Tax-efficient fund management pays off, study shows

By Editorial Staff *Thu, Aug 13, 2015*

A hypothetical investment of $10,000 in mutual funds in 1990 was shown to grow to $37,800 after 22 years in the most tax-inefficient funds and to $48,800 in the most tax-efficient funds.

Tax-efficient funds have tended to outperform other funds in before-tax and after-tax returns, according to “Tax-Efficient Asset Management: Evidence from Equity Mutual Funds,” a paper by Clemens Sialm of the McCombs School of Business at the University of Texas at Austin and Hanjiang Zhang of Nanyang Technological University in Singapore.

The authors hoped to find out whether or not tax-efficient fund management might in fact hurt after-tax returns by constraining the fund managers’ investment strategies. They found the opposite.

Shareholders of taxable mutual funds pay an average of about 1.12% of the value of their fund holding each year in dividend and capital gains taxes, the authors found. The annual tax burden rivals fund expenses and management fees, whose impact receives far more attention.

The authors examined U.S. equity mutual funds from 1990 through 2012, based largely on information from the CRSP Survivorship Bias Free Mutual Fund database that tracks fund returns, dividend and capital gains distributions, total net assets, fees, flows, and investment objectives.

On average, mutual funds that followed tax-efficient investment strategies generate better after-tax returns for taxable investors than funds that do not, the researchers found. Funds in the lowest tax-burden quintile over the prior three years exhibited excess returns net of taxes of -0.19% over the subsequent year. Funds in the highest tax-burden quintile, by comparison, exhibited excess returns of -2.29% after taxes. In other words, tax-efficient funds impose relatively less fee drag on the raw index returns.

The pre-tax return on funds in the lowest tax-burden quintile over the previous three years averaged 0.91 percentage points higher, in the subsequent year, than funds in the highest tax-burden quintile. Tax-efficient funds did not perform worse than their peers with regard to pre-tax returns.

An investment in 1990 of $10,000 in mutual funds in the highest tax burden decile would have compounded in 2012 to $55,800 before taxes and to just $37,800 after taxes. On the other hand, an equivalent investment in mutual funds in the lowest tax burden decile would have compounded to $58,900 before taxes and to $48,800 after taxes over the identical time period. Thus, investing in tax-efficient funds would have increased the final wealth of a typical taxable investor by more than $10,000.

Tax efficiency depends in part on the investment style of the fund. For example, small-cap funds may be forced to liquidate holdings in a company whose market capitalization gets too big, and vice-versa for a large-cap fund. Tax burdens also tend to be higher on funds that hold stocks paying high dividend yields and on funds that see high rates of redemptions and volatile investor flows.