Manulife Investment Management

Understanding Corporate Class Mutual Fund Dividends

In order to understand corporate class mutual fund dividends, you first need to understand how a corporate class mutual fund works. Please note that where we refer to a corporate class mutual fund, we are referring to a share class of a mutual fund corporation.

When you invest in a corporate class mutual fund, the class managers invest your money, along with the money of all the other shareholders (investors in the fund) in a class offered by the mutual fund corporation. Classes represent different portfolios of investment assets that might include equity securities (stocks), fixed income securities (bonds), Treasury bills and more. The exact mix depends on the objectives of each class, but the point is that the corporation is able to generate tax efficient income generally in the form of Canadian dividends and capital gains. Since different classes are held within a single corporation, expenses from one class can be used to reduce income in another, providing more flexibility in reducing potential taxable dividends.

You and other investors → Corporate class mutual fund → Stocks, bonds, other investment assets → Canadian dividends and capital gains

Canadian dividends and capital gains paid out annually as dividends

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But that's not the only way corporate class mutual funds can potentially make money. Over the course of the year, the portfolio managers constantly monitor the markets and the underlying securities in the fund, looking for the best opportunities. Portfolio managers will buy promising new securities and may sell others that have reached their full potential or are no longer appropriate for the fund. Every security sale will produce either a profit (capital gain) or a loss (capital loss) to the fund. In the simplest scenario, all the losses are subtracted from all the gains at the end of the year and any net capital gain is distributed to shareholders.

Buys	**Sells**	
Stock	Stock + **$$$**	Capital gains dividends paid out annually
	Stock - **$$**	
	Stock - **$**	
	Stock + **$$**	
	Net capital gain + $$ →	**Shareholder**

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You can choose to receive dividends in cash or automatically reinvest in additional shares of the corporate class mutual fund.

How dividends affect corporate class mutual funds

After a dividend is paid out, the fund's net asset value (NAV) goes down because it's holding fewer assets. The reduction in NAV is the same as the amount of the dividend. Your overall value, however, doesn't change, regardless of whether you choose to take your dividends as cash or re-invest in additional shares of the fund. Here's an example to illustrate, based on a fund with a $10 NAV per share (NAVPS) that pays a 5% dividend.

Fund NAV per share (Prior to dividend): $10 **Dividend: 5%**

Dividend received as cash

Value of your investment BEFORE dividend	5% dividend on dividend date	NAVPS	Received as cash	Value of your investment AFTER dividend
1,000 shares held @ $10 NAVPS = $10,000	1,000 shares @ $0.50 = $500	$10 NAVPS – 0.50 cents = new NAVPS of $9.50	$500	1,000 shares @ $9.50 = $9,500 held in the fund + $500 cash paid to you in cash = $10,000

Dividend reinvested in additional units of the fund on your behalf

Value of your investment BEFORE dividend	5% dividend on dividend date	NAVPS	Reinvested in additional units	Value of your investment AFTER dividend
1,000 shares @ $10 NAVPS = $10,000	1,000 shares @ $0.50 = $500	$10 NAVPS – 0.50 cents = new NAVPS of $9.50	$500/$9.50 = 52.6316 shares	1,052.6316 shares @ $9.50 = $10,000 You have more shares and the total market value is the same as prior to the dividend date.

Frequently asked questions

Q1. How is a corporate class mutual fund different from a mutual fund trust?

A corporate class mutual fund is a single taxable entity consisting of several classes of shares, with each class representing a different mutual fund. As an investor, you can buy into the overall corporate structure by purchasing shares of one or more classes. Since a corporation computes its net income and net capital gains as a single entity, it can offset the income and capital gains of one class with the expenses and capital losses of another, providing more flexibility in reducing potential taxable dividends.

Q2. Why are corporate class dividends either Canadian dividends or capital gains?

A corporate class mutual fund can't flow through ordinary income (i.e., interest or foreign income). Only Canadian dividend income or capital gains from a corporate class fund may be paid out to investors in the form of an ordinary Canadian dividend or a capital gains dividend (50% of the amount would be treated as a taxable capital gain) respectively.

Q3. My corporate class mutual fund has a negative annual return, but I still got a taxable dividend. How is that possible?

There are two reasons you might get a dividend even though the value of your fund has dropped.

