Independent Directors Council

Promoting Excellence in Fund Governance

ICI Response to kaChing

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Andy Rachleff, President and Chief Executive of kaChing Group Inc., incorrectly asserted in a kaching.com blog post that mutual fund investors “are paying someone else’s taxes.”

KaChing has also drastically overstated the fees and expenses of mutual funds. These calculations also understate the expenses associated with using kaChing, judging by kaChing’s own data.

Below, ICI explains the correct calculations on both counts.

I. Relying on faulty assumptions, kaChing drastically overstates fees and expenses paid by investors in mutual funds. In fact, fund expenses are less than half the level that kaChing asserts.

Here’s what kaChing claims about investors’ fees and expenses in a kaChing account and in an active mutual fund:

kaChing’s Calculations

	kaChing	Active funds
Management Fee	1.25%	0.69%
Trade Commissions	0.17%	0.10%
Soft Dollar Commissions	0.00%	0.10%

Marketing Fee	0.00%	0.53%
Other Expense Fee	0.00%	0.47%
Front-End Load	0.00%	0.32%
Back-End Load	0.00%	0.22%
Other Investors' Tax Liability	0.00%	0.94%
Total	**1.42%**	**3.37%**

The kaChing calculations double-count many mutual fund expenses and overstate others. Also, the figures presented for kaChing's expenses do not match the publicly available information presented on kaChing's website. Here's the reality of fund expenses.

Corrected Calculations

	kaChing	**All actively managed funds**	**Actively managed load funds**	**All actively managed no-load funds**
Management Fee (total expense ratio for funds)(1)	1.25%	0.95%	1.11%	0.82%
Trade Commissions(2)	0.51%	0.10%	0.10%	0.10%
Soft Dollars (included in trade commissions)	0.00%	0.00%	0.00%	0.00%
Marketing Fee (included in fund expense ratio)	0.00%	0.00%	0.00%	0.00%
Other Expense Fee (included in fund expense ratio)	0.00%	0.00%	0.00%	0.00%
Front-End Load or Back-end Load (but not both)(3)	0.00%	0.13%	0.33%	0.00%

Other Investors' Tax Liabilities (4)	0.00 %	0.00%	0.00%	0.00%
Total	**1.76 %**	**1.18%**	**1.54%**	**0.92%**

Source: ICI

Notes

(1) Expense ratios actually incurred by fund investors (asset-weighted average). A fund's total expense ratio already includes what kaChing calls "marketing fees" (i.e., 12b-1 fees) and what kaChing also calls "Other Expense Fee." This calculation accepts kaChing's stated "management fee" of 1.25 percent. However, kaChing's actual (asset-weighted) management fee, calculated from the figures on kaChing's website, is 1.28 percent.

(2) Trade commission costs of 0.10 percent for mutual funds are kaChing's estimates based on a kaChing formula shown on their website. This figure is close to the true cost of 0.09 percent, for domestic equity funds, which is based on Lipper data for 2009. In its table, kaChing uses a trading cost for its managers ("geniuses") of 0.17 percent. To be consistent, we estimate kaChing trading costs using the same formula that they apply to mutual funds in conjunction with figures that kaChing's website reports for its assets under management ($5.976 million); kaChing figures of brokerage commissions of $0.02 per share, and an-asset-weighted average portfolio turnover rate of 254 percent (also calculated from kaChing website figures). The higher trading cost figure in our table primarily reflects the fact that kaChing managers ("geniuses") have a portfolio turnover rate that is nearly 450 percent higher than that of the typical mutual fund.

(3) Load fund investors pay either a front-end load or a back-end load, not both. Figures shown in the table are ICI's figures of the annualized costs that load fund investors actually paid for load fees in 2009.

(4) As explained below, mutual fund investors are taxed only on the economic income they earn over the life of their investment.

II. Relying on a misrepresentation of tax laws, kaChing incorrectly states that mutual fund purchasers "pay someone else's taxes." In fact, every fund shareholder is taxed only on his or her own economic income over the life of the investment.

Taxable Events Affecting Mutual Fund Shareholders

Nearly one-half of long-term mutual fund assets are held in tax-advantaged accounts, such as retirement accounts. Outside those accounts, mutual fund shareholders are taxed on two types of transactions: distributions from the fund and the sale of the fund shares.

Shareholders purchase and sell a fund at the fund's net asset value (NAV), which is calculated daily. A fund accumulates realized and unrealized capital gains, interest, and dividends until it makes distributions. These gains and income increase the fund's NAV until they are distributed. A fund distribution reduces the fund's NAV; thus, amounts that are distributed reduce the gain (or increase the loss) that a shareholder realizes when fund shares are sold.

