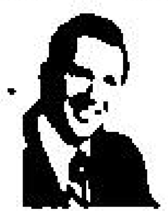
Business Outlook

Prices fall when dividends declared in mutual funds



IT'S YOUR MONEY

Paul J. Rockel

(NC)—The letter read: "How come the prices in the paper fell drastically at year end, when most mutual funds declared a dividend?"

While mutual funds have been around in Canada for over 55 years, even many people within the industry find it confusing when they see share prices (as printed daily in most newspapers) decline considerably in one day, even when the market was rising or holding steady. And that is why they ask questions such as above.

Firstly, let's examine what an equity mutual fund is. I guess the best way is to call a "conduit" for you and I, who invest in it and become owners of the fund. The professional managers who look after the fund (our investments) day by day, invest the pool of money we have put together (all of us) in what they consider to be the best possible investments.

A good portion of the monies in an equity fund are invested in ownership of industries, although I've seen equity funds be as much as 50% and better in "cash" (bonds, etc.) if they felt there would be a poor time in the equity market, or the economy.

When you "own an industry" (or part of it) you expect and hope for two things to happen. One, that the industry is profitable, and therefore distributes that profit to it's owners in what is called a dividend, and hopefully the industry will continue to grow and expand, and therefore, as an owner, (through the mutual fund) you share in its increased worth (this is called a capital gain).

An equity mutual fund has part ownership in dozens, and in some cases, hundreds of industries. These industries declare dividends periodically throughout the year, and when they do, a portion comes to the mutual fund in relationship to the number of shares the fund owns (actually you and I, as we are owners of the fund).

When the monies are received by the fund, they are added to the assets the fund holds. By law, the fund must evaluate itself each day, by taking the value of all its holdings and assets, in relation to the closing market prices that day, then divide the total by the number of shares outstanding, which produces the "net asset value" as found in the paper the following day. This is the value all shares are transacted at — be they purchases or redemptions during that day.

It's understandable then, that if a dividend is received, it adds to the value of the funds' holdings. Even if the "market" did nothing that day, if the dividends received were large, the fund value might increase by a penny. And so it goes, with many of the industries declaring dividends throughout the year, and the fund adding those dividends to their assets, which is then reflected in the daily "fund value" calculations.

Also, if the fund managers had bought a "stock" at bargain prices, and now *the market had moved those* share prices considerably upwards, they would sell out, and realize a capital gain. As an example, if they bought a stock at $10.00 per share, and now sold it at $15.00 per share, it is a "realized" capital gain. (They may have others bought at $10.00 and now worth $15.00, but they feel it may go even higher, so it is not sold until the higher price is reached. This is a capital gain calculated into the daily prices, but it is not a "realized" capital gain).

Because dividends and capital gains are taxable, the law demands that you and I, as owners of the fund, must pay tax on them. (Dividends have very little tax for most of us, and capital gains are completely free of tax, up to $100,000). Therefore the fund declares a "distribution" of those dividends and realized capital gains (plus any interest earned on it's cash reserves), in most cases, once a year, although some funds declare distributions four times per year.

When that happens, the share price drops.

If the funds share price had been $10.00, and the fund declared a distribution of $1.00, the value would decline to $9.00. What must be remembered is that the $1.00 in dividends and realized capital gains had been figured into the daily share prices whenever they where received, thus helping to elevate the funds prices bit by bit as received. Now the total is being taken out, and paid to you and I.

99.9% (or more) of mutual fund share holders choose to have the dividends automatically re-invested into additional shares. As a result, even though that $10.00 price declined to $9.00, we now have more shares; and our value in the fund is exactly the same. All we've done is distribute the earnings and realized capital gains, to be taxable in our hands. (Just as you have to pay tax on the interest earned in the bank, even if you leave the interest there).

That's why mutual fund prices decline when a distribution takes place, but values don't.

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For a FREE comparison of a mutual fund, 5-year GIC's, house prices, and inflation over the past 20 years, ask for "house prices" and write: Paul J. Rockel, Regal Financial Centre, 153 Union St. E., Waterloo, Ontario, N2J 1C4.