

Reducing the IRS' Bite with Tax-Efficient Funds

- ▶ When investing the assets in clients' taxable accounts (e.g., trust, joint, and individual accounts), COMPASS takes great care to invest in the most tax-efficient manner possible.
- ▶ This approach involves the use of tax-managed and tax-efficient mutual funds, as well as maintaining a clients' bond exposure in their retirement accounts, when available, to avoid taxes on the interest income that would otherwise be due.

Handing over a portion of your investment earnings to the IRS is never pleasant. Fortunately, a specific category of mutual funds, called tax-efficient funds, might help you keep the amount you send to Uncle Sam to a minimum. Here's how tax-efficient funds work. Mutual funds must pay you almost all of the money they make from interest, dividends, or capital gains (money made from selling stock) in a year. That's called a taxable distribution (since you must pay taxes on that money). Tax-efficient funds keep their taxable distributions as small as possible, thus lowering the amount you have to pay in taxes. Tax-efficient funds can use several strategies to keep distributions low. They avoid stocks that pay dividends. They don't sell their stocks very often. When they do sell stocks, they might also try to sell some that have lost money to offset those that have made money. They could also hold stocks for more than one year before selling, since the profits are taxed at a lower long-term capital gains rate than short-term transactions. These methods, as

well as some others, keep your tax bill lower.

While tax-efficient funds seem extremely attractive, there are a few drawbacks to note. First, there are only a handful of these funds available from which to choose (relative to other categories). Second, of the funds that do exist, few have long-term investment records that you can analyze. Finally, most tax-efficient funds stick mainly with large-company stocks and tax-free (municipal) bonds. That means you might have to look at non-tax-efficient funds to get exposure to other types of investments in an effort to build a diversified portfolio.

Diversification does not eliminate the risk of experiencing investment losses. Past performance is no guarantee of future results.

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