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Reinvesting At Year End Poses Choices

Investment Advisers Suggest Plowing Cash Back Into Funds Isn't Always the Best Alternative

BY KAREN DAMATO

IS IT TIME to jump off the reinvestment merry-go-round?

At the end of every year, mutual funds pay billions of dollars in dividends and capital gains to investors. It long has been an article of faith among most financial advisers that investors should arrange to have that money automatically reinvested in the funds from which it came. But some experts reject that conventional wisdom in some cases, advising investors to consider putting that money to work elsewhere.

In 2003, 80% of total stock and bond fund payouts made the instantaneous round-trip, and there are sound reasons for doing so. "It's an automatic way to keep your money invested" for long-term goals such as retirement, says Sheryl Garrett, a financial planner in Shawnee Mission, Kan. The alternatives of having distributions paid in cash or deposited into a money-market mutual fund are "more dangerous," she says, because the money easily could linger at low interest rates, or worse, be quickly spent.

Other financial advisers, however, say that conventional wisdom is too simplistic. For one thing, investors holding funds in their taxable accounts owe tax on dividends and capital-gains distributions even if those sums automatically are reinvested. Tax law requires funds to pay out to investors the net gains on securities sold as well as bond interest and stock dividends received (after subtracting fund expenses).

Particularly in taxable accounts, the reinvestment naysayers say, there are reasons to take the distributions in cash and then decide what to do with the money.

To James Wilson, an adviser in Columbia, S.C., the issue is taking control of one's finances. Rather than simply having distributions go back into the same funds without any planning, he suggests, "let's make a conscious decision about what we are going to do."

In the final weeks of the year, most funds pay out the bulk of their capital gains and a final dollop of dividends. An investor whose \$100,000 taxable investment account includes eight mutual funds might receive as much as \$5,000 near the year's end, Mr. Wilson says. If that investor holds only U.S.-stock funds, he says, it might be smarter to add an international-stock fund to the mix.

About once a year -- and year end is an obvious time -- investors also should "rebalance" their portfolios by shifting more dollars toward asset classes that have been lagging performers, advisers say. Saying no to reinvestment "brings cash flow in [to the portfolio] that can be used to rebalance," says Rick Ferri, a money manager in Troy, Mich.

Debra Wetherby, a San Francisco adviser, says she usually opts for reinvesting, but around this time of year she asks fund companies for their year-end distribution estimates -- and sometimes will opt not to reinvest as a way to take some money out of a fund whose strong performance has led it to become too large a piece of the pie. Another way to accomplish the same goal would be to reinvest now and sell later, though that might cause a taxable gain.

Tax complexities, meanwhile, are a top reason that John Costello, an adviser in Troy, N.Y., advises against reinvesting fund distributions in a taxable account.

When clients sell part of a mutual-fund holding or use fund shares for charitable giving, Mr. Costello advises them to specify the particular blocks of shares they are disposing of. Generally, it makes sense to sell the highest-cost shares, in order to minimize taxable gains, but donate the lowest-cost shares to charities to reduce future capital-gains taxes.

Doing that "specific identification" is much more complicated for investors who reinvest distributions, Mr. Costello says, because each reinvestment consti-

tutes a separate purchase. He notes that one of his favorite funds, Dodge & Cox Balanced Fund, pays dividends quarterly, which adds up to scores of distinct purchases over the course of many years. Skipping reinvestment helps "to simplify the whole process," he says.

Even advisers who shun dividend reinvestment in some cases favor it in others. Many advisers routinely reinvest within tax-favored Individual Retirement Accounts and 401(k) plans, for instance. Because withdrawals from those accounts generally are taxed as ordinary income, there is no hassle of tax-lot accounting on share dispositions. Investors always can sell shares to rebalance their portfolios without a tax bill or complicated tax accounting.

Tom Tracy, a San Francisco adviser, says he reinvests distributions in small accounts that hold only a single fund. He notes that fund investors typically pay no transaction costs to reinvest distributions. That is a reason to reinvest in cases where taking the cash and then purchasing additional shares later on would entail transaction costs.

Mr. Tracy generally suggests his clients, who mostly invest through Charles Schwab, reinvest their dividends in funds such as Lingleaf Partners Fund, T. Rowe Price Emerging Markets Stock Fund and Vanguard Value Index Fund for which they otherwise would have to pay Schwab transaction fees.

Brian Reid, deputy chief economist at the fund industry's Investment Company Institute, notes similarly that investors who buy Class A and Class B funds with sales commissions would pay additional commissions if they took their distributions in cash and later made additional purchases. But beyond saving on such costs, Mr. Reid focuses on the foibles of human nature in favoring reinvestment.

"I'm a big advocate of reinvesting. I do it with all my accounts," he says. "It's the easiest thing and makes sure I don't put money aside and forget to deal with

it.”

SPECIAL ETF DIVIDENDS: In connection with the special \$3-a-share dividend that Microsoft Corp. soon will pay on its common stock, two big exchange-traded funds -- Standard & Poor's Depository Receipts and Diamonds -- will pay special dividends as well, fund trustee State Street Bank & Trust Co. announced. The special payments are needed because the two portfolios -- which aim to track the Standard and Poor's 500-stock index and the Dow Jones Industrial Average -- are technically "unit investment trusts" which can't reinvest dividends they receive. If the cash from Microsoft were to sit in the portfolios until their next scheduled payouts, it would cause performance to deviate from the indexes.

Another ETF that is a unit investment trust and that has a very large Microsoft stake is Nasdaq-100 Index Tracking Stock. Officials at trustee Bank of New York couldn't be reached for comment. Almost all other ETFs and funds have no constraints on using dividends to buy new shares.