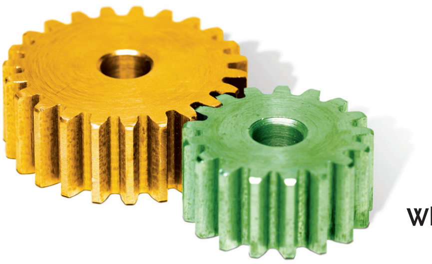
soundchoices®

THE INS AND OUTS OF CASH FLOW FROM A MUTUAL FUND

Many investors today seek out mutual funds with income-producing features, but how do you know which product is right for you?

When it comes to distributions, why you choose a cash-flow-producing mutual fund and the various sources of cash flow are crucial to your decision making process.

From conservative fixed-income mutual funds, to equity mutual funds that offer maximum cash flow, balanced mutual funds with a steady income stream, or even complete one-ticket income solutions, there are many choices available to you.



What are you doing after work?®

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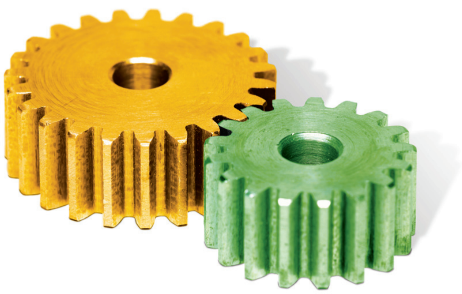
Distributions – What are they?

Many investors believe receiving distributions from a mutual fund are always representative of an increase in value to the fund and have the same tax treatment. However, these distributions come in many forms – dividends, return of capital, interest or even capital gains. They all have specific purposes and they all have an impact on your long-term goals.

KNOW YOUR FUND CHOICE

Before investing in a mutual fund it is important to know what type of distribution you are going to be receiving. Mutual funds that contain dividend-paying stocks can offer an attractive source of cash flow, whether monthly, quarterly or semi-annually. When you take into account that the stock can also provide capital growth potential, you can have an extremely attractive solution.

For investors seeking cash flow necessary for living expenses, a fund distributing dividends may not always provide steady and predictable cash flow. This is in part due to the irregularity of both payment frequency and dollar amounts distributed. Here an investor may want to look to other options available such as a Systematic Withdrawal Plan, or alternatively, mutual funds that offer Series T purchase options.



Different sources of distributions

DIVIDENDS

Dividends are distributions that companies pay from their earnings on a regular basis to shareholders. Typically dividends are paid by mature, profitable companies. Since these companies are no longer growing as rapidly, they give a portion of their earnings directly to the shareholders instead of reinvesting all of it back into their businesses.

Dividends are a signal that the company's fundamentals are healthy and that management is optimistic about future performance. While dividends aren't guaranteed, companies take these payments seriously and will typically go to great measures not to cut them for fear of reducing investor confidence.

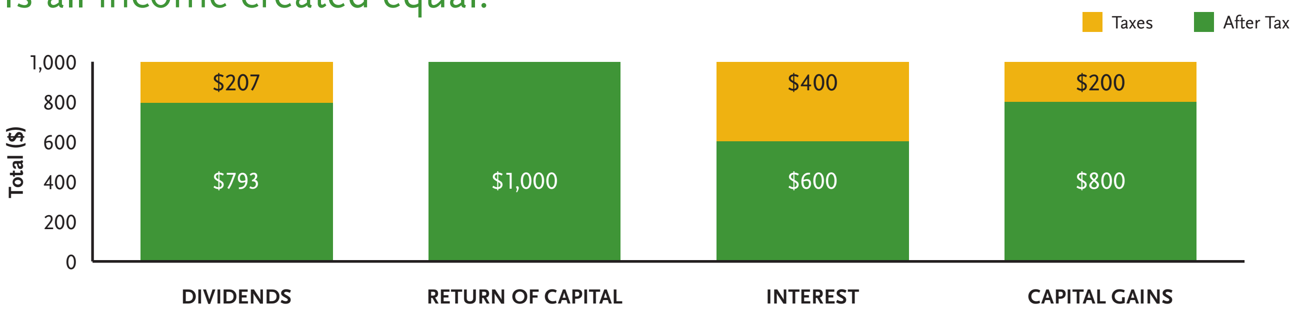
When you receive a dividend payment from a Canadian public company, you are eligible for a dividend tax credit. Dividends received from Canadian public corporations are tax preferred, so it can be beneficial to consider keeping these dividends outside your RRSP.

