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UNDERSTANDING THE TAX EFFICIENCY OF ETFs

StrategIQ[®] curates information that we feel provides valuable information for our clients and partners. Here is an insightful piece from American Century Investments[®].

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Understanding the Tax Efficiency of ETFs

EXCHANGE-TRADED FUNDS

Having a tax-efficient portfolio is critical for investors. The results of a recent case study by American Century Investments help quantify the tax efficiency of ETFs over mutual funds for both equity and fixed-income vehicles.

KEEPING AN EYE ON TAXES

Advisors and investors tend to look for opportunities to reduce capital gains near year-end. However, thinking about taxes all year long may create better outcomes. Opportunities to offset capital gains with capital losses, known as tax-loss harvesting, can emerge at any time. Take into consideration tax rules that need to be followed when tax-loss harvesting. Other strategies that investors may employ include capital gains avoidance and vehicle selection.

AVOIDING CAPITAL GAINS

Most mutual fund and ETF providers announce on their websites their estimated annual capital gains distributions beginning in September, with a payable date typically in December. Both mutual funds and ETFs are required to distribute capital gains and income to investors at least annually. It's important to pay attention to these estimates as there can be instances where the capital gains distributed represent a significant amount relative to the asset value. Investors may have an opportunity to sell a fund projecting a significant capital gain prior to the record date, thereby avoiding the taxable distribution. Bear in mind selling a position may avoid the current year distribution but itself creates a taxable event depending on the price and holding period of the investment.

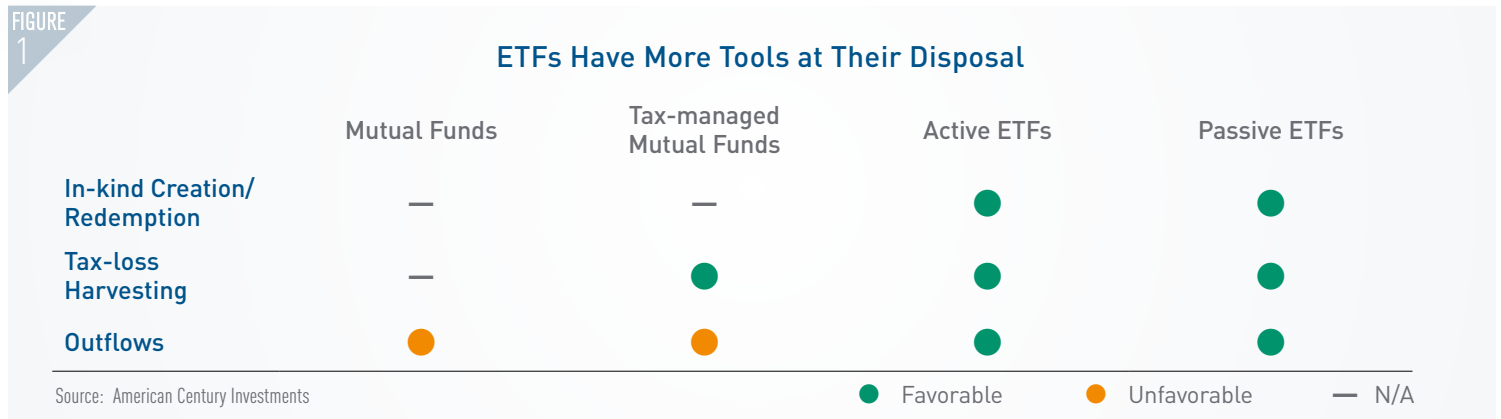
TAXES ON ETFs VS. MUTUAL FUNDS

Because of structural differences between mutual funds and ETFs, mutual funds generally incur more capital gains year over year, while the ETF structure minimizes capital gains until shares are sold. Generally, not only are ETFs liquid and low cost, they are also tax efficient. Deferring annual capital gains allows more of the assets to remain invested and potentially compound at a higher rate. As a result, ETFs may be the optimal vehicle for investors keen on managing their annual tax bills. Keep in mind, however, you are also subject to capital gains tax if you earn a profit from trading your individual ETFs or mutual fund shares (i.e., selling for a higher price than you paid).