For example, assume an investor purchases fund shares on Monday for $10 per share. The fund distributes a $1 capital gain dividend (attributable to previously realized gains accrued in the fund's NAV) on Tuesday. The $1 distribution reduces fund's NAV to $9. If the investor sells the fund shares on Wednesday for $9, the investor will have no gain or loss:

- No economic gain or loss: The investor purchased the fund for $10, and received a $1 distribution and $9 upon the sale of the shares. Thus, the investor paid $10 and received $10, for no net gain or loss.
- No taxable gain or loss: The $1 of capital gains distributed (on which tax would be due) is offset fully by the $1 loss realized when the shares purchased for $10 are sold for $9. Thus, the investor has no taxable gain or loss.

A More Detailed Illustration

Consider two scenarios:

Scenario 1: Assume that Investor A bought 100 shares of a fund for $10 a share. The shares rose in value to $20. Investor A then sells her shares, and owes taxes on $1,000—the capital gain of $10 a share times 100 shares. Investor B buys 100 shares at the fund's new NAV of $20 a share, which includes the embedded gains. If the shares rise to $30 a share, and Investor B sells his shares, he would owe taxes on $1,000—the capital gain of $10 a share, times 100 shares. In other words, Investor A owes taxes on the $10 gain accrued while she owned the fund, and Investor B owes taxes on the $10 gain accrued while he is invested. Each shareholder is paying for his or her own gains earned.

Scenario 2: Now assume this same set of transactions occurs, except that the fund distributes its $10 accrued gain on the day after Investor B bought his shares at $20. Investor A still owes taxes on $1,000—the $10 gain on her shares, bought at $10 and sold at $20, times 100 shares. Investor B must now pay taxes on $1,000—the $10 per share distribution, times 100 shares. The distribution reduces the fund's NAV to $10. If Investor B pays the taxes from other assets and reinvests the full amount of the $1,000 distribution, he will now own 200 shares. The first 100 shares were purchased at $20 a share, while the second 100 were purchased at $10 a share. Investor B's average cost basis for tax purposes is $15 a share.

The shares then rise by 50 percent, as in Scenario 1, to a new value of $15 a share. When investor B sells his 200 shares at $15 a share, for tax purposes he is treated as having purchased all those shares at his average cost basis of $15 per share. Thus, he has no new tax liability because he has already paid taxes on his own gain.

Is Investor B paying Investor A's taxes when he pays taxes on the $1,000 distribution? No. Investor A paid her own taxes on the $1,000 gain when she sold shares at $20 with a cost basis of $10; she delayed paying taxes until she sold. Investor B paid his taxes upfront, on the $1,000 distribution, but owed no additional taxes when he sold his shares at the same price ($15) as his cost basis. Thus, he pays taxes only on the $1,000 that he earned while he owned the shares.

Compared to other forms of investments, the only issue with a mutual fund is the timing of the taxes paid, not the amount of taxes paid. Taxes may be paid sooner (if gains accrued before purchase are realized and distributed) or later (if losses accrued before purchase offset realized gains), but total taxes paid will be the same.

Therefore, the taxes on gains are no more a "cost" with a mutual fund then they are if these same gains had been earned in a separately managed account, like those offered by kaChing.

Further Detail on Fund-Level Gains and Losses Impacting Investors Purchasing Mutual Fund Shares

A mutual fund portfolio may contain four types of gains and losses—realized gains, unrealized gains, realized losses, and unrealized losses—when an investor purchases fund shares. Each type of gain and loss has a different impact on a fund shareholder.

- **Realized gains.** Gains that the fund has "realized" (from the sale of portfolio securities), to the extent not offset by realized losses, must be distributed under the tax laws. All shareholders are taxed on the amount of net gain distributed to them; these distributions are calculated under the tax laws on a per-share basis and are paid to all investors who hold the fund on the date of the distribution, regardless of when the gain arose.
- **Unrealized gains.** Gains that are "unrealized" represent appreciation in the value of securities that a fund still holds. Unless the fund sells these securities and realizes the gains, they have no tax impact on an investor purchasing fund shares.
- **Realized losses.** Losses that a fund has realized from the sale of portfolio securities offset any gains realized by a fund. A fund is not required to distribute gains to investors until all losses are utilized fully.
- **Unrealized losses.** Losses that are unrealized represent depreciation in the value of securities that a fund still holds. A fund that otherwise would be required to distribute capital gains can reduce or eliminate the distribution by selling the depreciated securities and using the realized losses to offset the otherwise distributable gains.