Fund Research

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Which Funds are Most and Least Likely to Pay a Capital Gains Distribution?

Year-end capital gains distributions are very often the thorn in the side of investors who own mutual funds. Mutual funds that are structured as trusts can't pay capital gains taxes themselves, so the gains, along with the tax burden that comes with them, are passed on to unitholders in the form of a distribution. These distributions are often incorrectly viewed as being year-end bonuses, but fund companies aren't in the business of giving cash away and the payouts are in fact fully taxable at the relevant rate for capital gains. The best capital gains distribution is no distribution at all, but if it's any consolation, these distributions are generally a result of success within the portfolio.

The good news for fund managers (and ordinary taxpayers too) is that capital gains may be offset by previously incurred capital losses, and the greater the magnitude of the losses, the longer the fund can go before a distribution will have to be paid. The question then becomes, which funds have significant capital losses on the books? Fortunately, a fund's loss carry forwards are fully disclosed in its financial statements, and yes, we've compiled this information for you.

For the record, mutual funds can incur two types of losses. First are ordinary capital losses, which occur when a security is sold at less than its cost. These losses are no different than the capital losses that investors themselves experience when they sell a security for less than they paid for it. Ordinary capital losses can be carried back three years and carried forward indefinitely. The figure carried on a fund's books represents the amount that can be used against any future gains.

Funds may also incur non-capital losses. These losses are typically much smaller than capital losses and they are generated when portfolio expenses exceed the income from interest and dividends. Non-capital losses may be carried back three years but can only be carried forward seven years, after which they expire. Such losses can be applied against all income sources.

For the purposes of this report we focused on capital losses. When a fund's capital loss carry forwards are divided by its year-end assets, the resulting quotient is a figure we've termed the Tax Loss Ratio, or TLR. To illustrate the relevance of this number, suppose a fund with assets of $100 million has a capital loss carry forward of $25 million. The TLR in this instance would be 25%, meaning that the fund could appreciate in value by 25% (relative to total year end assets), realize all of those gains and still not pay any distributions. In some cases, the TLR is so high that it could be years before investors would ever have to worry about receiving a capital gains distribution.

It should be noted that in some instances, funds that incur capital gains that can't be used against previous losses can hold back on paying distributions thanks to a provision in the Income Tax Act called the Capital Gains Refund Mechanism (CGRM). This provision allows for the avoidance of double taxation of capital gains by reducing capital gains distributions the fund is required to make at year-end based on an estimate of the capital gains realized throughout the year by redeeming investors. To keep things simple we've taken the CGRM out of the equation.

We do not endorse the idea making of investment decisions or fund selections on the basis of tax considerations alone, but the magnitude of the capital loss carry forward for a fund being considered for a taxable account can be a valuable input in the final investment decision.

A large number of funds have seen their loss carry forwards dry up over the past few years as a result of strong stock market returns. Nonetheless, there are still several instances where significant gains would have to be incurred on the part of the fund before capital gains distribution distributions become a reality.

We considered the tax loss carry forward situation for close to 200 of the country's most prominent funds, from 15 fund companies overall.

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Table I highlights the funds with the largest tax loss ratios from the universe we analyzed, and there certainly are some extreme cases. The crystallization of severe losses on the part of a fund is a major influence on the size of the TLR, but outflows magnify the ratio as well. Suppose a fund goes through a very tough period and accumulates $500 million in capital losses. At the end of that period, assume the fund has assets of $1.5 billion. The TLR would therefore be 33%. Now assume that investors decide to head for the exits en masse and the fund experiences outflows of $500 million. All else equal, the fund's asset base would then be $1 billion, the capital loss carry forwards would still be $500 million and the TLR would jump to 50%.

For many of the funds in Table I, a big chunk of the capital loss carry forwards were accumulated in the early part of this decade when their asset bases were substantially higher. The subsequent erosion of their asset base has pushed the TLR higher. The fund that tops the list, Mackenzie Focus, was previously known as Mackenzie Universal Select Managers. You may recall the story there – a multi-manager approach was employed and aggressive bets juiced returns during the latter part of the 1990's. Then the bottom fell out of the TMT market, investors headed for the hills, and the result in a portfolio with a TLR of 301%.