With the potential for more taxable events, mutual funds may be more appropriate in tax-deferred accounts, such as retirement accounts. For accounts that are not tax advantaged, investors should consider ETFs over mutual funds to potentially reduce their annual tax bills.

TAX EFFICIENCY ACROSS INVESTMENT VEHICLES

American Century Investments recently analyzed the tax efficiency of various investment vehicles. We found ETFs—both active and passive—were the most tax-efficient vehicles in our study. **Figure 1** outlines our findings.



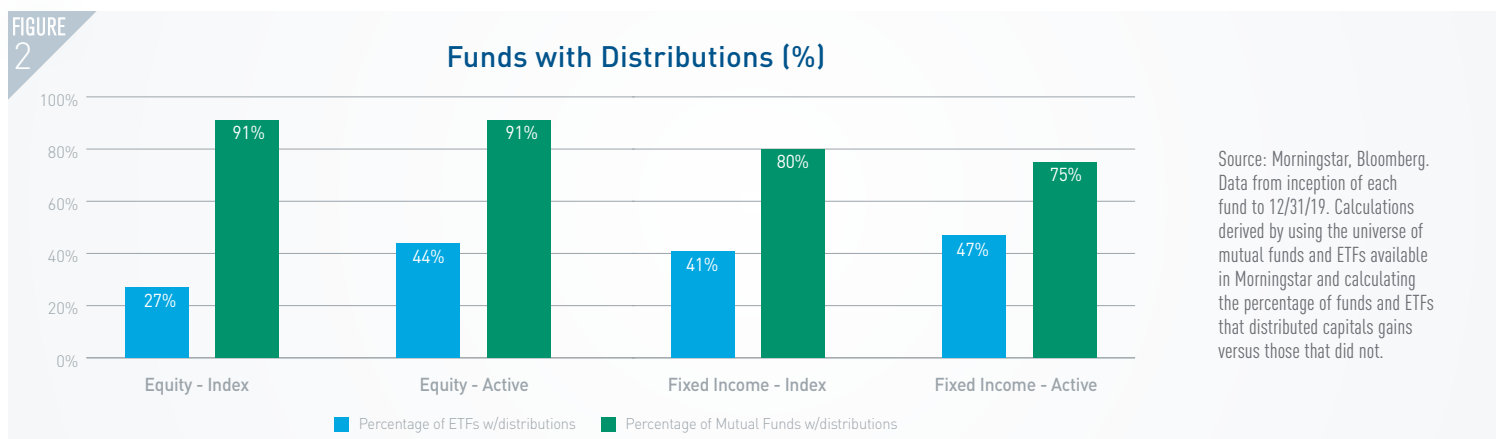
SOURCES OF TAX EFFICIENCY

With mutual funds, flows into and out of the fund are transacted in cash. The manager often must sell portfolio securities to accommodate shareholder redemptions or reallocate assets. These sales may create capital gains for all fund shareholders, not just the ones selling their shares. These gains are taxable for all fund shareholders.

