Investment Management

October 2019

Capital Gain Distributions

Frequently asked questions and answers about capital gain distributions

OVERVIEW

1. What are Capital gains?

   - Capital gains are profits generated from the sale of an asset (i.e., when a fund sells a security at a higher price than for the price at which is it was purchased). Capital gains are realized as either short-term profits, if the investment was owned one year or less, or long-term profits, if the investment was owned for longer than one year. Long-term gains are taxed at a lower rate than short-term gains.

2. Are capital gain distributions taxable events for shareholders?

   - Yes. Funds are required by law to pass through gains to shareholders. Shareholders receive these distributions and are responsible for paying taxes on the distribution amount (unless the funds are held in tax-advantaged retirement accounts). This includes cash distributions as well as distributions for which shareholders elect to reinvest the proceeds into additional fund shares.

   - Fund shareholders may be responsible for taxes resulting from capital gain distributions even if they haven't sold any shares of their investment, and regardless of how long the shareholder owned shares of the fund. Whether distributions are recognized as short-term or long-term capital gains is based on how long the fund itself held the securities before selling them.

   - Fund shareholders receive distribution information on IRS Form 1099-DIV after the end of each calendar year for funds with capital gain distributions held in a taxable account.

3. Why are capital gain distributions made?

   - When a fund sells securities, either losses or gains are realized to the fund. In the case where the gains realized within the fund exceed the losses realized, the fund is required to distribute these gains to its shareholders at least annually in order to satisfy federal tax rules.

4. How can funds make capital gain distributions when fund performance is down?

   - Capital gains (or losses) are determined by the sale of securities within the fund, not the fund-level returns or general market performance. Even in down markets, the fund may have held securities that appreciated over time and, once sold, generated a gain for the fund. While capital gains may be offset by capital losses incurred by the fund, a down market is no guarantee that net losses will exceed net gains over any given time period.

5. Do Schwab Funds and Laudus Funds try to limit capital gain distributions?

- Schwab and Laudus Funds are primarily managed in order to meet the stated investment objectives, found in each fund's prospectus. While Charles Schwab Investment Management (CSIM) is mindful about tax implications for the funds and for shareholders, most Schwab and Laudus Funds do not state tax-management as an investment objective.

6. Why do fund share prices drop when a capital gain distribution is paid?

   - Potential capital gains accumulate as stocks are sold within a fund over a given time period. These potential gains contribute to the rise of the net asset value (NAV) of the fund's shares. As the potential gains are realized and distributed to shareholders, the NAV of the shares is reduced by the amount of the distribution.

7. How does a fund's capital gain distribution affect its total return?

   - The total return of a fund accounts for capital gain distributions. Because the NAV of a fund drops in an amount equal to the level of the distribution, no value is lost to the investor. For example, if a fund with a NAV of $12 per share distributes $1 per share, the NAV would drop to $11and the shareholder would receive a $1 distribution. This distribution can come as either a cash distribution or as additional shares of the fund if the shareholder had elected to reinvest distributions.

8. What do Record Date, Ex-Dividend Date, and Payment Date mean for capital gain distributions?

   - These terms have slightly different meanings across types of securities, but for open-end funds, they are defined as follows:

     - Record Date: All shareholders of record at 4 p.m. Eastern time on this day are eligible to receive the distribution. This date is usually the business day prior to the Ex-Dividend Date.

     - Ex-Dividend Date: This is the date on which the distribution amount per share is deducted from the NAV per share. The ex-dividend date is generally the business day after the Record Date. If a fund shareholder buys a share of the fund on this date, they will not receive the distribution. This date is usually the day prior to the Payable Date.

     - Payable Date (or "Pay Date"): This is the date a fund pays all Record Date shareholders their proportional share of the distribution.

9. Do capital gain distributions differ between index funds and actively-managed funds?

   - Index funds have an investment mandate to closely track a benchmark, and therefore tend to buy and sell less often compared to actively-managed funds. This generally leads to fewer realized gains and losses in index funds compared to actively managed funds

10. What factors may contribute to index funds paying capital gain distributions?

    - Mutual fund redemptions may require more selling at the fund level. This can result in realizing gains on the fund's securities, which must be passed through to shareholders.

