The CJ Investment Newsletter

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When Statements Lie – ROC Dividends

Quick Look

Market	**Next Expected Move**
?	

	Month	**YTD**
DJI	1.68%	3.31%
COMP	0.33%	6.18%
SPX	1.79%	3.24%
Gold	0.50%	**<8.26%>**

- What are Return of Capital (ROC) dividends?
- Accounting requirements related to ROC dividends.
- Putting it together: Why CAN holding securities distributing ROC dividends distort statements to show losses not incurred?

ROC Dividends

Return of Capital (ROC) dividends are not mysterious at all. Income fund managers found out long ago that people who bought income funds wanted a steady stream of income over virtually all other considerations. This is true for all securities (mutual funds, closed-end funds (CEF's) and ETF's) that would be classified as income funds.

As an aside, CEF's were the original "mutual funds." What are now called "traditional mutual funds" came about decades later.

So, when fund managers are unable to cover their funds' monthly dividend requirement from current income plus previous monthly surpluses, they generally distribute their standard dividend anyway. They also try to restructure the fund's investment portfolio to generate more income, if possible.

What this means is that a portion of the dividend distributed was created from the capital contribution investors made when they originally purchased their shares. Ergo, *a portion of the dividend returned some of their invested capital to the shareholders*. This is the very definition of a Return of Capital (ROC) dividend.

As we alluded to before, income fund managers found out long ago that shareholders got MUCH more upset over a disruption of their income streams, as opposed to receiving ROC disbursed to keep their income streams steady.

Not surprisingly, ROC dividends are not taxable for US income purposes. After all, it is simply a return of previously invested capital. ROC dividends are not income, so they are not taxed. Your 1099 showing activity for the year will show the amount of ROC dividends received, if any.

Seems straightforward, right? How could ROC cause distortions in shareholders' monthly investment account statements? Well, the water gets a lot muddier from here. Let's see if we can clear it up a bit.

ROC Accounting and Accounting Requirements

The correct way to account for the receipt of ROC dividends would be this simple journal entry:

	Dr	Cr
Cash	XXX.XX	
Investments		XXX.XX

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** Merry Christmas and Happy Holidays **

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This is the simple recognition of the receipt of the cash and that *the ROC reduces the amount you have invested in the fund*. Further, you would need to divide the ROC dividend received by the number of shares you have invested in order to determine the new, lower cost basis per share of your investment.

Still doesn't sound like a big deal, right? Wrong.

Decades ago, before the age of computers – or at least what we consider computers now – the participant (investor) accounting for properly recording ROC dividends involved too many entities and variations to be calculated by the fund families and the custodians. Long ago, a special exemption was granted to the financial companies not to have to run the calculations down to the participant accounting level. A "compromise" was made – the companies issuing the 1099's would isolate the gross amount of the nontaxable ROC dividends and report it there, so investors would not have to pay taxes on the ROC dividends. Provided they understood what they were looking at, of course.

To sum up, dividends involving ROC dividends SHOULD be recorded as follows (following our previous general journal example):

	Dr	Cr
Cash (Total Dividend)	XXXX.XX	
Income (non-ROC)		XXXX.XX
Investments (ROC)		XXX.XX

Unfortunately, how they ARE recorded is like this:

	Dr	Cr
Cash (Total Dividend)	XXXX.XX	
Income (non-ROC)		XXXX.XX

See the difference? The ROC portion is not recorded anywhere, except on the records that roll up into the annual 1099. *The returned capital is not being used to reduce the cost basis of those investments, thus leaving those investments at original (now overstated) cost on the monthly statement.*

Let's apply some fictitious numbers to help describe the impact of this while keeping the math simple. An investor buys 100 shares of ABC CEF at $10/share. The original purchase would be recorded as

	Dr	Cr
ABC CEF	1000.00	
Cash		1000.00

The investment does well for a few years, even providing a small capital gain from the increase of the value of the shares. Great. The investor is both getting the income stream promised AND capital gains from her investment.