RETURN OF CAPITAL

Return of capital is typically provided by a publicly traded company that distributes money collected from their shareholders back to the shareholders themselves. The result is a distribution that is not immediately taxable but decreases the adjusted cost base of the original purchase (tax deferral). When it comes time to sell in the future, providing that there is a gain, the capital gains tax will be paid on the proceeds less the amount of the adjusted cost base.

Mutual funds sometimes pay return of capital to the investor on a regular basis, which represents a return of the investment the investor originally contributed to. This can be ideal for investors looking for regular streams of cash with minimum tax consequences applicable since they are drawing from their principal invested.

Is all income created equal?



Here are four different sources of distribution income from a mutual fund, each paying $1,000. While they all may look the same, they all have very different tax implications, which affects the value of a portfolio.**

INTEREST INCOME

Interest income is a gain to the portfolio (an example would be a money market mutual fund). It is typically received from GICs, corporate bonds, government bonds and T-Bills and can have a positive impact on the performance of the fund by adding more units. However it is important to keep in mind that interest income is 100% taxable. That means that if you earn $1,000 in interest for the year, $1,000 is added to your income and taxed at your marginal tax rate. Because of this, it can be more beneficial to have these types of investments inside a registered account such as an RRSP or TFSA.

For investors looking for a regular source of income, this type of income in today's market may not be suitable as interest rates are generally lower and you may typically receive small payout amounts.

CAPITAL GAINS

Capital gains result when you sell an investment higher than the price you purchased it at. The difference is taxable at 50% of your marginal tax rate. Capital losses can also occur if your sale results in receiving less money than you had originally invested (certain assets are exempt from this, including your primary residence for tax purposes, where you do not incur any capital gains taxes). Because of the favourable tax implications, they are an efficient source of cash flow and can be ideal outside of a registered account.

What type of investor are you?

De-accumulator – If you are retired, investing in a product that pays return of capital may be an ideal choice. There are some common risks that you may face in your retirement since you may be seeking to maintain a portfolio of investments to last over the long term, including:

1. Longevity risk – living too long
2. Market risk – premature portfolio depletion
3. Purchasing power – inflation

One approach is to invest in mutual funds that pay primarily return of capital. These are generally conservative products that can help protect your investment by not eroding your capital on the downside, a crucial component when drawing income in retirement. There are a number of mutual funds categories that may be ideal for this strategy; asset allocation funds, balanced funds or other generally conservative products that can protect against the potential for huge downward swings from the markets.

Accumulator – If you are an investor who has not yet reached retirement but are looking to supplement your income for other purposes, then a mutual fund containing stocks that pay dividends, or a fund that seeks to offer maximum cash flow, may be the right choice for you. These funds are usually more aggressive and, in turn, provide the opportunity for higher capital growth potential. This type of fund can experience more volatility than a more conservative product, resulting in the erosion of your principal.

So what does this all mean?

It is important to determine what your cash flow, tax and short- and long-term goals are before you and your advisor decide what type of investment is right for you.

Speak to your financial advisor to find out more about the ins and outs of cash flow from a mutual fund.

**Assumption: Interest is fully taxable with a 40% marginal tax rate, $1,000 in interest will return $600 after tax. Dividends: (assuming the individual is taxed in Ontario and the dividend is eligible) a $1,000 dividend gets grossed up by 38% in 2013 to make $1,380. Then the assumed 40% marginal tax is applied to give taxes of $552 (40% × $1,380). The $552 in taxes are reduced by the provincial and federal tax credit of 9.98% (including surtax) and 15.02%, respectively (9.98% × $1,380 + 15.02% × $1,380) which creates a tax credit of $345. This amount is subtracted by the taxes otherwise payable to give $207 tax payable ($552 – $345). Therefore a $1,000 Canadian dividend would provide an after tax return of $793. Return of Capital: The returned capital amount is not taxable in the year received, but reduces the adjusted cost base, which generally results in a larger capital gain when the investment is sold, hence taxes are effectively deferred. Capital Gains: Have preferential tax treatment where only 50% of the gain is taxable. Only 50% of a $1,000 capital gain is taxable, which means that only $500 would be subject to the 40% marginal tax. $500 × 40% = $200 taxes payable, therefore a $1,000 capital gain would result in an $800 after tax return.

For illustrative purposes only. Please speak to your financial and tax advisor for more information on specific tax consequences and any specific income requirements you may have.

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