Account Types Matter
But How Do I Choose?

Saturna Capital

From The Yardarm
Market Commentary & Analysis

May 2018

About Saturna Capital

Saturna Capital, manager of the Amana, Saturna Sustainable, Sextant, and Idaho Tax-Exempt Funds, uses years of investment experience to aid investors in navigating today's volatile markets. Founded in 1989 by professionals with extensive experience, Saturna has helped individuals and institutions build wealth, earn income, and preserve capital.

Saturna's deep-rooted belief in value investing shines through in the quality of our investments. We don't follow trends, we analyze opportunities. Years of experience have given Saturna financial strength and stability. Most important to Saturna's success, however, is our clients' success. We believe that our clients' interest always come first.

At Saturna, we believe in making your investment dollars work hard for you. Toward this end, Saturna strives to not only offer the best investment opportunities from mutual funds to IRAs, but to match those sound investments with superior customer service.

Amana Mutual Funds Trust

SEXTANT MUTUAL FUNDS

IDAHO TAX-EXEMPT FUND

SATURNA SUSTAINABLE FUNDS

Please consider an investment's objectives, risks, charges, and expenses carefully before investing. To obtain this and other important information about the Amana, Sextant, Idaho Tax-Exempt, and Saturna Sustainable Funds in a current prospectus or summary prospectus, please visit www.saturna.com or call toll free 1-800-728-8762. Please read the prospectus or summary prospectus carefully before investing.

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Account Types Matter

Whether you're saving for retirement, your children's education, a much-needed getaway, or just a rainy day, *everyone* has financial goals. But when you're saving and investing, it's important to know how different investment account types can impact your after-tax returns. The basic considerations covered here can help you choose the most efficient account type to help you reach your goals.

From a taxation point of view, not all sources of returns are created equal. For example, the IRS treats dividends as current income but doesn't consider capital gains or losses that you have yet to realize (by selling your investment) as income. Selling shares of your investment might generate a capital gain or loss, and the tax rates are different for short-term versus long-term gains or losses. You can receive a taxable capital gain distribution from a mutual fund you own—whether you sold shares that year or not—which makes it imperative that you pay extra attention to the tax implications of the account type you have selected to avoid surprises come tax time.

For the purposes of this article, we'll define dividends as investment income paid to shareholders. Dividend income is taxable in the year it is received, unless held in a tax-qualified account, and it comes in two flavors: ordinary and qualified. Ordinary dividends are taxed as income while qualified dividends are taxed at long-term capital gains rates, which tend to be lower.

EXAMPLES OF QUALIFIED ACCOUNTS:

- Individual Retirement Accounts (IRAs)
- Education Savings Accounts (ESAs)
- Health Savings Account (HSAs)
- Traditional 401(k)s and Profit Sharing Plans
- Thrift Savings Plans (TSPs)
- Simplified Employee Pensions (SEPs)
- Savings Incentive Match Plans for Employees (SIMPLE IRAs)

How Dividends Affect Share Price

Before we get into the weeds about investment account types, let's do a crash course on how dividends affect the share price of your investment and its returns. If you've ever owned a stock or a mutual fund, it's likely that you've received a distribution. Distributions have an immediate and sometimes large impact on the net asset value (NAV) or price of the security. Mutual funds are required to distribute certain types of income and gains to their shareholders to maintain their tax advantaged, pass-through status. On the other hand, stocks from publicly traded companies make distributions based on the decisions of their boards of directors. In both cases the distributions will decrease the price of the security, all else equal, on the day they go ex-dividend. Said another way, on the first day that a security trades without the right to the declared distribution, the price will decrease. It makes sense that somebody buying a security should not have to pay for the dividend or other distribution that they are not entitled to receive. It should also be said that purchasing a security right before it pays a dividend is not in your best interest as your sole reward will be a tax bill.

Mutual fund and stock distributions make up only one part of your investment return. Share value variations make up another component. To measure your total investment return, combine both the price movement and the value of distributions received. If you ignore the distribution, you may look at the price of your shares and wonder, "What's going on? My mutual fund shares are down 10% today!" In this example, the 10% decrease may be reflected in the price per share; however, when you include the distribution from that day, it's possible that your account actually increased in value due to market appreciation. Now imagine that you owned a security for years and that you bought and sold shares of the security numerous times over the same period. Also imagine that you have received many distributions that were reinvested in more shares instead of paid out in cash; this is when calculating your investment return starts to get tricky and when your account type can make a material difference.

