



Embedded Capital Losses in Stock Mutual Funds: Opportunities for Taxable Investors?

Should five percent appear too small
Be thankful I don't take it all
'Cause I'm the taxman
Yeah, I'm the taxman
(The Beatles)

Overview

Mutual funds currently have large embedded losses that can offset future capital gains.

Shareholders may benefit from a fund's capital loss carry-forwards—but not by avoiding taxes forever.

A fund's capital loss carry-forward reduces future net capital gains distributions by the same amount, allowing shareholders to benefit by deferring taxes on that amount until they redeem their shares.

If capital gains tax rates rise in 2011, the benefits of deferring taxes before 2011 may turn negative.

We have heard reports that some taxable investors are being advised they have a rare opportunity to beat the taxman by investing in stock mutual funds right now. Could this be true? Hard to imagine, especially since UBS Swiss accounts are an option no longer. What are the reports about? Following the horrific stock markets of 2008 and the first quarter of 2009, mutual funds have sizeable embedded capital losses that can save investors taxes. Being familiar with a particular tax asymmetry in the Internal Revenue Code (IRC) that *might* benefit investors, we decided to take a look.

Specifically, mutual funds must distribute realized net capital gains but cannot distribute realized net capital losses. Surely, this means that mutual funds with embedded capital losses must be able to offset *some* capital gains--*sometime*. This won't matter to nontaxable investors (or for retirement accounts), but it does matter to those investors who are holding or considering holding mutual fund shares in their taxable accounts.

Before generating too much excitement, let us dismiss one piece of reported advice: "If you invest in a mutual fund with embedded capital losses you won't have to pay taxes on that amount of capital gains." Wrong. Embedded capital losses do not reduce future tax bills (under the current tax regime); they only lead to a change in the timing of those tax payments. Here's why: The IRC requires that mutual funds carry forward net capital losses rather than pass them through to shareholders in the tax year of their realization. Therefore, an investor in a mutual fund cannot access losses to write off gains on other investments in the same tax year. Instead, the mutual fund can carry that dollar loss forward for up to eight years and write off the same dollar amount of future net gains, if realized by the eighth year (when the carry-forward "dies on the vine"). This does not mean that shareholders will avoid paying taxes on the same dollar amount. The reason is that if a fund has future net capital gains (realized or unrealized) its Net Asset Value (NAV) will increase to reflect those gains. Remember that after a loss carry-forward is booked, it has no impact on future fund NAV since it only reflects net losses that occurred in the past. Therefore, at redemption an investor receives his pro rata share of the fund's NAV, which should reflect the gains that a capital-loss-carry-forward offset. In short, the investor should expect to pay taxes on those gains at the time of redemption or exchange.

So, how can the mutual fund shareholder benefit? Under the current law, mutual funds must distribute net capital gains realized in any tax year. These distributions are taxable to the shareholder whether they are reinvested or not. Even if a shareholder plans to hold the fund (and reinvest income and gains and not redeem) for, say, twenty years, he will owe taxes every year there is a distribution. Now, if the fund does not have to make a distribution during a given year, a shareholder owes no tax that year unless he redeems.

This is exactly where the fund's loss-carry-forwards come into play. The fund can write off future net capital gains by the amount of the carried losses and avoid making distributions. Therefore, provided the fund realizes some net capital gains on stock sales before the eight-year write-off period ends, the loss-carry-forward leads to tax savings for shareholders in the year(s) of a write-off. For the aforementioned investor who plans to hold the fund for twenty years, the loss-carry-forward provision allows him to defer paying (some) taxes for up to twenty years. Assuming tax rates do not increase, this tax deferral has positive value. If tax rates are expected to rise, however, this may not be the case since a shareholder would be deferring tax payments at today's lower rate to a time when rates are expected to be higher.

