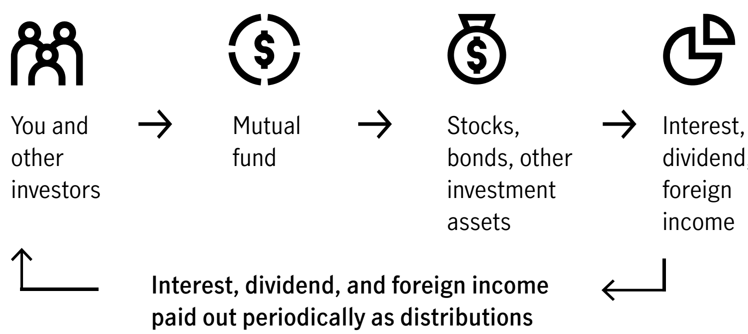
Manulife Investment Management

Understanding mutual fund trust distributions

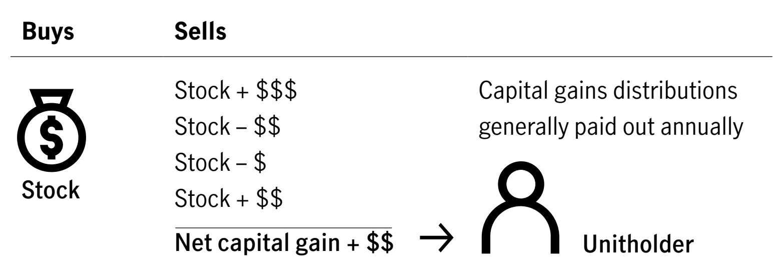
In order to understand mutual fund trust distributions, you first need to understand how mutual fund trusts work.

When you invest in a mutual fund trust, the fund managers invest your money, along with the money of all the other unitholders (investors in the fund), in a portfolio of investment assets that might include equity securities (stocks), debt securities (bonds), treasury bills, and more. The exact mix depends on the objectives of the fund, but the point is that all of these investment assets aim to generate income for the fund, generally in the form of interest or dividends. All of the income received by the fund (net of fund expenses) is paid out to unitholders on a monthly, quarterly, or annual basis, as it's earned.



For illustration purposes only.

But that's not the only way mutual funds make money. Over the course of the year, the fund managers constantly monitor the markets and the underlying securities in the fund, looking for the best opportunities. They'll 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 unitholders.



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You can choose to receive distributions in cash or automatically reinvest in additional units of the fund.

How distributions affect the fund

After a distribution 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 distribution. The overall value of your portfolio, however, doesn't change, regardless of whether you choose to take your distributions as cash or reinvest in additional units of the fund. Here's an example to illustrate, based on a fund with a $10 NAV per unit (NAVPU) that makes a 5% distribution.

Fund NAVPU (prior to distribution): $10 **Distribution:** 5%

Distribution received as cash

Value of your investment **before** distribution	5% distribution on distribution date	NAVPU	Received as cash	Value of your investment **after** distribution
1,000 units held @ $10 NAVPU = $10,000	1,000 units @ $0.50 = $500	$10 NAVPU – $0.50 = new NAVPU of $9.50	$500	1,000 units @ $9.50 = $9,500 held in the fund + $500 paid to you in cash = $10,000

Distribution reinvested in additional units of the fund on your behalf

Value of your investment **before** distribution	5% distribution on distribution date	NAVPU	Reinvested in additional units	Value of your investment **after** distribution
1,000 units @ $10 NAVPU = $10,000	1,000 units @ $0.50 = $500	$10 NAVPU – $0.50 = new NAVPU of $9.50	$500/$9.50 = 52.6316 units	1,052.6316 units @ $9.50 = $10,000 You have more units and the total market value is the same as prior to the distribution date.

Frequently asked questions

Q1. My mutual fund trust has a negative annual return, but I still got a taxable distribution. How is that possible?

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

1. Interest, foreign income, and dividend income. Receiving a fund distribution in a down market is kind of like owning a house that you rent out. Even if the value of the property is going down, your tenants will still be paying you rent, which is income in your hands. Similarly, you'll receive distributions of interest, dividend, and foreign income earned by your fund even if its value goes down.
2. Capital gains. As explained above, any net capital gains that a fund earns are distributed to unitholders at the end of the year—regardless of whether the value of the fund has gone up or down. For example, the fund 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 sizable capital gain. At the same time, the fund 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 distribution.

Q2. Why do investors pay the tax on fund earnings instead of the mutual fund trust?

If the mutual fund didn't distribute the investment income, it would be taxed at the equivalent of the highest personal tax rate within the mutual fund trust and then the after-tax income would be eventually taxed a second time in the investor's hands when they sell their units for a nonregistered account or withdraw the funds from a registered account. By distributing the investment income to investors, it's taxed once at their marginal tax rate. Lowering the taxes paid by a mutual fund means more income for fund investors. In addition, the investment income retains its character—in other words, outside of registered accounts, distributions of dividend income and capital gains will receive the same preferential tax treatment they would if you earned them directly instead of through the mutual fund.

Q3. Why is the mutual fund trust return on my annual statement different from the annual mutual fund trust 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 mutual fund trust.

Month	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Return
Fund NAVPU	$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.

Q4. I purchased a mutual fund unit before a distribution was made. There was no change in the mutual fund's value before or immediately after the distribution as it was automatically reinvested. Why am I seeing a loss on my statement after the reinvested distribution?

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

Before distribution

Market value and ACB = $10
NAV = $10

1 unit:
$9.50 value of underlying security
$0.50 income → Fund distributes income and it's re-invested in the same fund

After distribution

Reinvested income purchases an additional new partial unit.

New total number of units	New NAV	Total asset value	Investor fair market value (FMV)	Investor adjusted cost base (ACB)
1.053 = (1+(0.50/9.50))	$9.50 = (10–0.50 distribution)	$10	$10 = (9.50*1.053 units)	$10.50 = (10+0.50)

After the distribution, the investor is in a loss position. This has been caused because of the distribution. The reinvestment maintains the loss (FMV is $10 and ACB is $10.50). The investor has now made a total of two purchases for $10.50 combined. The original purchase of 1 unit for $10 and subsequent purchase of 0.053 units for $0.50 with the reinvested distribution. However, the total value of assets in the fund has not changed, therefore the 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).

Distribution: A payout of fund earnings (dividends, interest, foreign income, capital gains) made by a mutual fund trust to unitholders; may occur monthly, quarterly, or annually.

Distribution date: The day on which a mutual fund trust pays out investment earnings of interest, dividends foreign income or capital gains to unitholders as cash or reinvests them in additional fund units on their behalf; record date is the day prior to the distribution payment.

Dividend: A payout of company earnings made to shareholders.

Interest: Income generated by investment assets such as bonds.

Foreign income: Income such as dividends and interest earned outside of Canada.

NAVPU: Net asset value per unit—the total market value of a mutual fund's assets minus fund liabilities divided by the number of units issued.

Unitholder: A person who invests in a mutual fund.

Please note: This article deals only with distributions from mutual fund trusts. Distributions from mutual fund corporations 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 commentary in this publication is for general information only and should not be considered investment or tax advice to any party. Individuals should seek the advice of professionals to ensure that any action taken with respect to this information is appropriate to their specific situation.

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.

Please consult with your tax advisor regarding the tax implications of receiving distributions. See the fund facts as well as the prospectus for more information on a fund's distributions policy.

Commissions, trailing commissions, management fees, and expenses all may be associated with mutual fund investments. Please read the fund facts as well as the prospectus of the mutual funds before investing. Mutual funds are not guaranteed, their values change frequently, and past performance may not be repeated.

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