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WWW.SATURNA.COM/DIVIDENDS-AND-DISTRIBUTIONS

How to Choose an Investment Account Type

Which account type should you use to hold your investment? There are two main categories: qualified and non-qualified. Qualified accounts allow you to save for retirement pretax, that is, with money that hasn't been taxed yet. 401(k) Plans and Traditional Individual Retirement Accounts (IRAs) are types of qualified accounts. Contributions made either by an individual or their employer will grow tax-deferred. You won't pay tax on this money until you begin taking distributions—hopefully in retirement, although there are some IRS exceptions. The government does want you to eventually pay tax on this money, so at age 70½ you'll need to start taking Required Minimum Distributions (RMDs) until the account is depleted. The IRS imposes a stiff 50% penalty on RMDs not taken on time. For more detailed information about IRA distributions, see IRS Publication 590-B.

For example, if your annual income falls into the 24% marginal tax bracket, your long-term gains would be taxed at 15% versus 24% for short-term gains.

Roth 401(k)s (offered through employers) and Roth IRAs are funded with after-tax contributions, meaning applicable payroll withholdings have already been deducted from money contributed. Roth IRAs aren't subject to RMDs, unless you inherit one, but we'll save that for another article. You can always withdraw your Roth contributions penalty-free, and you can withdraw the earnings tax-free after age 59½. Like Traditional IRAs, there are qualifying life events that may allow you to withdraw money before retirement without taxes and penalties, but keep in mind that the most effective retirement savings vehicle is one that you don't raid to fund your current expenses.

If you plan to trade more frequently and realize short-term gains from investing, a qualified account is likely the best place to employ that strategy.

Non-qualified accounts hold after-tax money, meaning you've already paid income or other taxes on it, and do not offer any tax-deferral benefits. The types of investment income generated from these accounts can have a big impact on your after-tax investment returns. Qualified dividend income and long-term gains receive more favorable tax treatment than interest income, ordinary dividends, and short-term capital gains, which are taxed at your ordinary income rates. Mutual fund distributions of qualified dividend income and long-term capital gains, also receive favorable tax treatment. For example, if your annual income falls into the 24% marginal tax bracket, your long-term gains would be taxed at 15% versus 24% for short-term gains.

Taxable or Tax-Deferred?

How investment income is taxed over the long term can significantly affect your after-tax investment performance. Let's continue our example from above of 15% tax versus 24% tax but add some wrinkles. Imagine you own a growth-oriented mutual fund — let's call it "ISAVX" — that pays long-term capital gains and qualified dividend income distributions; you own this fund in both qualified and non-qualified accounts. Over time, as you receive distributions and sell shares to realize gains and losses, your after-tax returns for this holding will be different in each account type.

Let's illustrate this with an example:

1. You buy 100 shares of ISAVX for $10 per share for an initial investment of $1,000.
2. In years one, two, and three, ISAVX pays a $0.25 per share qualified income dividend and a $0.25 per share long-term capital gain distribution. All distributions are paid in cash (not reinvested in fund shares) and then held in the account for qualified accounts or paid to you in non-qualified accounts. For simplicity, we assume cash from distributions earns no interest.
3. At the end of year three you sell ISAVX for $15 per share (or $1,500 total) and realize a long-term gain of $500. Also, at the end of year three you decide to withdraw $1,500, plus accumulated cash from distributions, from your qualified account to fund your retirement expenses.

Here's what that activity might look like on an account statement:

PURCHASE INITIAL INVESTMENT	SHARES	PRICE PER SHARE	TOTAL INVESTMENT
	100	**$10.00**	**$1,000**
ACCOUNT ACTIVITY	*Qualified Income Dividend*	*Long-Term Capital Gain*	*Accumulated Distribution*
End of Year 1 (per share)	$0.25	$0.25	$50
End of Year 2 (per share)	$0.25	$0.25	$50
End of Year 3 (per share)	$0.25	$0.25	$50
Total distributions x 100 shares	**$75**	**$75**	**$150**
	SHARES	PRICE PER SHARE	WITHDRAWAL
End of Year 3: **Sell**	**100**	**$15.00**	**$1,500**
Total sale proceeds			**$1,650**

Assume that you were in the 15% tax bracket when the initial contribution was made in the account. Each subsequent year you were in the 24% marginal tax bracket for ordinary income. Also assume that you are using an IRS allowed exemption or are over age 59½ so that additional penalties for qualified accounts don't apply. Here's how your after-tax returns would differ by acount type:

Qualified Account

- **Traditional**
  - Distributions from qualified accounts are treated as ordinary income bringing your 24% tax bill on the $1,650 withdrawal to $396. Your net amount after taxes would be $1,254. Taking it a step further, the cost of your initial investment could be thought of as being reduced by the immediate tax savings you received from making a tax-deductible contribution. You avoided paying $150 in taxes initially (15% tax on $1,000), reducing your cost for the initial investment to $850. Applying this concept, the net after-tax total return on your initial investment would be **47.53%** (13.84% annually).
- **Roth**
  - In a Roth IRA, contributions aren't deductible but later qualified distributions are tax-exempt. It is likely you paid 15% income tax on $1,176 (which is the amount you need to earn to have $1,000 to invest after accounting for income taxes paid of $176). That increases the initial cost of investing and brings the net after-tax total return to **40.25%** (11.94% annually).

	QUALIFIED ACCOUNT (TRADITIONAL)	QUALIFIED ACCOUNT (ROTH)
Adjusted initial investment cost	**$850**	**$1,176**
Withdrawal/sale proceeds	**$1,650**	**$1,650**
Tax on appreciated shares ($1,500 x 24%)	($360)	n/a
Tax on accumulated distributions ($150 x 24%)	($36)	n/a
Total tax liability at withdrawal	($396)	n/a
Sales proceeds after tax	**$1,254**	**$1,650**
After-tax Total Return	47.53%	40.25%
After-tax Annualized Total Return	13.84%	11.94%

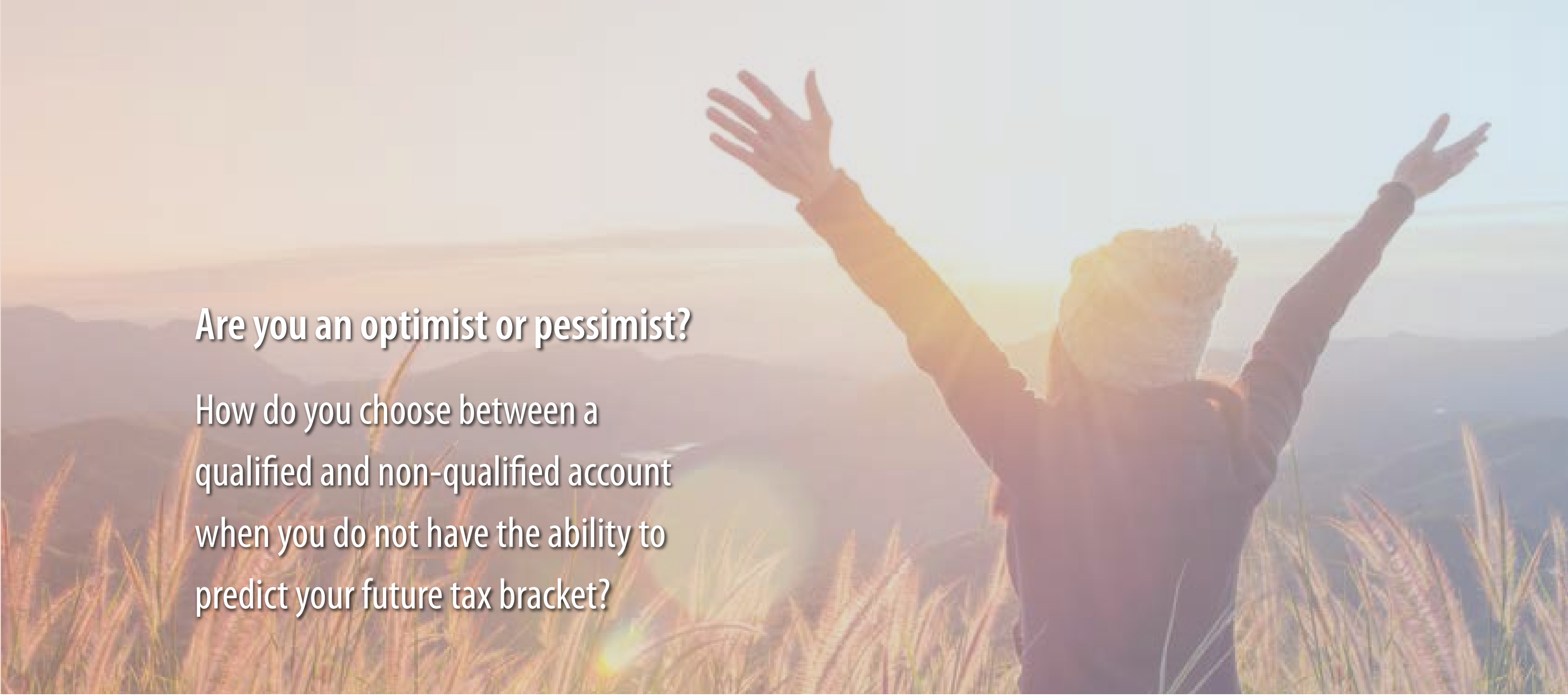
While this example portrays a more favorable result for the Traditional qualified account, the outcome can be greatly affected by the tax bracket you're in when taxes become due.