We have dismissed one part of the reported reason to invest in stock mutual funds, but it remains to determine if the tax deferral proposition merits calling a tax accountant or tax advisor. Here is our assessment of capital-loss-carry-forwards for a mutual fund investment on its own, that is, without considering an investor's other assets and total tax situation:

1. Under the current tax structure and assuming a continuation of it:
 - The value of deferring shareholder taxes on capital gains is positive but small in most cases,
 - If an investor is already a shareholder in a mutual fund with a loss-carry-forward, that investor will benefit from some future tax deferral savings.
 - If an investor is considering a new investment in a mutual fund with a loss-carry-forward, he can expect some degree of tax relief. If this investor does invest, he will share equally with all other shareholders in the loss-carry-forward. Since a fund must issue additional shares for a new investor and any loss carry-forward is fixed in size, this means that a new investor reduces the loss per share, thereby diluting the write-off and benefit for other shareholders.
 - If an investor is choosing between two different mutual funds that he thinks are virtually identical in terms of expected rate of return, asset class, turnover, fees, etc., he should choose the one with the larger capital-loss-carry-forward.
 - If an investor wants to make a new investment with a particular stock manager, and the manager offers both mutual fund and separate account vehicles, a loss-carry-forward in the mutual fund should not be the deciding factor. Aside from the fee issue (which is probably higher for the fund), the investor would have more control with the separate account in terms of
 - Having access to realized capital losses and the ability to use them to write off gains on other investments,
 - Communicating with the manager about harvesting of losses,
 - Not being affected by the actions of other investors.
 - Especially large mutual fund capital-loss-carry-forwards are not a sound reason for investing.
2. If capital gains tax rates increase after 2010 in line with President Obama's current budget proposal (and there are no other or mitigating changes):
 - All of the above points would hold after December 31, 2010, that is, would apply once the new tax regime is in place. However, they might not hold for deferrals made between now and December 31, 2010.
 - The value of deferring capital gains distributions and their taxes from 2009 and 2010 to 2011 and beyond could turn negative.
 - If an investor is choosing now between two different mutual funds that he thinks are virtually identical in terms of expected rate of return, asset class, turnover,

fees, etc., his choice depends on his expected holding period (when he plans or expects to redeem) in the following way:

- If he plans to redeem at the end of 2010 or before, he should choose the one with the larger capital-loss-carry-forward. However, because the value of deferring taxes for such a short time period is negligible, it matters little which he chooses.
- If he plans to redeem in 2011, he should choose the mutual fund with the lower capital-loss-carry-forward—ideally one with no capital-loss-carry-forward. The reasoning is as follows: deferring capital gains that would be taxed at 15% for one tax year to a time when they will be taxed at 20% implies an exorbitant borrowing cost of $33\frac{1}{3}\%$ $((20\%-15\%)/15\%)$.

Of course, an investor could always lock in the current tax rate on capital gains accumulated through 2010 by redeeming shares before the end of 2010, but this is a complicated investment question beyond the scope of this note.

- If the investor plans to redeem beyond 2011, there is no simple answer.
3. The uncertainty about changes in taxes that affect mutual funds and their shareholders obviously complicates investment decisions for taxable investors. Decisions should be made based on what the investor expects them to be.

In the remainder of this note, we summarize facts and analysis that support our opinions. We begin by providing data on mutual fund embedded losses, since they, frankly, surprised us. We summarize the salient tax issues, discuss the value of deferring taxes, and provide tables that report on the value of deferring taxes under various scenarios. Finally, we provide a brief update on current proposals to revise the mutual fund tax laws that are the subject of this note.

The Current Level of Mutual Fund Embedded Capital Losses

To see how large mutual fund capital losses are now, we collected data available through Morningstar Direct. Specifically, we analyzed the Potential Capital Gains Exposure (PCGE) calculated by Morningstar. PCGE is calculated as the sum of a fund's realized and unrealized net capital gains divided by the net asset value of the fund. In other words, PCGE is capital gains (or losses) expressed as a percentage of NAV. As such, it provides an indication of future taxable capital gains distributions—or losses that can potentially offset future gains and reduce future distributions.¹ We investigated PCGE for samples of U.S. large-cap growth and value open-end funds as of 7/31/09. We chose some relatively large samples in order to obtain a reasonable sense of how large mutual fund capital losses currently are. We selected only funds that had inception dates before 2008 in order to observe the effect of returns during the worst part of the credit-crisis-induced bear market.