Table I: Funds with the Largest Tax Loss Ratio

Fund	Year-End Assets ($000)	Cap Loss Carry Fwd ($000)	Tax Loss Ratio
Mac Focus	672,669	2,022,518	301%
AGF Aggressive US Growth	338,715	587,094	173%
AGF Global Equity	81,830	116,105	142%
CI American Equity	300,398	243,426	81%
CI International Balanced	301,762	241,594	80%
Mac Universal European Opps	525,699	366,419	70%
AIC American Focused	400,729	238,480	60%
CI Global	1,406,580	528,315	38%
CI American Value	250,116	73,475	29%
Dynamic Power Small Cap	218,626	62,129	28%
Dynamic Power American Growth	359,208	87,443	24%
Fidelity Europe Fund	1,020,539	229,799	23%
AGF Canadian Small Cap	367,109	76,582	21%
AGF Global Value	3,263,332	671,887	21%
AIC Diversified Canada	1,337,116	226,414	17%
AIC Advantage II	743,144	107,762	15%
AIC Canadian Focused	546,726	77,341	14%
AIM Canadian Premier	936,527	131,415	14%
AIC Canadian Balanced	546,726	63,179	12%
AGF World Balanced	837,243	93,527	11%

Source: Company reports, Dundee Securities Corporation

A significant proportion of the TLRs that were around last year have either been wiped out or reduced. We considered approximately the same number of funds for the TLR piece we published last year, and Table II provides a sense of how dramatically TLRs have been whittled away. Strong equity market performance was no doubt the driver behind the changes.

Table II: Comparison of TLR Frequency and Magnitude

	This Year	Last Year
TLR of 20th Highest from Table I	11%	67%
Average TLR of Funds Considered	26%	64%
% of Funds Considered with TLR >0%	28%	39%

Source: Dundee Securities Corporation

Table III presents information that may have broader relevance as it highlights the tax loss ratio for only the largest funds of those we considered. Note that funds with no capital loss carry forwards were excluded from this table.

Table III: Tax Loss Ratios for Funds with >$1 Billion in Assets

Fund	Year-End Assets ($000)	Cap Loss Carry Fwd ($000)	Tax Loss Ratio
Templeton Growth	6,313,278	69,143	1.1%
AGF Global Value	3,263,332	671,887	20.6%
AGF Canadian Stock	2,796,048	40,484	1.4%
Fidelity Global	2,781,959	22,156	0.8%
Mac Ivy Foreign Equity	2,761,036	92,118	3.3%
Templeton International Stock	2,418,842	87,498	3.6%
CI Global	1,406,580	528,315	37.6%
AIC Diversified Canada	1,337,116	226,414	16.9%
AGF Canadian Growth Equity	1,124,836	14,049	1.2%
AGF Canadian Balanced	1,111,233	1,625	0.1%
Fidelity Europe Fund	1,020,539	229,799	22.5%
Mac Cundill Global Balanced C	1,004,405	9,161	0.9%
AIC Advantage	1,003,979	4,826	0.5%

Source: Company reports, Dundee Securities Corporation

It's reasonable to suggest that funds with no capital loss carry forwards are more likely to pay distributions down the road than funds with capital loss carry forwards. It is also fair to say that the likelihood of a fund triggering capital gains is greater when returns continue to be positive. Table IV reveals the funds that have no tax loss carry forwards to speak of and that saw positive performance on a YTD basis through June 30. We would consider the funds from Table IV with the strongest returns and the highest levels of turnover to be the most likely to pay a capital gains distribution at the end of the year.

Table IV: Large Funds with No Loss Carry Forwards and Positive YTD Returns Through June 30

Fund	Year-End Assets ($000)	Tax Loss Ratio	2-Yr Avg Turnover	YTD Return to June 30
Fidelity Canadian Asset Allocation	9,097,068	0%	85%	4.9%
Fidelity True North Fund	6,887,657	0%	47%	5.9%
CI Harbour Growth & Income	6,579,625	0%	16%	2.8%
CI Canadian Investment	5,538,406	0%	34%	1.8%
CI Harbour Fund	5,208,115	0%	18%	3.1%
AGF Cdn Large Cap Dividend	3,678,479	0%	31%	2.9%
CI Signature High Income	3,493,019	0%	63%	3.2%
Fidelity Canadian Balanced Fund	2,821,557	0%	46%	3.4%
Fidelity Canadian Growth Company	2,198,713	0%	79%	6.9%
Fidelity Canadian Disciplined Equity	2,096,396	0%	177%	6.9%
IA Clarington Canadian Dividend	2,016,271	0%	41%	0.6%
Dynamic Focus + Diversified Income	1,917,937	0%	1%	8.8%
Dynamic Power Cdn Growth	1,757,480	0%	156%	8.6%
Fidelity Monthly Income	1,516,890	0%	39%	1.5%
CI Signature Canadian Balanced	1,488,282	0%	98%	0.5%
Dynamic Focus + Balanced	1,382,120	0%	95%	10.0%
Acuity High Income	1,359,810	0%	129%	8.1%
Mac Universal Canadian Resource	1,354,260	0%	77%	11.6%
Dynamic Cdn Dividend Fund Ltd.	1,299,410	0%	29%	6.2%
Mac Universal Canadian Growth	1,181,174	0%	37%	1.9%
GGOF Monthly High Income II	1,011,238	0%	33%	7.1%

Source: Company reports, Dundee Securities Corporation

The funds in Table V are other large funds with no loss carry forwards, but these experienced negative returns for the six months ended June 30. Of course, anything can happen to returns over the next six months, so we felt it would be prudent to present this information.

