THE SO-CALLED CERTAINTIES IN LIFE SEEM A LOT LIKE MUTUAL FUNDS

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If the only certainty in life is death and taxes, we have more in common with mutual funds than it appears.

How so?

I came across a disturbing statistic recently: *Over the past five years, the average annual tax hit from fund distributions has subtracted 1.8% from mutual fund returns in U.S. equity strategies.*[1]

That is not a typo. 180 basis points sapped from fund returns annually.

While the effect of taxes on returns is not just limited to capital gains, that figure is substantially greater than comparable WisdomTree ETFs. Not to mention, we have a few Funds that never paid a single capital gain during their entire 14+ years of live performance.

How is all this possible?

The first is centered around the active nature of mutual funds and portfolio turnover. With equity markets at new highs, accrued capital losses have likely disappeared, causing more capital gains to be realized.

The second reason highlighted was “outflows from funds.” A mutual fund portfolio manager may need to sell securities to meet the cash outflows of a security. The pandemic selloff in early 2020 likely triggered forced selling that resulted in capital gain distributions to current shareholders at year-end.

So how did ETFs fare in 2020?

An ETF’s unique creation and redemption process, involving an in-kind transfer of securities, makes the investment vehicle substantially more tax efficient than its mutual fund peers.

Ben Johnson of Morningstar recently highlighted a drastically better experience for ETF investors. He wrote that only 5% of 1,400 ETFs run by the 12 largest sponsors (95% of the ETF assets under management [AUM] in the U.S.) will have a year-end taxable distribution in 2020. [2]

This equates to only 70 ETFs paying capital gains. Many are tiny—84% of those ETFs had distributions that were less than 1% of the funds’ respective net asset value (NAV) as of November 30, 2020. And 80% were fixed income funds, which carry their own set of factors that differ from the U.S. equity strategies previously mentioned.

A separate new study by finance professors at Villanova and Lehigh universities declared that an ETF’s tax burden was 0.92 percentage points less than the typical mutual fund over the past five years due to its avoidance of distribution of realized capital gains.[3]

It gets worse. This is not a U.S. phenomenon, nor just a 2020 phenomenon.

According to data from ETF.com, the average emerging markets equity mutual fund paid out 6.46% of its NAV in capital gains annually. Compare that to emerging market ETFs, which only paid out 0.01% of their NAV over that same time frame![4]

This extreme may not last forever. Many emerging markets countries are restricted from performing in-kind deliveries of securities. So, an emerging market ETF might trigger taxable events and subject investors to capital gains in the future. But the results speak for themselves thus far.

Why are advisors still holding on to mutual funds in taxable accounts?

Ironically, one of the biggest advantages that ETFs possess over mutual funds is also one of the biggest hurdles holding advisors back from migrating to ETFs. Capital gains in taxable accounts are a lifeline for the mutual fund structure.

While not an issue for new money, many advisors feel *locked* into their investments while fully *acknowledging* a better long-term solution exists for their clients. I am often exposed to this situation when consulting with advisors on our ETF Model Portfolio offerings.

But do not just take my word for it: WisdomTree conducted extensive research into Model Portfolio perceptions and adoption. The research study identified “avoidance of capital gains” as a top factor prohibiting an advisor from moving an existing client account into a new Model Portfolio.

The good news is that this friction is being reduced.

Familiarize yourself with 55ip—it’s a pioneer in automated tax technology and provides financial advisors with a tax-smart investment strategy engine. Reflecting on 2020, this firm pointed out[5] two eye-opening statistics in a banner year for tax loss harvesting.

First, for accounts that had 55ip’s ActiveTax Technology® overlay for all of 2020, advisors generated an estimated average of 2.58%[6] in tax savings for their clients. This is both impressive and supportive of the fact that market volatility equals tax loss harvesting opportunities.

Second, in the volatility of early 2020, 68%[7] of 55ip-powered accounts using tax-smart transition were able to leverage volatility to complete their portfolio transitions with zero additional tax budget. In other words, accounts were able to transition into the new Model Portfolio without the end client feeling like they just had a root canal procedure.

What does this mean for mutual funds going forward?

I am not saying mutual funds are going to become extinct anytime in the immediate future. Eric Balchunas from Bloomberg wisely highlighted on Twitter that Fidelity’s fee revenue is more than double that of the entire ETF industry.[8] The combination of a strong bull market and attractive fund fees encourage legacy mutual fund firms to keep the engine running.

But actions speak louder than words.

Many of these same legacy mutual fund companies announced their first ETF launches over the past few years. Have you seen any legacy ETF issuers advertise the launching of their first mutual fund?

Is it surprising an investment vehicle first launched in 1993 (ETF) would contain improvements over an incumbent first launched in 1924 (mutual fund)?

Whether we are discussing buildings, aircrafts, electronics or investment vehicles—the better structure tends to win over time. And if the only certainty in life is death and taxes, we have more in common with mutual funds after all.

[1]Source: A November review by Morningstar strategist Amy Arnott. Article: Jackie Noblett, “ETFs’ Tax Efficiency Shines in Tumultuous 2020: Morningstar,” Ignites, 12/18/20.

[2]Also appeared in article above. Original source: Ben Johnson, "ETFs Again Proved Their Worth to Taxable Investors in 2020," Morningstar, Inc., 12/15/20.

[3]Joe Morris, "ETFs' Tax Advantage Drives Sales: Study," Ignites, 2/17/21. Referencing: Rabih Moussawi, Ke Shen and Raisa Velthuis, "ETF Heartbeat Trades, Tax Efficiencies, and Clienteles: The Role of Taxes in the Flow Migration from Active Mutual Funds to ETFs," 12/8/20. Available at SSRN: https://ssrn.com/abstract=3744519 or http://dx.doi.org/10.2139/ssrn.3744519

[4]"Best Of 2020: Why Are ETFs So Tax Efficient?" ETF.com, 12/22/20.

[5]"Year in Review: Our Value to Advisors & Their Clients," 55IP, 2/11/21.

[6]Source: 55ip. The underlying product fees cited do not include any fees paid to 55ip or the clients' advisors on the referenced portfolios. Includes all 55ip-powered portfolios incepted by 12/31/19. Estimated tax savings are the difference between the average estimated tax bill across portfolios without active tax management that were fully invested in their model at inception and the estimated tax bill with active tax management stated as a percentage of portfolio value. Tax rates: Short-term capital gains are taxed as ordinary income; data shown incorporates the highest federal tax rate of 37% unless specific federal tax rates were supplied by advisors for individual accounts. Long-term capital gains are taxed at the highest federal tax rate of 20% unless specific federal tax rates were supplied by advisors for individual accounts. An additional 3.8% net investment tax is applied to both short-term and long-term tax rate calculations. Tax rates are subject to change over time. It is assumed that the investor has, or will have, sufficient capital gains from sources outside of this portfolio to fully offset any net capital losses realized, and any resulting tax benefit has been included in this calculation of after-tax performance.

[7]Source: 55ip, as of 12/31/20.

[8]Eric Balchunas, 1/5/21, www.twitter.com/EricBalchunas/status/1346449532540825603/photo/1

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DEFINITIONS

Basis point : 1/100th of 1 percent.

In-Kind Creation/Redemption : The process of exchanging a basket of assets for ETF shares.

Net Asset Value (NAV) : The calculated assets minus liabilities divided by shares outstanding. NAV is the straightforward account of the actual assets in the fun.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Bullish : a position that benefits when asset prices rise.