Tables 1 and 2 below summarize capital gains exposure for two styles of large-cap growth and large-cap value funds. The tables include PCGE data for all share classes except load-waived. Both tables reveal large embedded capital losses as a % of current NAV. For the 1,000 plus large growth fund sample, PCGE has an average size of about -60% and a minimum below -1,000%! Average PCGE of the large value funds is somewhat higher but still in the neighborhood of -40%. Large cap mutual funds have sizeable embedded losses to offset potential future gains. Almost none have embedded gains. Although PCGE includes unrealized losses as well as loss carry-forwards, it suggests that many funds will not be distributing taxable capital gains in the near future.

¹ PCGE is only an indication because 1) the unrealized portion of the numerator may not be realized (it depends on changing prices of the underlying securities and trading activity by the manager) and 2) the denominator, NAV, may change (prices of portfolio securities can change as can the number of shares in the fund). Nonetheless, it is a readily available measure and is estimated monthly.

Table 1: Large Cap Growth Funds: Potential Capital Gains (Loss) Exposure.

Large Growth Mutual Funds*	Russell 1000 Growth Prospectus Benchmark	S&P 500 Prospectus Benchmark
	PCGE (%) as of 7/31/09	PCGE (%) as of 7/31/09
All Share Classes except LW		
Mean	-61.2	-51.8
Median	-30.5	-26.2
Std. Dev.	112.4	114.2
Minimum	-998.2	-1,128.1
Maximum	87.7	45.6
# Observations	687	442
# with PCGE >0	39	32
A-Share Classes		
Mean	-63.1	-47.6
Median	-29.9	-26.9
Std. Dev.	115.4	103.6
Minimum	-856.4	-825.9
Maximum	84.7	36.0
# Observations	124	69
# with PCGE >0	11	4

* Open-end mutual funds in Morningstar Large Growth category; inception before 2008.

Table 2: Large Cap Value Funds: Potential Capital Gains (Loss) Exposure.

Large Value Mutual Funds*	Russell 1000 Value Prospectus Benchmark	S&P 500 Prospectus Benchmark
	PCGE (%) as of 7/31/09	PCGE (%) as of 7/31/09
All Share Classes except LW		
Mean	-47.7	-35.0
Median	-39.6	-27.0
Std. Dev.	60.3	42.4
Minimum	-1,123.5	-353.9
Maximum	43.4	95.9
# Observations	644	320
# with PCGE >0	10	19
A-Share Classes		
Mean	-42.1	-41.7
Median	-36.4	-29.6
Std. Dev.	34.5	53.6
Minimum	-259.3	-353.9
Maximum	6.5	18.0
# Observations	113	56
# with PCGE >0	3	3

* Open-end mutual funds in Morningstar Large Value category; inception before 2008.

Tax Treatment of Mutual Funds

Mutual Fund Level

We begin by recapping key elements of mutual fund taxation. The Investment Company Act of 1940 (1940 Act) and the Internal Revenue Code are the primary Federal laws governing mutual funds. The 1940 Act sets forth the requirements necessary for a pooled investment vehicle to achieve the status of a Registered Investment Company (RIC). Once qualified as an RIC, a mutual fund can pass through income and tax liabilities to its shareholders and avoid paying corporate tax rates on income at the fund level (thereby avoiding triple taxation on the earnings regular U.S. corporations pay to their investors). RICs must distribute 98% of income (dividends, interest and short-term capital gains) and 90+% of net long-term capital gains realized from the sale of securities. If it fails to make such distributions, a fund must pay taxes on undistributed income at the corporate tax rate and an excise tax of 4% on undistributed capital gains. Consequently, mutual funds distribute virtually all dividends, interest, short- and long-term realized capital gains.

Shareholder Level

Mutual fund shareholders pay taxes in three ways if they hold shares in taxable accounts:

1. A shareholder realizes either capital gains or losses at the time of redemption (or exchange). If there is a gain (sale price exceeds tax cost basis), the shareholder pays capital gains tax on the gain unless it can be offset by losses realized on other asset sales. If there is a loss (tax cost basis exceeds sale price), the loss can offset equal-sized gains from other asset sales, up to \$3,000 of ordinary income if there are insufficient gains to offset, or be carried forward to offset future gains.
2. A shareholder pays tax on income distributions from the fund at his marginal tax rate² whether the shareholder reinvests the income in the fund or not.
3. A shareholder pays tax on capital gains distributions from the fund depending on his marginal tax rate. Again, this is the case whether the shareholder reinvests gains in the fund or not. The maximum capital gains tax rate now is 15%³, but under President Obama's 2009 budget proposal, this rate would revert to 20% after 2010 when the Bush tax cuts expire.