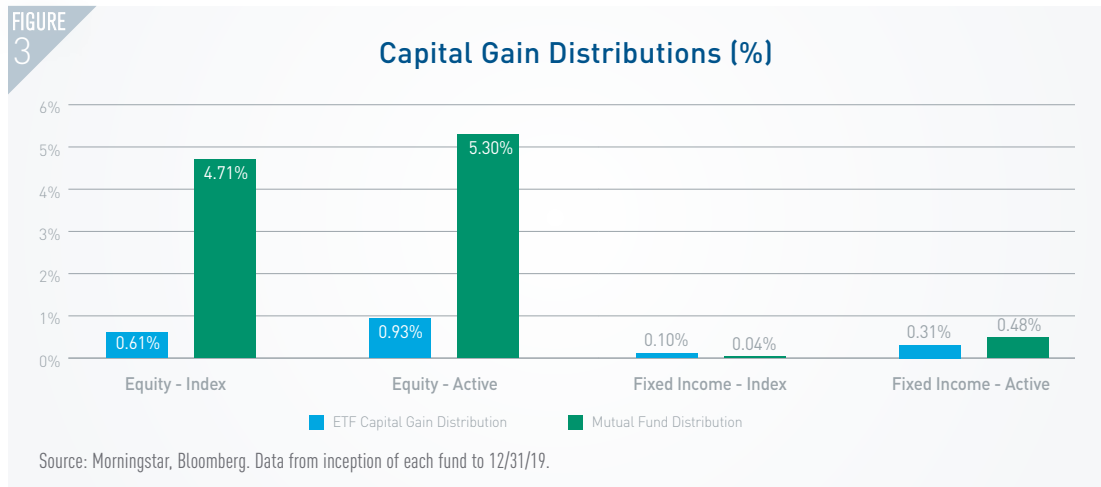
By contrast, ETF managers accommodate investment inflows and outflows through the in-kind share creation and redemption process, which enables them to shed securities that may generate significant capital gains. ETF shares are passed back and forth on the exchange without transactions occurring among the underlying securities. This creates an additional level of liquidity. Trading in-kind may help eliminate or significantly reduce costs compared to trading the underlying securities. In addition, when managers rebalance an ETF portfolio, they typically apply tax management strategies, such as tax-loss harvesting, to minimize gains distributions.

DISTRIBUTION PATTERNS OF ETFs VERSUS MUTUAL FUNDS

We also examined historical capital gains distributions by strategy—index and active—for equity and fixed-income portfolios. **Figure 2** shows the percentage of funds distributing in each category from the inception of each fund to December 31, 2019. The percentage of equity ETFs paying capital gains was significantly lower than mutual funds in all categories. Fixed-income ETFs cannot always transfer certain securities in-kind, so creating custom baskets is much more challenging. Because bonds mature regularly, portfolio managers can't take advantage of the same tax-loss harvesting strategies as they can for stocks because they need to manage to specific durations. However, there were still fewer fixed-income ETFs distributing capital gains. Even for active equity ETFs, less than half (44%) paid out gains, compared with 91% of their mutual fund counterparts. Similarly, less than half (42%) of the active fixed-income ETFs paid capital gains, while 78% of active fixed-income mutual funds did.



Using the same categories, we evaluated the average capital gains distribution as a percent of the fund's net asset value. As **Figure 3** highlights, the amount that equity ETFs distribute was significantly lower than mutual fund distributions. In fact, the equity mutual fund distributions were four to five times larger than the ETF distributions. While not as large a dispersion, the fixed-income ETFs' distributions were slightly higher in all but the active category.



Actively managed ETFs are now on the same playing field as indexed ETFs. Securities and Exchange Commission Rules 6c-11 now allow active managers to use optimized and custom or negotiated in-kind baskets for ETF creations and redemptions. The rules seek to provide more transparency to investors by requiring firms to provide historical premium, discount and bid/ask spread information on their websites. Additionally, it will further enhance the tax efficiency of transparent and nontransparent active ETFs.

AN EFFECTIVE TOOL FOR MANAGING TAXES

Not only do ETFs offer lower cost and liquidity, they also offer tax efficiency, which can aid a portfolio's overall performance and allow investors to keep more of what they've earned invested. Keeping an eye on taxes year-round can help manage the tax bite at year-end.

MANAGING MONEY, MAKING AN IMPACT

American Century Investments® is a leading asset manager focused on delivering investment results and building long-term client relationships while supporting research that can improve human health and save lives. It's how we and our clients together Prosper With Purpose.®

Every day people are increasingly focused on investing to make the world a better place for themselves, their families, their organizations and the world at large. It is possible to live a more meaningful and impactful life and give back something that's more valuable than money.

When you invest with us, you can also invest in the future of others and have the potential to impact the lives of millions. That's possible because of the distinct relationship with the Stowers Institute for Medical Research, which owns more than 40% of American Century. Our dividend payments provide ongoing financial support for the Institute's work of uncovering the causes, treatments and prevention of life-threatening diseases, like cancer.

Together we can become a powerful force for good.

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