The next year, the securities making up the fund do not do as well and the promised dividend amount can't be paid out of income alone. Rather than further burdening the fund with interest expense, the fund manager decides to liquidate one of the fund's investments and pay out a ROC, along with the amount that current income would allow. This gets her up to the promised dividend. Assuming (to make the math simple) that the promised dividend was a sky high 10% and that the ROC portion of what was paid was 5%, the entry to record the annual transactions for our investor should be:

	Dr	Cr
Cash (Total Dividend)	100.00	
Income (non-ROC)		50.00
Investments (ROC)		50.00

Then, for the monthly statement, the per share cost basis of the ABC investment would be reduced by $50/100 shares = $0.50/share. The investor should start to see her total cost basis reduced from $1000 to $950 and the per share cost basis from $10 to $9.50. *None of that happens*, though, as we described above, on the investor's monthly statement, which still shows the original cost basis.

Note that the investor has not lost a dime on this investment – unless the market value of the shares has declined from other investors selling their shares for some reason. pRegardless, the cost basis appearing on her statements is $0.50 too high and her profit is understated or her loss is overstated, depending upon the market price of the shares.

Stop right here and think about that before moving on.

The Bear Market of 2008-9 and The Fed

After suffering a significant bear market for 10 months (12/2007-8/2008), the Fed took a fateful and unprecedented step: *They instituted the ZIRP (Zero Interest Rate Policy) and left it in place for* ***over 7 years***.

Back to basics for a second. What is the *cost of money*? Not its *value*, its *cost*. The cost of money is called *interest* to a borrower. Therefore, interest is the expense incurred by a borrower to *rent someone else's money* before paying it back. Remember this concept. It's critically important to understanding what we are going to talk about soon.

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Another important concept is expressed as a principle: *When something is free, people overuse and waste it*. If gasoline was free tomorrow, do you think people would waste it at a far greater rate than they do now, or would they be "responsible" and continue to use it at the rate they did prior to it becoming free? This is an easy one. They're going to waste it. There is much too much history proving this behavior happens.

Our last concept is that *market distortions happen when prices are changed from external manipulation instead of occurring through the natural actions of free markets*. The price manipulation doesn't have to be for ALL goods; it will flow to other parts of the economy quickly. Of course, our government has its hands in darned near everything involving human life, and market manipulation is no exception.

Let's look at how these three concepts interacted in real life after the Fed instituted the ZIRP policy in the fall of 2008. The ZIRP was not for all interest rates – thank goodness. The Fed can only "control" overnight interest rates, *aka* Fed Funds. The most commonly tracked interest rates are the overnight (which was zero after ZIRP), the 1-year, and 5 year and 10 year rates. As we recall, they generally were at these levels before and through the ZIRP period:

	Before*	After
Overnight	3-3.5%	0.0%
1 Year	4-4.5%	<1.0%
5 Year	5-6.0%	2-2.5%
10 Year	7.0+%	3-3.5%

**Rough* historical average

As you can see, rates were cut by more than half and very short term rates were virtually free. What could we expect from these lower rates?

- A lot more money will be borrowed and wasted due to money being so cheap to borrow.
- Other distortions will happen in all markets involving the US$, which is effectively the entire world.

Did any of this happen after ZIRP was implemented?

The real estate market was immediately turned even more upside down after ZIRP. What matters to most homeowners with mortgages is the monthly payment and that the house keeps its value or appreciates. The price of the house is less important than its affordability. Its affordability generally considers the income of the homeowners compared to their overall expenses, plus the monthly payment for the house itself. Banks make the potential buyers go through this evaluation process. The government makes potential buyers go through it for government guarantees from programs like FNMA, GNMA and others.

The monthly payment is calculated as an amortization using the price of the home and the applicable interest rate for the period of the mortgage. The payment is directly proportional to both the price of the house and the applicable interest rate. However, the *price of the house* and the *applicable interest rate* are *inversely* proportional. If interest rates go up, the price of the house will decline in most cases in order to maintain a monthly payment at close to the same level as before. The reverse is also true – and happened after ZIRP was implemented. The prices of homes boomed as the interest rates declined.