What if a mutual fund has realized capital gains?

Net realized capital gains will be distributed and produce a tax liability for the shareholder. They will also change the shareholder's tax cost basis: capital gains distributions should be added to the cost basis, meaning that the shareholder will not pay taxes on that amount again at redemption. This is an important concept to grasp in the overall understanding of mutual fund tax treatment. For the taxable shareholder, the distribution of capital gains affects the timing of tax payments—not the total amount of tax expected over his holding period—unless tax rates change. Put simply, as capital gains are realized by the fund, a shareholder pays on those gains each year rather than when he sells his shares. At the end of his investment period (assuming it is not at death when estate tax rules take over), he only owes taxes on the difference between sale price and cost basis, which has been adjusted upwards by the amount of previous capital gains distributions.

This tax treatment led to mutual fund shareholder outrage in the bear markets of 1987, the early 1990's, the collapse of the internet bubble in 2001, and again in 2008 as they experienced large losses in share values yet were confronted with tax bills due to capital

² We do not discuss the intricacies of mutual fund income distributions.

³ The lowest rate through 2010 is 0% and applies to shareholders in the 10% or 15% marginal tax brackets. (TIPRA 2006)

gains distributions from many mutual funds.⁴ Why do mutual funds make capital gains distributions in such times? One of the primary reasons is that some shareholders redeem their shares in efforts to preserve wealth. Redemptions force the fund manager to sell securities, some of which may have been in the portfolio for long periods and have large accumulated capital gains. Because each share “shares” equally, shareholders who remain in the fund rather than redeem receive a pro rata share of the capital gains. In other words, they are subject to externalities created by other shareholders. These tax externalities are well known and a major argument for choosing a separately managed account format instead of a mutual fund. For with a separate account, capital gains (and losses) result from the accountholder’s initiatives (communicated to the account manager via investment agreement) rather than the actions of other, unrelated investors.

What if the fund has realized capital losses?

This brings us to a key asymmetry in the tax law: While mutual funds (RICs) must distribute net capital gains realized in a tax year, they cannot distribute net capital losses. Instead, net realized capital losses can only be carried forward for up to eight years and used to offset capital gains during that subsequent eight-year period. For a shareholder, this means tax relief is deferred unless the shareholder redeems shares and recognizes a loss on his own fund share transaction. This represents another major difference between investing in mutual funds as opposed to investing via a separately managed account (SMA). With an SMA, the manager can harvest losses for the investor to offset gains in that particular SMA or in any other of the investor’s assets, as well as up to \$3,000 of ordinary income.

Investors who are considering investment in mutual funds today should be pleased to find that many funds have embedded realized losses to carry forward. This means that future capital gains distributions of said amount will not be made, which in turn means that tax bills on that amount will not be owed. However, they must remember that any future net capital gain should increase the net asset value of the fund by approximately the same amount, so at redemption they will realize and pay tax on that gain. This is a classic example of “Pay me now or pay me later.”⁵

Valuing the Tax-Deferral Benefits of Capital-Loss-Carry-Forwards

If a mutual fund has loss-carry-forwards that can offset future realized capital gains, capital gains distributions to shareholders will be zero until the carry-forwards are exhausted. This means that shareholders will not have to pay taxes on that amount of capital gains until they redeem shares. The value of such a deferral equals the present value of the expected deferred taxes before redemption less the present value of taxes expected at redemption.⁶

⁴ According to the Investment Company Institute (ICI), mutual funds distributed \$133 billion in capital gains in 2008, down from \$414 billion in 2007 and \$257 billion in 2006. In 2008, 30% of stock mutual funds distributed capital gains and half of those distributed at least 4%.

