ETF
Know:How

Tax efficiency in exchange-traded funds

Investors are drawn to exchange-traded funds (ETFs) for many reasons, including potential tax efficiency. ETFs tend to be more tax efficient than traditional mutual funds, largely because they are exchange traded and they have a unique redemption mechanism. By understanding the mechanics behind ETFs, investors can potentially limit taxable events caused by their investment funds.

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Capital gains distributions matter

Several factors contribute to an ETF's overall long-term holding costs. Capital gains distributions (and taxes) are an example of one such contributing factor. When an ETF distributes capital gains to its investors, the investors ultimately bear the cost of this taxable event.

ETFs are generally tax efficient for three reasons:

1 Most ETFs track an index.

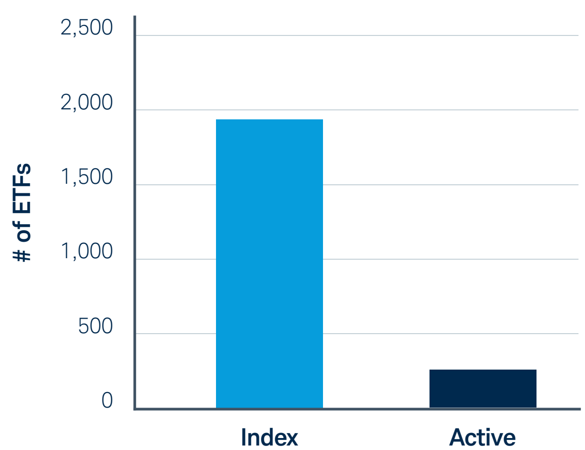
2 ETFs are exchange traded.

3 ETFs have a unique redemption mechanism.

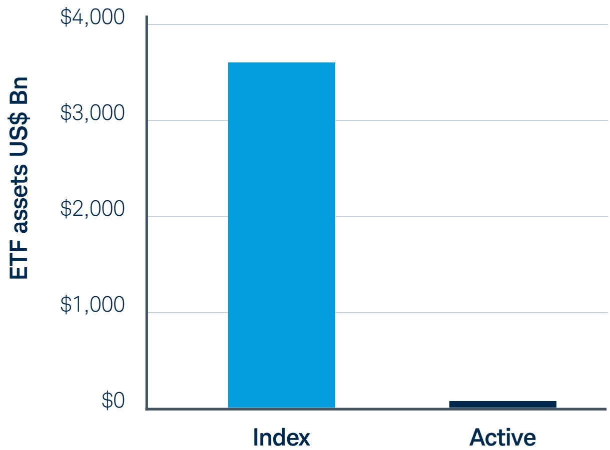
1 Most ETFs track an index.

As of December 31, 2017, 89.4% of all ETFs tracked an index, and 98.7% of all ETF assets were tied to indexed products.[1] Index-tracking funds tend to have less securities turnover compared with actively managed funds. This helps index-tracking funds minimize incurring capital gains and thus capital gains distributions to investors.

Index vs. active ETFs (count)



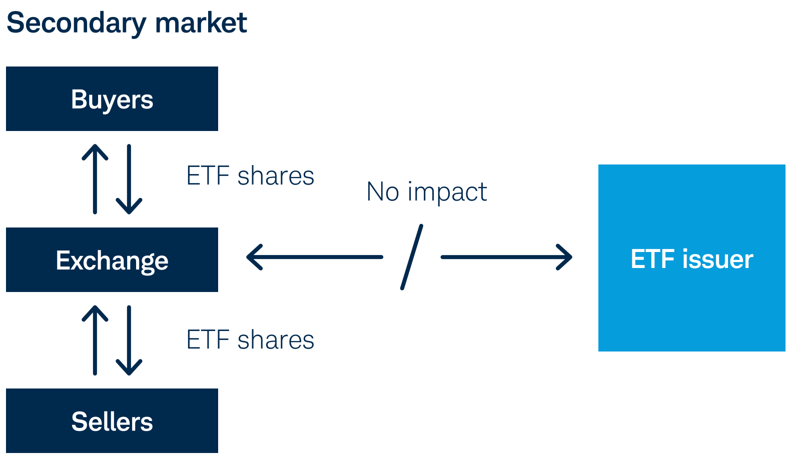
Index vs. active ETFs (assets)



Source: Strategic Insight Simfund, December 31, 2017.

2 ETFs are exchange traded.

Like stocks, ETFs are traded throughout the day on exchanges, such as NYSE Arca and Nasdaq. When investors want to sell their ETF shares, they usually sell them on an exchange without transacting directly with the ETF issuer. The ETF shares are simply transferred from the seller to the buyer, and the underlying securities held in the ETF are unaffected.