We discussed it plenty in my newsletters (available on TCM's website) from about 2006 until it was over. The root cause was laid out in TCM newsletters many times before it ever happened. Here's a hint: the government's goal of greater home ownership was implemented by requiring lenders to lend to people who did not actually qualify for prime loans, especially home mortgages. Thus, Sub-Prime mortgages were born. The interest rate for home mortgages was mandated to be lower than before, too. Human nature being what it is, there were plenty of abuses, but the *root cause for the financial crisis was forced upon the banking system by the federal government through Fed policies*.

Please note: The government created distortions over many markets from lowering interest rates on real estate, eventually causing a bear market and a huge recession. We believe it's noteworthy that their "answer" to the financial crisis was to lower the interest rates on *everything*?

Phantom Losses in Your Portfolio

All of the above discussion laid the groundwork for you to understand why your balance sheets or monthly statements will overstate materially the cost of some investments in your portfolio, especially income funds, since 2008.

When the Fed instituted ZIRP in 2008, many massive distortions were created in the securities markets. We'll attempt to explain what happened relevant to the subject at hand – how ROC dividends can distort monthly statements under certain conditions. Income funds, among others, will experience a premium or discount to net asset value (NAV)

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depending upon how much the fund's yield is relative to current market yields. When the Fed implemented ZIRP, virtually all such securities jumped in value because their portfolios were now loaded with much higher yielding securities than were available in the market place. When you have a portfolio with an average maturity of 5 years and your securities are yielding 5-6% instead of 2-2.5%, the price of your product will go up. Clients also like it when they are showing capital gains and a yield 300 basis points (3%) over the market.

As ZIRP dragged on and the securities in the funds' portfolios matured, the new securities that replaced them yielded at a much lower rate, so the funds found themselves having trouble meeting the income streams promised. Thus, the use of ROC dividends to supplement the income payout to the level expected would not only shrink the overall size of the fund portfolio (NAV) and the market would recognize this and the shares would sell for lower prices. *Still, as we discussed above, the cost of the fund shares were still showing at original cost on the monthly statements – NOT adjusted for the ROC dividends received.*

Our original explanation of not reducing original cost basis for funds distributing ROC dividends now becomes not a one-time, but an *annual* event after the Fed implemented ZIRP and left it in place. ROC dividends became *additive* each year they were distributed.

Using our original cost basis of $10/share for ABC CEF, the first year ROC caused the original cost basis to be overstated by $0.50/share. Now, the continued use of ZIRP forces the funds to make more ROC dividends *each year*. Of course, we know that none of those ROC dividends were used to reduce original cost either. The failure to reduce original cost basis from ROC dividends expanded from a small difference to a major misstatement on your monthly statement.

Our original 5% overstatement starts to reach levels near ***40%*** after being repeated for 7 more years, all other variables being the same, which, most likely, they are not. Just continuing with that scenario, the original $10/share should actually be $6/share. That is a *huge* percentage difference. The poor investor now has a monthly statement that shows massive losses – but they're *not real*. These "losses" are now included in cash and may have been even used to purchase other assets.

No losses were incurred from your ROC dividends. The fund's shares declined in value due to the lower market interest rates and the shrinkage of the available assets/share from the distribution of the ROC dividends. How can you tell if you are seeing "phantom ROC losses?" Look at your statements over a period of years. If the overall totals of your statements remain stable over a period of years, yet some of your individual investments show mounting losses, this is the likely cause. How could your statements remain stable or even grow some while you incur large real losses?

We know this is a bit like saying, "Are you going to believe your lying eyes or are you going to believe us?" Still, what we're telling you is absolutely true and people who have held these funds for that period are looking at severely misstated statements. After almost a decade of ZIRP, there may be – and likely are – some real losses in there, but because of the improper recording of ROC transactions, there's a good chance your statements are lying to you.

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I consider important when investing may help you. I'd also love to hear any questions or comments you may have about my letter.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.