place greater emphasis on this attribute in their mutual fund choice process. This in turn will create incentives for fund managers to take actions that reduce the tax burden to their investors. This logic, however, tells only part of the story.

New investors face a danger from what is commonly termed an "embedded tax liability" in a fund. An embedded tax liability is a measurement of the dollar assets held in the fund that would be subject to capital gains taxes if the fund was liquidated. Because this number is computed relative to the dollar assets that are not subject to taxes, this number can (and often does) range above 100%. Returning to the example in Figure 1, because the stock held by the fund was purchased for $5 but appreciated to $10, the fund had an embedded tax liability of $2 \times \$5 = \$10$ or $\{[2 \times (10-5)]/(2 \times 5)\} \times 100\% = 100\%$ before the capital gains distribution. When Investor B sold his or her shares and the fund issued a capital gains distribution to Investor A, the fund effectively transferred its embedded tax liability to the individual investors. Investor B will have to pay a capital gains tax on the $5 he or she gained because of the fund's share price appreciation. Investor A has to pay taxes on the $5 capital gains distribution. The $10 embedded tax liability of the fund has vanished.

Revisiting this example illustrates a central point to this argument. Equity mutual funds that are successful (hold assets that increase in value) create tax liabilities. Although management exerts some control over when these liabilities will be realized, it cannot make them simply go away. Taxes on the $10 gained through appreciation must be paid eventually. The same steps fund managers can take to reduce capital gains distributions to current shareholders will necessarily cause the embedded tax liability of a fund to rise. The central question then becomes, Who does, or should, care if the embedded tax liability of a fund increases? The answer is new investors.

Whereas existing fund investors would generally prefer the fund to defer realizing capital gains indefinitely, new investors should avoid funds with large embedded tax liabilities. Large embedded tax liabilities at the fund level increase the present value of new investors' tax liability. This liability measures the extent to which the fund is capable of generating a capital gains distribution. As such, it measures the risk exposure to new investors of a sudden accelerated tax liability. These risks are particularly acute if some event causes the fund to contract (e.g., a market downturn causes a sizable proportion of investors to exit the equity markets). Fund contraction forces management to generate cash to pay off investors who are exiting the fund. The need for cash requires the sale of assets held by the fund. If, on average, these assets are highly appreciated, their sale will create large capital gains distributions to the shareholders. This is the basic logic behind Barclay, Pearson, and Weisbach's (1998) model in which fully informed new investors avoid funds with large embedded tax liabilities, especially if market conditions are volatile.

There is little doubt that the vast majority of mutual fund investors do not understand the tax implications of the funds they hold. Although I know of no academic study that deals directly with this issue, two publicly available industry studies speak directly to investors' lack of knowledge in this area. A study detailed on the Dreyfus Service Corporation's (1999) Web site found that 82% of 1000 randomly selected investors were unable to identify the maximum rate for long-term capital gains. A similar study by the online mutual fund information service Brill Editorial Services (1999) found that approximately 60% of readers who chose to answer an online questionnaire were correctly able to identify factors that may influence after-tax returns. Note that the 60% figure was derived from a sample of people who were using the Internet to obtain information on mutual funds. This is hardly a representative sample and strongly suggests that knowledge of taxes in the general investing population is significantly lower. Thus, the world envisioned by Barclay, Pearson, and Weisbach (1998), in which fully informed new investors avoid funds with large embedded tax liabilities, is probably not particularly descriptive of the marketplace.

This relative ignorance is precisely the problem that the Mutual Fund Tax Awareness Act and the SEC's response to that act attempt to ameliorate. However, by focusing on only one dimension of the problem, the current SEC response, at a minimum, does not resolve the problem the Commission seeks to address, and under certain, realistic market conditions, the SEC's response could create more problems for investors than if the government took no action on the issue.

