COMPASS WATCH

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GIVE ME A (TAX) BREAK: TAX IMPLICATIONS OF MUTUAL FUND INVESTING

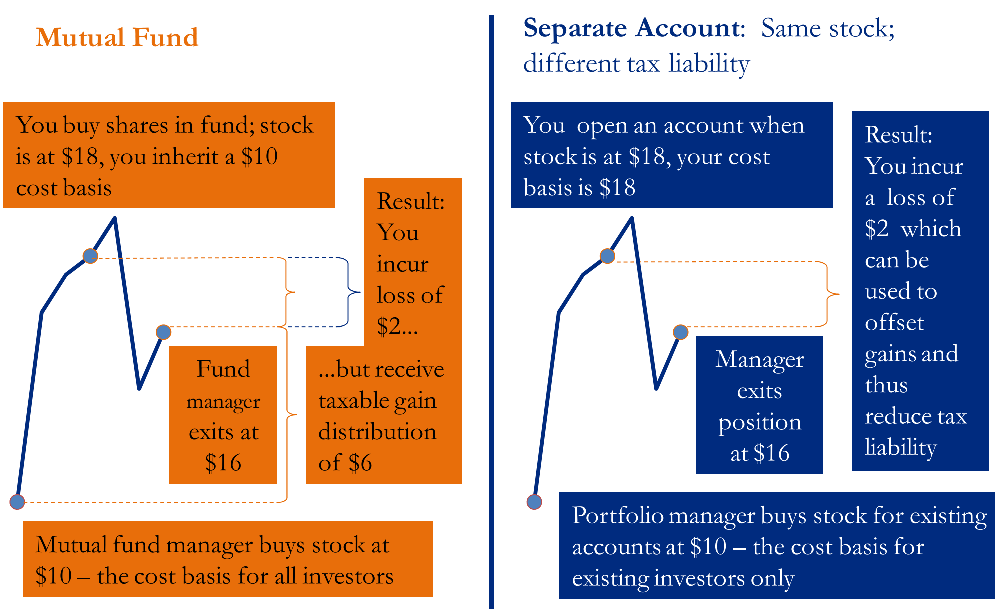
Investors looking to commit capital to the stock market have two primary options. They may choose either a pooled investment (e.g. mutual fund) or direct stock ownership. Both options appear to be equal at face value. However, one important, but often overlooked consideration is the tax implication of each option.

What's the difference and why should I care? An equity mutual fund registered under The Investment Advisers Act of 1940 pools money from many investors to invest in stocks. In this case, investors own a pro-rata and passive interest of shares in the mutual fund, not in the underlying securities. Conversely, in a separately-managed stock portfolio, investors have direct ownership in the companies and have all of the rights and privileges that accompany direct ownership. Why does this matter? Investors with direct ownership of stocks are provided benefits that include portfolio customization, transparency, portability and greater control over taxes.

Many equity mutual funds lack the tax-efficiency that can be managed easily with a portfolio of stocks. In fact, for mutual funds held outside of a tax-deferred account, investors could be footing the capital gains tax bill for gains they did not benefit from (see insert). Mutual funds are required annually to pass on 90% of its net investment income to shareholders based on asset sales inside the fund itself. For example, if your neighbors have to liquidate their mutual fund holdings to pay for college and you (holding the identical fund) may end up having to pay taxes on their transaction. How much sense does that make? Additionally, a mutual fund is prohibited from directly passing losses through to its shareholders. Furthermore, if you purchase mutual fund shares shortly before a dividend distribution, you may be "buying" a tax-liability. Finally, because mutual funds tend to wait until late December before announcing the amount they are distributing to shareholders, year-end tax planning is virtually impossible.

Simply stated, when an investor buys shares in a mutual fund, they inherit the fund's cost basis in the underlying stocks—many of which may have been purchased years before at low prices. As a result, the investor may end up paying capital gains tax on stocks that have lost value since they bought the fund. But when an investor holds individual stocks directly, the cost basis, for tax purposes, is the price paid for that stock when it was added to your customized portfolio. Of course, tax liabilities can still occur for stock investors.

Tax Implications[1]



[1] Morgan Stanley, 2015 (hypothetical illustration)

But, as each client account is separate, rather than being part of a larger pool, this allows for greater control over future tax consequences. For example, clients can take advantage of tax planning tools, including offsetting gains by "harvesting losses," identifying highly appreciated stocks that can be donated to maximize the benefits of charitable giving or passed along at death, eliminating any unrealized gains.

At Compass, we own a diversified portfolio exclusively of 25 mid-to-large sized and growing companies. Tax-efficiency and low-turnover are simply by-products of our long-term, disciplined investment philosophy we have been successfully using for nearly 27-years. How may we assist you?

For more information regarding our company, disciplines and results; please call, write, e-mail or visit our website: www.compasscap.com