Key terms

Authorized participants

Large institutions that transact directly with the ETF issuer to create or redeem shares of an ETF.

Creation unit

The minimum number of ETF shares required to transact directly with the ETF issuer. This is typically at least 25,000 shares.

Primary market

The direct exchange of securities for shares of an ETF between authorized participants and ETF issuers.

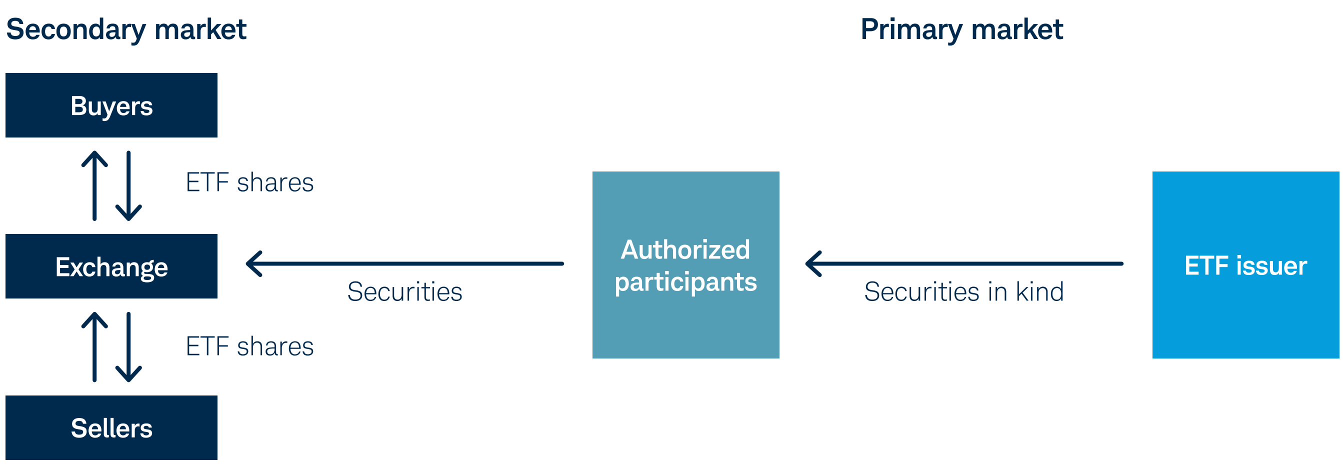
Secondary market

The national markets system (e.g., the stock exchanges and other venues where listed securities can be traded). Investors continuously buy and sell shares of ETFs throughout the day on an exchange or other trading venue.

3 ETFs have a unique redemption mechanism.

When a mutual fund receives a redemption order from an investor, the fund may have to sell some of the securities it holds to raise capital to deliver cash to the investor. In contrast, an ETF's unique redemption mechanism through authorized participants (APs) commonly allows the ETF to divest some underlying securities without having to sell those securities from the fund.

An AP is a large institution that transacts directly with the ETF issuer to create or redeem ETF shares in bulk quantities known as creation units. The AP effectively acts as an intermediary in the ETF redemption process. During a redemption, the ETF issuer delivers the underlying securities in the redemption basket to the AP.[2] The AP, as opposed to the ETF issuer, sells those securities on an exchange.



Summary

ETFs have shown that over the last 25 years, their unique construct has led to tax efficiencies not generally achieved in other fund structures.

ETF Know:How

We're always here to help

ETF Know:How is a full-spectrum curriculum of ETF tools, resources, and insights created for all levels of ETF expertise. This educational program offers you a 360-degree view of ETF investing, with tactical steps to help support your business—from client engagement to portfolio implementation.

To learn more about ETF Know:How and how it can help advance your ETF expertise, call 877-824-5615 or visit schwabfunds.com.

Investment returns will fluctuate and are subject to market volatility, so that an investor's shares, when redeemed or sold, may be worth more or less than their original cost. Unlike mutual funds, shares of ETFs are not individually redeemable directly with the ETF. Shares of ETFs are bought and sold at market price, which may be higher or lower than the net asset value (NAV).

[1] Strategic Insight Simfund, December 31, 2017.

[2] Redemption baskets may also contain a cash portion, along with securities "in-kind." Certain ETFs, such as those targeting esoteric asset classes, hard to access or less liquid securities, may not transact with the AP "in-kind", but may do so with only cash, or with a large cash component. When redemptions occur with only cash, or a large cash component, as opposed to largely "in-kind" with securities, it may increase the likelihood of a taxable event.

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