    - Unlike actively-managed funds, index funds follow rules set by the index provider to track their respective indexes, including when to rebalance.

- Rebalancing involves buying or selling securities to align the weights of the holdings in the index fund to the weights of the index constituents, and is usually done on an annual or quarterly basis, with dates set by the index provider.
- Rebalancing creates turnover, and sales of any holdings may generate capital gains or losses for the fund.

11. Do capital gain distributions differ between large-cap equity indexes and small-cap equity indexes?
    - All funds are required to distribute gains, if and when they are realized by the fund.
    - In a positive return market, a market characterized by recent stock price appreciation, it may be the case that small-cap stocks can grow in market value to become large-cap stocks, requiring the small-cap index to "promote" the stock out of the index. The small-cap fund tracking the index would be required to sell the stock and potentially create a capital gain.
12. Do capital gain distributions differ between market-cap index funds and fundamental index funds?
    - All funds are required to distribute gains, if and when they are realized by the fund.
    - In general, the Fundamental Index strategies tend to have slightly higher turnover than market cap index strategies, especially in momentum-driven markets, as it is attempting to sell securities as fundamentals rise in value and buy securities as fundamentals become cheaper, which can increase the likelihood of triggering capital gain distributions.

Exchange Traded Funds ("ETFs")

13. What are the components that tend to make ETFs more tax-efficient than both index and actively managed mutual funds?
    - Most ETFs track an index, like index mutual funds
        - Index-tracking funds tend to have less securities turnover compared with actively-managed funds. This helps index-tracking funds minimize incurring capital gains and thus capital gains distributions to shareholders.
    - ETFs are exchange traded
        - Like stocks, ETFs are traded throughout the day on exchanges, such as NYSE Arca and Nasdaq. When shareholders want to sell their ETF shares, they usually sell them on an exchange without transacting directly with the ETF issuer. The ETF shares are simply transferred from the seller to the buyer, and the underlying securities held in the ETF are unaffected. Therefore, the fund does not have to buy or sell securities to support each client's buys and sells. As a result, it can have smaller capital gains.
    - ETFs have a unique redemption mechanism
        - When a mutual fund receives a redemption order from an investor, the fund may have to sell some of the securities it holds to raise capital to deliver cash to the investor. In contrast, an ETF's unique redemption mechanism commonly allows the ETF to redeem shares by divesting underlying securities through an authorized participant (AP) without having to sell those securities from the fund.
        - An AP is a large institution that transacts directly with the ETF issuer to create or redeem ETF shares in bulk quantities known as creation units. The AP effectively acts as an intermediary in the ETF redemption process.

During a redemption, the AP transacts with the fund - exchanging shares of the ETF in return for a portion of the ETF's underlying securities. Then the AP sells those securities, rather than the fund selling them.

- Redemption baskets may also contain a cash portion, along with securities "in-kind." Certain ETFs, such as those targeting esoteric asset classes, hard to access or less liquid securities, may not transact with the AP "in-kind," but may do so with only cash, or with a large cash component. When redemptions occur with only cash, or a large cash component, as opposed to largely "in kind" with securities, it may increase the likelihood of realizing capital gains within the ETF.

- More information on tax efficiency in exchange-traded funds can be found by clicking here.

ETF KEY TERMS

- Authorized participants: Large institutions that transact directly with an ETF issuer to create or redeem shares of an ETF.
- Creation unit: The minimum number of ETF shares required to transact directly with an ETF issuer. This is typically at least 25,000 shares.
- Primary market: The direct exchange of securities for shares of an ETF between authorized participants and ETF issuers.
- Secondary Market: The national markets system (e.g., the stock exchanges and other venues where listed securities can be traded). Investors continuously buy and sell shares of ETFs throughout the day on an exchange or other trading venue.

For more information

Please visit Schwab's Distributions and Tax Center page on schwabfunds.com for more information on the expected capital gain distribution schedules for Schwab ETFs, Schwab Funds, and Laudus Funds.

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Charles Schwab Investment Management

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Investors should consider carefully information contained in a fund's prospectus, or if available, the summary prospectus, including investment objectives, risks, charges and expenses. You can view and download a prospectus by visiting www.schwabfunds.com/schwabfunds_prospectus. Please read the prospectus carefully before investing.

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

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