NEWS / INVESTMENT STRATEGIES

Fund manager finds way around capital gains distributions

Huber Capital Management borrows a page from the exchange-traded fund industry to protect mutual fund investors from taxes.

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3 MINS

As an investor in the mutual funds he manages, Joe Huber will do whatever it takes to avoid those pesky capital gains distributions that can blindside and frustrate long-term investors.

The founder and chief executive of Huber Capital Management applies four basic tax management strategies and then goes to the next level with a fifth technique that has enabled the $400 million fund shop to avoid paying out "material" capital gains distributions over its entire 14-year history.

"I say we never paid out any material capital gains because one year we had less than a penny in capital gains distributions," Huber said.

Most of Huber's tax management strategy resembles the approach taken by other tax-conscious portfolio managers.

He pays close attention to opportunities for tax-loss harvesting and he tries to avoid short-term taxes by holding securities for at least a year, which folds into his long-term investing approach. And when Huber wants to reduce the weighting of a security, he will use inflows to dilute that weighting instead of triggering a taxable event by selling securities.

Huber separates his fund company from virtually every other asset manager in the business by employing a tax management strategy that borrows a page from the ETF industry.

While mutual funds almost always honor fund redemptions with cash, they can also provide investors with actual securities from the fund.

“We have from time to time negotiated with non-taxable clients to move money into separate accounts, and we deliver them securities,” Huber explained. “Because they’re non-taxable [qualified accounts] we get to decide which tax lots we deliver them.”

By moving securities out of the portfolio without selling them, Huber can better manage the fund’s annual capital gains distributions, which can hit mutual fund investors even in years when a fund posts a negative return.

The strategy resembles the way that exchange-traded funds redeem by giving shares back to a middle person, known as an authorized participant, who stands between the ETF and the investor. That’s one of the reasons ETFs are much more tax-efficient than actively managed mutual funds.

“He’s essentially treating investors that want their money back as separate from the pool of assets in the fund, because he’s transferring some of the underlying stock into a new entity, without penalizing the broader investor base,” said Todd Rosenbluth, director of mutual fund and ETF research at CFRA.

“The technique is highly beneficial to other shareholders, who often are dragged along for the ride when fellow shareholders have shorter time horizons,” Rosenbluth said.

While moving securities into separate accounts has proven effective in reducing the tax hit, Huber said there are reasons most fund companies are not following his lead.

“We’re not the only ones to figure this out, but there are negatives associated with it that other fund companies probably don’t want to deal with,” he said. “For starters, you have to call up clients, wasting a touch point by asking them to do some work for you.”

Huber said that he “incentivizes” investors to go along with moving the assets into separate accounts by offering to manage the assets in the separate accounts for a reduced fee.

“The separate account is an expensive proposition that cost me $10,000 a year per account,” he said. “My first four tax management tools are basic blocking and tackling, but don’t require a ton of work. This fifth one requires a ton of work and involves working with bankers, accountants, custodians and lawyers.”

Christine Benz, Morningstar’s director of personal finance, described Huber’s strategy of moving securities to separate accounts as “very clever.”

“Most mutual fund prospectuses include language that funds can redeem in kind,” she said. “It is nicely addressing the disadvantage that ETFs have uncovered in active mutual funds.”

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