The problem with the current SEC proposal is that it requires fund companies to display their annual after-tax returns but does not require them to divulge their embedded tax liability. According to previous arguments, the same management actions that will tend to raise annual after-tax returns (i.e., low fund turnover) will also tend to build up a fund's embedded tax liability. In Barclay, Pearson, and Weisbach's (1998) full-information model, rational investors will balance the advantages of short-term tax efficiency with the risks of embedded tax liability exposure. However, considering the relative ignorance of investors on this issue and the ability of advertising to communicate information, the conclusion is clear: This new advertising law will lead investors to pay more attention to short-term tax efficiency issues, but these same investors will probably completely ignore the risks this short-term tax efficiency generates. These risks would then reveal themselves only in the event of market contraction, precisely the time that the consequences of investors learning about otherwise unconsidered elements of risk could be most detrimental. To illustrate this point clearly, Figure 2 presents a modified version of the example given previously.

Figure 2 depicts a bad situation for investor C, who has lost money on his or her investment. However, this investor will face a positive tax bill at the end of the year and is essentially left "holding the bag" as other investors exit the fund.

There is a way that investors can avoid these taxes: They can sell their shares in the fund and generate a loss at the individual level. This loss will offset the distributed capital gains and erase their tax bills. However, there are many reasons that investors would avoid taking this course of action. Selling shares in an equity mutual fund immediately after a market downturn might seem, perhaps quite reasonably, to be a bad strategy to some investors. Furthermore, many fund companies have now imposed "short-term trading fees" on their funds. Investors who hold shares in the fund for less than a prescribed period are assessed an often substantial exit fee when they sell their shares. In short, selling shares in the fund may impose serious costs on the investor.

Implications for the Proposed Advertising Rule Change

Advertising is a powerful tool for calling attention to particular attributes of a product. The SEC's response to the Mutual Fund Tax Awareness Act would effectively highlight one part of the tax implications of a mutual fund and ignore another. Because these two parts, short-term tax efficiency and embedded tax liability, are inversely related, the proposed rule will have the effect of steering investors toward funds with large embedded tax liabilities. It will also create incentives for managers of mutual funds to focus exclusively on short-term tax efficiency at the expense of their embedded tax liabilities. This could create serious and unexpected problems for many investors, particularly if market conditions cause a significant contraction in the assets of equity mutual funds.

Figure 2. Example of a Taxable Distribution in a Falling Market

A mutual fund currently owns two shares of the company Example.com. The shares were purchased by the fund at \$5 per share and are currently selling for \$10 per share. The fund has issued two shares of its own, owned by Investor A and Investor B. The current net asset value per share of the fund is thus \$10 per share.

Investor C buys a share of the fund for \$10. The fund uses the proceeds to buy another share of Example.com. The fund now owns three shares of Example.com with acquisition costs of \$5, \$5, and \$10.

The stock of Example.com drops to \$9 per share. This drop causes the net asset value per share of the fund also to drop to \$9.

Investors A and B decide to redeem their shares. To meet this redemption, the fund sells two shares of Example.com with a cost basis of \$10 for one share and \$5 for the other. This generates a realized capital gain of \$9 – \$5 = \$4 for the share purchased at \$5 and a realized capital loss of \$10 – \$9 = \$1 for the share purchased at \$10. Thus, the fund realizes a net capital gain of \$4 – \$1 = \$3. This is distributed to Investor C. The net asset value of the fund falls to \$6 per share, and assuming reinvestment, Investor C now owns 1.5 shares.

Although investor C's investment has generated a 10% negative return, he or she will still face a capital gains tax of .2 × \$3 = \$.60.

A change in advertising law that would require mutual fund companies to divulge their embedded tax liability if they advertise the tax efficiency of the fund would better approach the goal of the congressional mandate. This strategy would call attention to the issue and reduce the incentives for fund managers to take actions that are not in the best interest of investors. Even if investors do not fully understand the advertised embedded tax liability, such disclosures will alert them that they need to learn more about this issue. Requiring the inclusion of this information in advertisements would probably boost the amount of attention the popular press pays to this issue, spurring publications such as *BusinessWeek* and *Money* to write about it. Finally, it is relatively common in the market for financial services for consumers, or investors, to make decisions that affect their ability to retire, send their children to college, purchase a home, and arrange for many other contingencies about which people care a great deal. Many investors, a substantial proportion of whom have a fairly limited understanding of basic investing, have become much more involved in their own investment choices (Levitt 1998). It is therefore imperative that government agencies charged with regulating this industry carefully consider allocating additional resources toward educating the investing public. Effective and complete disclosure requirement rules would certainly be a step in the right direction.

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