

How to Focus on the Bottom Line this Capital Gains Season

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What a remarkable year it has been. The pandemic forced the shutdown of the economy and a large market sell-off in March. Yet, broad markets rebounded with force, with many reaching new, all-time highs. With this kind of volatility, investors should prepare and not be surprised to see mutual funds distribute large capital gains during this upcoming holiday season.

Tax efficiency is one of the prime benefits of exchange-traded funds (ETFs), and I expect this tax reporting season to accentuate the benefits of the ETF structure. Let me explain why I believe ETFs manage taxes in a more efficient manner than mutual funds, and why I expect little in the way of capital gains distribution from traditional U.S. equity ETFs this year. Likewise, there are a few reasons why mutual funds distribute large capital gains when investing in U.S. equities:

1. **Portfolio turnover:** The active nature of mutual funds involves portfolio turnover, and when there is turnover and trading, capital gains experienced inside the fund must be distributed to the fund's shareholders. With the markets at new highs, capital losses that might have built up seem to be getting taken away and more capital gains are being realized.
2. **Outflows from funds:** If investors rebalance their portfolios and, on a net basis, sell their shares in a mutual fund, the portfolio manager may need to sell securities to meet these cash outflows from the fund. This generates a taxable event for the remaining shareholders, even if they choose to maintain their investment. During the pandemic sell-off earlier this year, outflows likely triggered forced selling and any resulting capital gains will have to be distributed to shareholders.

ETFs' Creation/Redemption Process Helps Manage the Realization of Capital Gains Taxes

The creation and redemption process for creating new shares and redeeming shares of an ETF provides more tools to manage capital gains, even those experienced inside the fund itself.

In-Kind Transfer is the Key: The creation and redemption process involves an in-kind transfer of securities into and out of the fund. The ETF's underlying constituents are delivered into the ETF in exchange for newly issued shares of the ETF during the creation process. When shares are redeemed, the underlying components are delivered from the ETF portfolio to the **authorized participant** in exchange for ETF shares that are no longer considered shares outstanding. Neither of these transactions is considered a taxable trade. The in-kind transfer of securities is the mechanism that helps make ETFs such tax-efficient vehicles. It becomes something of a rare event for a security to be sold within a fund, as most sales are

handled through this redemption process. The exception is portfolio adjustments that need to be made for corporate actions or other extraneous portfolio activity.

Best Place for Portfolio Turnover: Within an ETF

One of the reasons ETFs have a reputation for being tax efficient is that there tends to be less portfolio turnover in index-based strategies than in active strategies. But not all ETFs have absolutely low levels of turnover. If there is a good place to have turnover, I would argue it is within the ETF structure, because of the in-kind transfer mechanism described above. Some of the new **smart beta** strategies incorporate rules-based rebalances back to a sense of relative value, and these rebalances can create 30%–40% turnover, or more, on an annual basis. Some of the tax consequences of these in-fund portfolio rebalances can be offset via the efficient management of the fund achieved through the creation and redemption process. This creation/redemption process is a key element to what makes ETFs tax efficient and why I think they will remain so, despite the market continuing to recover.

Not All Markets Allow In-Kind Transfers

Not all markets can be as tax efficient as U.S. equities. The key to U.S. equity tax efficiency, in my mind, is the fact that most of the execution of the underlying components of ETFs happens outside the fund structure, by the authorized participants. Not all markets possess this in-kind transfer attribute. For instance, not all fixed income securities can be transferred in-kind. And not all emerging markets countries allow for in-kind transfer of securities. In fact, MSCI, a global index provider, has cited this mechanism as one of the reasons it classified South Korea as an emerging market, as all other developed market countries do have this in-kind transferability.

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ETFs that incorporate a relative value rebalance in their methodology can manage valuation risks, but in a tax-efficient format within the ETF structure.

WisdomTree created a [tool](#)¹ that allows the user to see capital gains announcements across the fund world. The tool allows the user to looking up the fund they want to examine. We encourage financial professionals to use this tool to check different funds' capital gains distributions and find the WisdomTree ETFs that we believe offer a compelling alternative.

¹This tool is available for financial professionals only.

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