Distributions and Mutual Funds*

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1997 December 13

Yesterday evening, Amit Patel wrote

> I've had my eye on [Fidelity Select Electronics] for almost a year now because it's been ranked at the top for three years. Today it dropped 21%.... Twenty-one percent in a single day seems way too high for a mutual fund.
>
> How does this "distributions" thing work? Would that be done at this time of year?

Yes, a twenty-one percent drop in one day is quite a large drop, especially considering the technology-laden NASDAQ market dropped only 1.41%. Mr. Patel gave the right clue when he asked about "distributions."

Visiting the Fidelity Investments WWW page and following the appropriate links, we read that Fidelity Select Electronics declared distributions of $6.95 with a record date of 12 December.

1 What are Distributions?

Mutual funds are collections of stocks, bonds, and other financial securities mutually (jointly) owned by a group of people. Thus, when one purchases one share of a mutual fund, one is effectively purchasing, for example, 0.03 shares of Intel, 0.05 shares of Exxon, $3.00 of a 30-year U.S. Treasury bond, and 2.34 shares of Stockmaster.

Most mutual funds frequently buy and sell stocks and bonds so, even though you may still own one share of the same mutual fund, it know could now represent

0.4 shares of Compaq, 0.03 shares of Dow Jones, and 2.34 shares of Stockmaster. When the mutual fund company sells some securities for a higher price than it originally paid for them, a *capital gain* occurs. If it sells for a lower price, a *capital loss* occurs. A stock or bond owned by the mutual fund may also pay a *dividend*, that is, cash paid by the stock or bond. *Distributions* consist of capital gains, capital losses, and dividends paid to mutual fund shareholders.

2 Why, When, and How do Mutual Funds Pay Distributions?

To avoid paying taxes themselves, mutual fund companies pay almost all capital gains and income to shareholders. When these people receive the gains and income, they, not the mutual fund company, owe taxes on the amounts.

Most mutual fund companies pay distributions once or twice a year. Although they buy and sell securities throughout the year and stocks pay dividends at different times during the year, the cost of bookkeeping and mailing statements to shareholders limits the frequency of distributions.

The two dates associated with each distribution are:

record date is the date when the mutual fund company records who owns how many shares.

payable date is the date when the distribution is actually given to the shareholders.

The payable date is usually a few days after the record date to permit computation and printing checks to send to shareholders.

Distributions can be paid using cash, i.e., by sending a check to the shareholder. Most mutual fund companies give the option of using this cash to purchase additional mutual fund shares. Even though the shareholder would receive only a statement listing the reinvestment, he still owes taxes on these reinvested distributions.

3 Financial Impact of Distributions

A mutual fund's price (*net asset value*) will drop on the record date by the amount of the distribution. In our example, one share of Fidelity Select Electronics Fund was worth $37.65 the day before the record date. The instant the stock market opened on the record date, its per-share value dropped by the amount of the distribution, i.e., $6.95. Nobody has gained or lost money. Some of the share's value has been converted to cash. One share is now worth $30.70 plus $6.95 in cash. (During the day, the stocks and bonds that Fidelity Select Electronics owned did decrease 3.6% in value, but this is unrelated to the distribution.)

The shareholder owes taxes on the distribution. The long-term capital gains are taxed at the long-term capital gains rate while short-term capital gains and dividends are taxed as ordinary income.

4 How do Distributions Affect When I Should Purchase a Fund?

Generally, one should not purchase a mutual fund a few days before the record date to avoid owing taxes on the entire distribution. Suppose we purchased $10,000 of Fidelity Select Electronics Fund at $37.65 per share the day before the record date. Since we owned 265.6 shares on the record date, we would receive a distribution of $1845.95. We neither gained nor lost money, but some of it has been converted into cash. Unfortunately, the distribution is taxed so we'd pay income taxes on the $1845.95. Thus, it's generally a good idea to purchase mutual funds after, not before, record dates.

Some mutual funds actively trade securities, generating a large amount of short-term capital gains. Owning these mutual funds means one must pay taxes, at one's ordinary income tax rate, every year. If you use your distributions to purchase more shares, you'll need to find other cash to pay your income taxes on the distributions.

Others trade very infrequently, generating very small amounts of distributions. Thus, your annual income taxes will be lower. The taxman still cometh, however. When selling these funds, one has to pay capital gains taxes. Since long-term capital gains are taxed at lower rates than short-term capital gains, you can still reduce your tax bill. Thus, mutual funds rated with the highest annual appreciation may not yield the largest after-tax appreciation.

All these taxing problems are avoided for mutual funds held in tax-deferred accounts, e.g., IRAs. For these, there's no need to pay income taxes and no need to worry about record dates.