Non-Qualified Account

Using the same assumptions as with the qualified account, taxes chip away at distributions and gains rather than taking a bite at the beginning or end.

- Each year, the distributions you received were taxed at 15% for a total tax liability of $22.50. The tax rate on the distributions is determined by the type of distribution, in this case: qualified income dividends and long-term capital gains, bringing the total dividend income to $127.50 net, after taxes.
- You made a long-term capital gain of $500 ($1,500 - $1,000). This is also taxed at a 15% rate currently, making the tax liability on the gain $75 ($500 x 15%), and bringing the total gain to $425 net, after taxes.
- Just like in the Roth example, if the initial contribution came from earned income, then you likely paid income tax of 15% income tax on $1,176 (again, this is how much you need to earn to have $1,000 to invest after accounting for taxes), raising the initial cost of the investment. It is possible for the contribution source to be something other than earned income (e.g., inheritance or settlement proceeds) which would present a different outcome.
- This brings the net after-tax total return to **31.96%** (9.69% annually).

	NON-QUALIFIED ACCOUNT
Adjusted initial investment cost	**$1,176**
Withdrawal / sales proceeds	**$1,650**
Tax on accumulated distributions ($150 x 15%)	($23)
Tax on capital gain ($500 x 15%)	($75)
Total tax liability at withdrawal	($98)
Sales proceeds after tax	**$1,552**
After-tax Total Return	31.96%
After-tax Annualized Return	9.69%



HSA: Triple Tax Advantage

Health Savings Accounts (HSA) are another type of qualified investment account that allow you to save pretax dollars to pay for medical expenses (see IRS Publication 969 for details). Contributing to an HSA requires a qualifying high-deductible health insurance plan (check with your insurance provider to confirm you qualify). In addition to tax-deductible contributions you make, your employer can choose to make contributions to this account and depending on your health insurance type, you may make individual or family contributions each year (since other factors could affect your allowable contribution amount, it's a good idea to consult your tax adviser to confirm). HSAs are unique in that they are triple tax advantaged. Not only can you make tax deductible contributions, interest and investment earnings in the account aren't taxed, and you can withdraw HSA funds without tax penalties to pay for qualified medical expenses. HSAs are a great way to save for medical expenses in retirement; if you don't need to use your HSA funds to pay for your current medical expenses, save those receipts and let your account grow tax-free. You can reimburse yourself at a later date (even years later) with a tax-free distribution. Be aware that taking withdrawals before age 65 for expenses, medical or otherwise, that aren't qualified medical expenses will result in a 20% penalty.

	QUALIFIED ACCOUNT (HSA)
Adjusted initial investment cost	**$850**
Withdrawal/sale proceeds	**$1,650**
Tax on appreciated shares	n/a
Tax on accumulated distributions	n/a
Total tax liability at withdrawal	n/a
Sales proceeds after tax	**$1,650**
After-tax Total Return	94.12%
After-tax Annualized Total Return	24.74%

Keep Calm, Save On

Still with us? We know it's a lot to think about. The returns calculations above could be affected by other choices you make, such as whether or not you reinvest dividends, or whether you are able to earn interest on your cash balances. Also, there is always going to be some uncertainty around which tax bracket your income will be in during retirement; Congress could raise or lower tax rates, you could receive an inheritance, etc. Generally speaking, if you believe you'll be in a lower tax bracket in retirement than you are now, you might want to make pretax contributions to a Traditional IRA, 401(k), or a similar qualified plan. If you expect to be in a higher tax bracket in retirement, then consider funding a Roth IRA or Roth option for your qualified plan through work. Non-qualified accounts can benefit from investments that earn more tax efficient returns, such as qualified income dividends and long-term capital gains. Also, non-qualified accounts can benefit from timing the realization of gains and/or losses. Managing this process poorly can have a big impact on after-tax returns.

Consider consulting a tax adviser for recommendations on how to become more tax-efficient. Be aware of the tax ramifications and potential differences in net returns between account types. And, ultimately, keep saving for your goals — account types and tax savings strategies are moot if you haven't saved in the first place.

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