Vanguard

Why cost basis is not performance

A question many investors have about their investments is "How much money did I make?" They often look at cost basis to answer that question. However, cost basis isn't intended to tell you how much money you've made on an investment. Instead, cost basis is used to help determine capital gains or losses for tax purposes.

Investors have the option to purchase shares in an investment by reinvesting interest, dividends, or other distributions. Oftentimes, people consider these distributions to be part of their return. But these distributions are added to the cost basis when they're reinvested. Although money was earned on the original investment by way of a distribution, it's not considered part of the performance.

As a hypothetical example, let's say you invest $10,000 in Mutual Fund A and $10,000 in Mutual Fund B on the same day. The $10,000 investment is the original cost basis for each fund. (Figure 1)

Figure 1: Beginning balances

	Mutual Fund A	Mutual Fund B
Initial investment	**$10,000**	**$10,000**
Price/share	$10	$10
Shares	1,000	1,000
Cost basis	$10,000	$10,000

During the first year, Mutual Fund A increases $1,000 due to market changes, and ends with a balance of $11,000. Mutual Fund B earns $1,000 in dividends that are reinvested, and also ends with a balance of $11,000. (Figure 2) Here's where cost basis and personal performance differ.

Figure 2: Account activity

	Mutual Fund A	Mutual Fund B
Initial investment	$10,000	$10,000
Increase due to market appreciation	$1,000	$0
Dividends paid and reinvested	$0	$1,000
Dividend reinvestment price/share	n/a	$10
Dividend reinvestment shares	0	100
End of year account value	**$11,000**	**$11,000**

At the end of the year, Mutual Fund A still has a cost basis of $10,000, but since the fund increased due to the market there's a gain of $1,000.

Now let's look at Mutual Fund B. At the end of the first year the cost basis of this fund is $11,000, so when looking at the value of the investment it shows there's no gain. (Figure 3)

Figure 3: Ending balances

	Mutual Fund A	Mutual Fund B
Account value	**$11,000**	**$11,000**
Price/share	$11	$10
Shares	1,000	1,100
Cost basis	$10,000	$11,000
Unrealized appreciation	+$1,000	$0
Total investment returns	**+$1,000**	**$1,000**

Why the difference? In Mutual Fund B, income was distributed and used to purchase more shares. These reinvestments are treated the same as any other investment you would make in the fund. So your basis increases, even though you didn't actually put any new money into the investment.

In the end, look at your cost basis information to help you figure out the tax consequences of selling an investment. If you want to know how much money you've made or lost in an investment, look at your personal performance.

This hypothetical example does not represent any particular investment.

Vanguard