Table V: Other Notable Funds with No Loss Carry Forwards

Fund	Year-End Assets ($000)	Tax Loss Ratio	2-Yr Avg Turnover	YTD Return to June 30
Mac Cundill Value C	7,440,437	0%	20%	-11.7%
Trimark Income Growth	6,496,933	0%	50%	-2.5%
Trimark Select Growth	5,360,446	0%	40%	-11.3%
Trimark Fund	5,097,476	0%	41%	-8.0%
Mac Ivy Canadian	4,456,270	0%	28%	-6.3%
CI Signature Select Canadian	3,896,107	0%	92%	-0.3%
Fidelity Northstar	3,776,733	0%	114%	-5.9%
Manulife Monthly High Income	3,690,787	0%	20%	-1.6%
Trimark Select Canadian Growth	3,432,951	0%	12%	-5.7%
Bissett Canadian Equity A	3,414,796	0%	24%	-1.6%
Brandes Global Equity	3,299,940	0%	34%	-17.4%
Mac Ivy Growth & Income	3,194,687	0%	28%	-4.0%
Mac Maxxum Dividend	2,817,181	0%	13%	-6.2%
Mac Cundill Canadian Security C	2,659,466	0%	22%	-10.3%
Trimark Canadian	2,575,258	0%	40%	-5.6%
Trimark Select Balanced	2,258,076	0%	42%	-3.3%
Mac Cundill Canadian Bal C	1,942,393	0%	21%	-6.4%
Templeton Global Smaller Cos	1,864,798	0%	17%	-10.9%
CI Signature Dividend	1,740,317	0%	49%	-4.4%
Trimark Global Balanced	1,699,067	0%	40%	-6.0%
Trimark Global Endeavour	1,613,706	0%	29%	-19.7%
Mac Cundill Recovery C	1,599,282	0%	26%	-12.5%
Trimark Canadian Endeavour	1,483,966	0%	32%	-14.6%
Mac Maxxum Dividend Growth	1,470,586	0%	13%	-6.3%
AIM Canadian Balanced	1,394,848	0%	45%	-1.8%

Source: Company reports, Dundee Securities Corporation

In the TLR piece that was published last year, we highlighted a number of funds that we believed were likely to pay larger than average distributions come year-end, and as it turns out, our analysis did display very strong predictive value. The funds we pointed out, which are listed in Table VI, paid an average capital gains distribution of 7.2% at the end of 2007 whereas the average distribution across all funds we looked at in our annual expected distributions piece was 4.3%.

Table VI: Fund that Were Predicted to be Candidates for Dist'ns and Actual Dist'ns Paid

Fund	2007 Year-End Distribution
Acuity All Cap 30 Cdn Equity	1.9%
Acuity Growth and Income	0.0%
Acuity High Income	0.0%
Brandes Sionna Canadian Balanced	1.3%
CI Canadian Asset Allocation	20.6%
CI European	6.6%
CI International	4.7%
CI Signature Canadian Balanced	16.2%
CI Signature Canadian Resource	14.0%
Dynamic Power Balanced	7.2%
Dynamic Power Cdn Growth	11.5%
Fidelity Far East Fund	11.0%
Fidelity Focus Financial Sevices Fund	4.7%
Fidelity Northstar	14.0%
IA Clarington Canadian Balanced	5.9%
IA Clarington Canadian Equity	2.8%
IA Clarington Canadian Income	0.3%
Average	**7.2%**
Average of all funds that paid distn's*	**4.3%**

**Based on our annual review of expected distn's*

Source: Dundee Securities Corp., Morningstar

Finally, we wanted to present a distribution horror story to illustrate an extreme case for capital gains distributions. AGF Aggressive US Growth, which historically has posted turnover rates of 250% or more per annum, posted an almost unbelievable return of 195% in 1999. However, the piper had to be paid in 2000, and the fund ended up losing 14% during the year. During 2000, the fund's turnover was 523% and the year end distribution was 23%. What's worse is that the fund lost 39% between the end of February and December 31 of that year. In other words, if you had invested in the fund at or near its peak, not only would you have had to deal with a severe loss of capital, but you would actually have had to have paid a very large capital gains tax bill as a result of the fat distribution that came your way. Talk about adding insult to injury!

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