⁵ It is not quite that simple because a current shareholder will be affected by the actions of other current shareholders or new shareholders. Inflows into a fund give rise to the issuance of additional shares which own a *pro rata* share of assets, unrealized gains or losses, and also loss carry-forwards—which are fixed in total dollar size at a single point in time. Therefore, new inflows dilute previously accumulated gains and losses. While a dilution of capital gains is beneficial for current shareholders, a dilution of capital losses is not: on a per share basis, the former lowers the size of any imminent per share capital gains distribution, thus deferring some imminent taxes. The dilution of a loss, however, reduces the amount of per share future capital gains that can be offset, thus accelerating the payment of taxes on a per share basis. Therefore, shareholders expecting to have taxes deferred on some level of future gains could receive an unpleasant surprise if the fund attracts other, new investors: a taxable capital gains distribution could come sooner than expected.

⁶
$$PV \text{ of savings due to tax deferral} = \sum_{t=1}^T \{ (Z_t d_t) / (1 + r)^t \} - Z_T \left(\sum_{t=1}^T d_t \right) / (1 + r)^T ,$$

where Z_t is the capital gains tax rate in year t , d_t is the capital gain distribution in year t that is offset by a capital-loss-carry-forward, T is the holding period (years to redemption), and r is a reasonable after-tax discount rate.

We provide values for a simplified tax deferral case in Tables 3 and 4. Specifically, we consider the case where a mutual fund's NAV appreciates at a constant growth rate, that realized capital gains are a constant percentage of appreciation, that all current shareholders reinvest their capital gains, the fund attracts no new investors in the future, and the capital gains tax rate is constant. While this may seem overly simplistic, it allows us to focus on the key issue of paying taxes later rather than sooner. We constructed tables for the case where a mutual fund has a capital-loss-carry-forward equal to 40% of its current NAV. The shaded areas of the tables indicate the approximate number of years a 40% loss carry-forward will still be available to offset realized gains for a particular growth rate in NAV. (We do not consider funds with expected negative growth.)

As Tables 3 and 4 demonstrate, the value of tax deferral as a % of initial investment is small for the scenarios described and unlikely to compensate for loss of the control a separate account would afford, *ceteris paribus*. It is worth noting that the unshaded area of each table reports savings that are more substantial. Given the table assumptions of a 40% loss carry-forward, the carry-forward "runs out" before the unshaded portion comes into effect. It would be effective, however, if the carry-forward were unlimited. This is exactly the effect sought by tax reform proposals like H.R. 3429, which would change the tax law to allow mutual fund investors to defer taxes on reinvested capital gains distributions until they redeem their shares. We briefly discuss proposed tax reforms later.

Table 3:
Present Value of Expected Savings from Deferral of Tax on Capital Gains Distributions

Shades areas indicate approximate holding periods for which a 40% loss carry-forward has not been used up.

Capital Gains Tax Rate: 15%
Discount rate: 5%
Distribution as % of Growth: 40%

Value of Tax Deferral as % of Initial Investment

Holding Period:	1	2	3	4	5	6	7	8
Expected Growth rate:								
5%	0.00%	0.01%	0.04%	0.08%	0.13%	0.19%	0.26%	0.35%
10%	0.00%	0.03%	0.08%	0.16%	0.27%	0.41%	0.57%	0.77%
15%	0.00%	0.04%	0.12%	0.25%	0.43%	0.66%	0.94%	1.27%
20%	0.00%	0.05%	0.17%	0.35%	0.60%	0.93%	1.36%	1.88%
25%	0.00%	0.07%	0.21%	0.45%	0.79%	1.25%	1.85%	2.61%
30%	0.00%	0.08%	0.26%	0.56%	0.99%	1.60%	2.42%	3.49%

Table 4:
Present Value of Expected Savings from Deferral of Tax on Capital Gains Distributions

Shades areas indicate approximate holding periods for which a 40% loss carry-forward has not been used up.

Capital Gains Tax Rate: 20%
Discount rate: 5%
Distribution as % of Growth: 40%

Value of Tax Deferral as % of Initial Investment

Holding Period:	1	2	3	4	5	6	7	8
Expected Growth rate:								
5%	0.00%	0.02%	0.05%	0.11%	0.17%	0.26%	0.35%	0.46%
10%	0.00%	0.04%	0.11%	0.22%	0.36%	0.55%	0.76%	1.02%
15%	0.00%	0.05%	0.17%	0.34%	0.57%	0.87%	1.25%	1.70%
20%	0.00%	0.07%	0.22%	0.46%	0.80%	1.24%	1.81%	2.51%
25%	0.00%	0.09%	0.29%	0.60%	1.05%	1.66%	2.46%	3.48%
30%	0.00%	0.11%	0.35%	0.74%	1.32%	2.13%	3.22%	4.65%

Current Proposals for Mutual Fund Tax Reform

We have no particular insight into the politics and probabilities of tax reform. Because there is renewed lobbying for reform of the mutual fund tax issues discussed in this note, we thought it fitting to mention two current proposals to change mutual capital gains tax rules.