1. Dividend income. Receiving a fund dividend in a down market is kind of like owning a house that you rent out. Even if the value of your property is going down, your tenants will still be paying you rent, which is income in your hands. Similarly, you will receive the dividend income earned by your fund even if its value goes down.
2. Capital gains. Any net capital gains that a fund earns are distributed to shareholders at the end of the year – regardless of whether the value of the fund has gone up or down. For example, the portfolio managers may decide to take profits on securities bought years ago that are now trading for many times the original purchase price. This could generate a sizeable capital gain. At the same time, the portfolio managers might choose to hang on to securities that are currently valued at much less than they paid because they believe the securities will ultimately recover and prove profitable. These assets could have a significant impact on the value of the fund. Result: negative annual return and a taxable dividend.

Q4. Why are dividends paid to investors instead of staying in the corporate class mutual fund?

If the mutual fund didn't pay the dividends to investors, they would be taxed within the corporation. By distributing the dividends to investors, it is taxed at their marginal tax rate. In addition, the investment income retains its character — in other words, outside of registered accounts, distributions of dividend and capital gains will receive the same preferential tax treatment they would if you earned them directly instead of through the mutual fund.

Q5. Why is the corporate class mutual fund return on my annual statement different from the annual corporate class mutual fund performance figures reported by the mutual fund company?

The answer has to do with how the annual returns are calculated. Mutual fund companies use a time-weighted method for calculating fund returns over a specified period of time (quarterly, annually, year over year, or since inception). This calculation doesn't take into account investors' withdrawals from the fund or deposits into it. The annual return on your individual annual statement from your advisor, on the other hand, is dollar-weighted. It takes into account not only the investment performance of the fund but also the impact of any cash deposits or withdrawals you made during the year. As a result, the return on your statement is individualized to your unique situation.

In the example below, you can see how three investors can have three very different annual returns even though they all invest the same amount in the same corporate class mutual fund.

Month	Jan.	Feb.	Mar.	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Return
Fund NAVPS	$10	$10	$10	$9.5	$9	$10	$11	$11	$12	$12	$12	$11	10%
Tom	Invests $1,000												10%
Sally	Invests $500		Withdraws $250		Invests $500			Invests $250					13.62%
Drew	Invests $200		Invests $250		Invests $200		Invests $200		Invests $200				6.78%

For illustration purposes only

Q6. I purchased a corporate class mutual fund share before a dividend was made. There was no change in the corporate class mutual fund's value before or immediately after the dividend as it was automatically reinvested. Why am I seeing a loss on my statement after the reinvested dividend?

Consider the following example:
Investor purchases 1 share of a corporate class mutual fund for $10. The corporate class mutual fund theoretically has 1 security in it.

Before dividend

Market value and ACB = $10
NAV = $10

1 share:
$9.50 value of underlying security
$0.50 dividend → Dividend is re-invested in the same corporate class mutual fund

After dividend

Reinvested dividend purchases an additional new partial unit.

New number of shares	New NAV	Total Asset Value	Fair Market Value (FMV)	Adjusted Cost Base (ACB)
1.053	$9.50	$10	$10 (9.5*1.053 shares)	$10.50

After the dividend, the investor is in a loss position. This has been caused because of the dividend. The reinvestment maintains the loss (FMV is $10 and ACB is $10.50). The investor has now made a total of 2 purchases for $10.50 combined. Their original purchase of 1 share for $10 and their subsequent purchase of 0.053 shares for $0.50 with the reinvested dividend. However, the total value of assets in the corporate class mutual fund has not changed, therefore their FMV remains at $10.

Glossary of key terms

Capital gain (or loss): The profit or loss resulting from the sale of a capital asset, such as an equity security (stock).

Dividend Distribution: A payout of ordinary Canadian dividends and capital gains made by a corporate class mutual fund to shareholders on an annual basis.

Distribution date: The day on which a corporate class mutual fund pays out ordinary Canadian dividends or capital gains dividends to shareholders as cash or reinvests them in additional shares of the fund on their behalf; record date is the day prior to the dividend payment.

Dividend: A payout of company earnings made to shareholders.

NAVPS: Net asset value per share — the total market value of a corporate class mutual fund's assets minus fund liabilities divided by the number of shares issued.

Shareholder: A person who invests in a corporate class mutual fund.

Please note: This article deals only with distributions from corporate class mutual funds. Distributions from mutual fund trusts are treated differently and will yield different results. Also note that a number of simplifying assumptions have been made in the article for clarity.

The payment of distributions is not guaranteed and may fluctuate. If distributions paid by the fund are greater than the performance of the fund, then your original investment will shrink. Distributions should not be confused with a fund's performance, rate of return, or yield. You may also receive return-of-capital distributions from a fund.

MK35925E 04/23 AODA 2833019