

'Tis the Season—for Considering Tax Efficiency of Investment Vehicles

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With the markets reaching new all-time highs, many investors will see their mutual funds distribute large capital gains during this holiday season. This is especially true in the mid- and small-capitalization segments of the market, given the generally strong returns this year and based on initial capital gains releases that I have been monitoring from some of the largest mutual fund companies. 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's explore why I believe ETFs manage taxes in a more efficient manner and why I expect little capital gains from the traditional U.S. equity-related ETFs. There are a few reasons why mutual funds distribute large capital gains when investing in U.S. equities:

1) Portfolio Turnover: Their active nature 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 must sell securities to meet these cash outflows from the fund, which generates a taxable event for the remaining shareholders in the fund, even if they choose to maintain their investment. With the markets high, this fund outflow can trigger capital gains.

ETFs' Creation/Redemption Process Helps Manage 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 trade for tax purposes. This 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 will be 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”-related 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 provided by the functionality of 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 hitting new all-time highs.

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. Not all emerging market countries allow for in-kind transfer of securities. In fact, MSCI even cited this mechanism as one of the reasons it qualified South Korea as an emerging market—as all other developed market countries do have this in-kind transferability (as we discussed in this previous [blog post](#)).

Focus on the Bottom Line This Capital Gains Season

One portfolio manager in Texas I spoke with this year said to me that his clients no longer have losses built up in their portfolio—a very nice problem to have, one can say. But this makes portfolio rebalancing tougher for this advisor, because his clients do not always like to see the capital gains taxes that come with incorporating a portfolio rebalance. This is where some of the ETFs that incorporate a relative value rebalance in their methodology can manage valuation risks—but in a tax-efficient format within the ETF structure. The U.S. mid- and small-cap segments, which have some of the strongest gains this year, are a prime area to consider such relative value-based rebalancing ETFs.

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