1. **Coates Report:** In July of this year, the Committee on Capital Markets Regulation⁷ released a report by John C. Coates,⁸ Professor at the Harvard Law School. Professor Coates argues, first, that asymmetries within the U.S. tax code often place U.S. mutual fund investors in disadvantageous positions relative to U.S. investors who utilize separately managed accounts and, second, that differences between U.S. and foreign (E.U.) mutual fund securities laws and regulations put U.S. mutual fund companies in a competitively disadvantaged position relative to those in many foreign countries. He proposes numerous changes to the regulation and the following three recommendations with respect to the taxation of U.S. mutual funds:
 - Permit investors owning less than 2% of shares in a U.S. mutual fund to defer capital gains tax until they sell their fund shares,
 - Allow U.S. mutual fund investors to realize capital losses in the same manner as they realize capital gains, and
 - Permit U.S. investors to invest in foreign funds that only impose tax on investors when dividends and capital gain are distributed without incurring any additional U.S. taxes or penalties.
2. **HR Bill 3429:** On July 30, 2009, Representatives Ryan (R-WI), Artur Davis (D-CA), and Crowley (D-NY) introduced House Bill 3429, which proposes to amend the IRC to allow individuals to defer recognitions of reinvested capital gains distributions from RICs until they redeem shares. The bill is cited as the “Generate Retirement Ownership Through Long-Term Holding Act of 2009” (“GROWTH Act of 2009”) and was referred to the Committee on Ways and Means.

Concluding Remarks

The recent bear market has left most stock mutual funds with net realized and unrealized capital losses. Although they are restricted by law from distributing net realized losses to shareholders, mutual funds can carry them forward, offset the same fixed amount of future realized gains, and thereby reduce future taxable distributions by that amount. However, as a fund generates gains in the future, its NAV increases while a shareholder’s tax cost basis does not. Therefore, a shareholder should expect capital gains at redemption to include capital gains that were not previously taxed.

Given the current capital gains rate of 15% and the fact that capital gains distributions are generally below 10% of NAV, the value of deferring tax payments on distributions that can be avoided by current mutual fund loss carry-forwards is relatively small even assuming that there will be no flow of new money into funds. If funds issue new shares because of reinvested income distributions or inflows from new investors, this will dilute the loss-carry-forward per share and make the value of per share tax deferrals even smaller. We think that with a lot of money still “on the sidelines,” net inflows to mutual funds are very likely. The value of tax deferrals does not appear large enough to tip the scales in favor of mutual funds over separate accounts.

⁷ The Committee on Capital Markets Regulation is an independent and nonpartisan 501(c) (3) research organization dedicated to improving the regulation of U.S. capital markets.

⁸ John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, June 10, 2009 (available at: http://www.capmksreg.org/pdfs/09-June-10-Reforming_the_Taxation_and_Regulation_of_Mutual_Funds.pdf)

If a mutual fund is what an investor wants, his decision should take into account the length of his expected holding period and the tax rates that will apply at the end of the holding period. If capital gains rates remain at their current levels, mutual fund capital-loss-carry-forwards add value for shareholders, albeit modest. If capital gains tax rates increase after 2010, mutual fund capital-loss-carry-forwards may actually impose additional costs on shareholders who invest before 2011. On the other hand, once we reach January 1, 2011, any remaining or new capital-loss-carry-forwards would once again benefit shareholders under the President's proposed new capital gains tax regime.

The question we explored in this note is complicated, technical, and probably unexciting. Due largely to the uncertainty of future tax rates and tax reform, some answers are clear but others are not. As that uncertainty is resolved, we hope to provide answers that are more definitive.

Pat Little, Ph.D.

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