ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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How Important Is Tax Efficiency?

Here at Adviser Investments, we feel the main goal of investing isn't to avoid taxes, but to maximize wealth. That said, careful consideration of tax burdens should be part of any investment strategy, so this week, we thought it'd be useful to look at the tax efficiency of funds from Fidelity and Vanguard over the three years through April.

Before we dig into the data, it's important to note that tax efficiency for funds is generally calculated in one of two ways. The first assumes you still own your shares at the end of the period, paying taxes on distributions along the way; this is the method we used to calculate the percentages you'll see below. The second assumes that you've sold all shares, meaning that it also accounts for any additional short- or long-term capital gains you've realized since you bought the fund (tax efficiency will generally be considerably lower using this method if your investment has gained value over time).

Because of Adviser Investments' long-term investment philosophy, we think it's more useful to look at the tax efficiency of funds you plan to hold on to. (When our clients are drawing down their accounts with us, however, we do consider how taxes will come into play when deciding what to sell, and together work out a plan that best meets each client's needs.)

Fidelity's Most and Least Tax-Efficient Funds

Fund	Symbol	3-Year Return	Tax-Adjusted 3-Year Return	Tax Efficiency
Growth Discovery	FDSVX	11.2%	11.1%	100%
Growth Strategies	FDEGX	9.3%	9.2%	99%
Nasdaq Composite Index	FNCMX	14.9%	14.6%	98%
Emerging Asia	FSEAX	7.3%	7.1%	98%
Japan	FJPNX	6.7%	6.4%	97%
Select Retailing	FSRPX	17.3%	16.8%	97%
Emerging Markets	FEMKX	3.7%	3.6%	97%
Stock Selector Large Cap Value	FSLVX	7.6%	7.3%	96%
Blue Chip Value	FBCVX	8.9%	8.5%	96%
Event Driven Opportunities	FARNX	11.4%	10.8%	95%
Total Stock Market Index				

Freedom Income	FFFAX	3.4%	2.1%	61%
Asset Manager 20%	FASIX	3.1%	1.9%	61%
Select Consumer Finance	FSVLX	6.2%	3.7%	60%
New Markets Income	FNMIX	6.6%	3.9%	59%
International Real Estate	FIREX	3.2%	1.8%	56%
Select Pharmaceuticals	FPHAX	3.2%	1.6%	50%
Global Balanced	FGBLX	1.8%	0.8%	45%
Leveraged Company Stock	FLVCX	4.0%	1.5%	37%
International Index	FSIIX	0.8%	0.2%	23%
Convertible Securities	FCVSX	2.3%	0.1%	4%

Source: Morningstar. Note: Three-year returns are annualized through April 2017. After-tax returns assume the highest applicable tax rate for each distribution and reinvestment of whatever's left after taxes. Funds with losses over the period were excluded from the table.

One thing that you might notice in the tables is that a handful of funds from each family have achieved excellent tax efficiency, but that their after-tax returns over the period were weaker than some of the funds that were less efficient. A clear example of this is Vanguard Market Neutral, which allowed investors keep 97.2% of their gains after taxes on distributions, making it the firm's most tax-efficient fund over the period. But, unfortunately for investors, it only generated a 2.0% gain per year while doing so. Compare that to the Explorer fund, which was one of Vanguard's 10 worst funds for tax-efficiency, but still gained 5.0% a year after taxes.

Vanguard's Most and Least Tax-Efficient Funds

Fund	Symbol	3-Year Return	Tax-Adjusted 3-Year Return	Tax Efficiency
Market Neutral	VMNFX	2.1%	2.0%	97%
MidCap Growth Index	VMGIX	9.2%	8.8%	97%
Growth Index	VIGRX	11.3%	10.9%	96%
Admiral Tax-Managed SmallCap	VTMSX	10.7%	10.3%	96%
FTSE Social Index	VFTSX	11.1%	10.5%	95%
SmallCap Growth Index	VISGX	7.1%	6.7%	95%
MidCap Index	VIMSX	9.3%	8.8%	95%
Extended Market Index	VEXMX	8.3%	7.8%	94%
Admiral Tax-Managed Capital Appreciation	VTCLX	10.3%	9.6%	94%
Total Stock Market Index	VTSMX	9.9%	9.3%	93%
Total Stock Market Index				
Explorer	VEXPX	7.5%	5.0%	66%
Managed Payout	VPGDX	4.7%	3.0%	64%
Emerging Markets Stock Index	VEIEX	2.0%	1.1%	53%
FTSE All-World ex-U.S. SmallCap Index	VFSVX	1.9%	0.9%	50%
Global ex-U.S. Real Estate Index	VGXRX	3.3%	1.6%	50%

Convertible Securities	VCVSX	2.5%	1.0%	38%
Admiral Developed Markets Index	VTMGX	1.4%	0.5%	36%
Total International Stock Index	VGTSX	1.3%	0.4%	30%
FTSE All-World ex-U.S. Index	VFWIX	1.3%	0.4%	29%

Source: Morningstar. Note: Three-year returns are annualized through April 2017. After-tax returns assume the highest applicable tax rate for each distribution and reinvestment of whatever's left after taxes. Funds with losses over the period are excluded from the table, as are multiple share classes of the same fund.

You might also notice that there are no funds with negative returns listed. This is not because there weren't any funds from the two firms that lost money over the period. We excluded these funds because investors had nothing to show at the end of the period, even though in every case they were stuck paying taxes on distributions, which resulted in negative tax efficiency. (A fund can also have negative tax efficiency if it has a positive pre-tax return that becomes a loss after taxes, which was the case for a couple of funds over this period, namely Fidelity Select Automotive, Vanguard Capital Value and Vanguard International Value.)

About 37% of the Fidelity funds with a positive return (54 of 146) had a tax efficiency of 85% or better over the three years through April, while more than 46% of Vanguard's funds (31 of 67) surpassed that mark. Not bad, although the percentages are slightly lower than when we ran three-year numbers last year. (The reason for this is the stock market's gains over the last few years—funds have had to pay out larger capital gains, and managers have used up the unrealized losses in their portfolios that could have offset some of these distributions.) It's also worth bearing in mind that these are all point-in-time numbers, and results can vary dramatically from one period to another, both on a return basis and in terms of how tax-efficient a fund was.

If you own a fund not included in either of these tables and would like to see its after-tax returns, both Fidelity and Vanguard publish this information on their websites for a handful of different periods. You can find the information by going to an individual fund's "performance" page—both firms show after-tax returns before and after the sale of shares. To calculate tax efficiency, simply divide the after-tax return by the pre-tax return for a given period.

Tax efficiency is important, but it is just one consideration of many we use when selecting funds and managers to invest with. After a long period of gains, you may owe (or have paid) a sizeable amount in taxes, but in our experience, most investors are happier with more money in their pockets after taxes than holding onto tax-efficient investments that leave them with less.

To learn more, we encourage you to read our exclusive Special Report, *Investing and Taxes: Maximizing Gains While Minimizing Taxes*. The report discusses critical tax considerations for investors of every stripe, including three account types you need to know, tax efficiency in fixed-income investing and why index funds aren't a tax cure-all. Download this free report now by clicking here!

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recognized on the *Financial Times* 300 Top Registered Investment Advisers list in 2014, 2015 and 2016.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.

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