ETF Know:How
Insights on Exchange-Traded Funds
Summer 2019

charles SCHWAB Investment Management

A look at what's behind ETF tax efficiency

Most advisors seem to know exchange-traded funds (ETFs) can be more tax efficient than comparable active or passive mutual funds, but they may not know exactly why this is the case. Here, we cover the "why" and present a case study using the experience of small-cap funds during 2018 to illustrate the point. We believe that understanding the key operational differences between ETFs and mutual funds and how these differences may potentially impact the tax obligations of investors, will help you better serve them.

Deferral: A major driver of relative tax efficiency in ETFs

The so-called "tax efficiency" of an ETF is a reference to the ability of this investment vehicle to defer distribution of capital gains, and the associated tax bill, to shareholders for substantial periods of time—in many cases for years. ETFs don't necessarily generate lower tax obligations for shareholders over the course of the full life cycle of an investment when compared to mutual funds. In either case, a shareholder will pay taxes on any realized capital gains and other income generated by the investment. However, deferring tax payments may allow for additional compounding power over the investor's holding period. In theory, the investor might also enjoy a benefit from paying the deferred taxes in a period when tax rates are lower, if capital gains tax rates go down at some future date (or they could be worse off, if tax rates rise).

How ETFs can defer capital gains

Most diversified investment portfolios, whether held in a mutual fund or an ETF, are going to have some level of holdings turnover in the course of a tax year. The main driver of turnover in an index mutual fund or ETF are changes in the index being tracked. Actively managed portfolios will generally make trades based on changes in their investment outlook.

Regardless of the reason for turnover in a portfolio, in periods of price appreciation in stocks and bonds, mutual funds are more likely than ETFs to generate realized capital gains.

The reason for this difference lies in how mutual funds and ETFs manage their trading activities. When a mutual fund manager needs to eliminate a security from the portfolio, they must sell it on the open market; any security sold for a profit triggers a realized capital gain for the current tax year.

Key takeaways

- ETFs are considered more tax efficient than mutual funds because they don't typically distribute capital gains each year.
- Tax withholding on distributed capital gains reduces the compounding power of an investment.
- ETFs generally give investors more control over the timing of their taxable liabilities than comparable mutual fund investments.

On the other hand, an ETF can often avoid selling assets on the open market by instead exchanging securities in-kind. For example, during an index rebalance, an ETF may transfer a basket of securities that need to be removed from the portfolio to an authorized participant in exchange for an equivalent value of shares[1] of the ETF (see Exhibit 1).

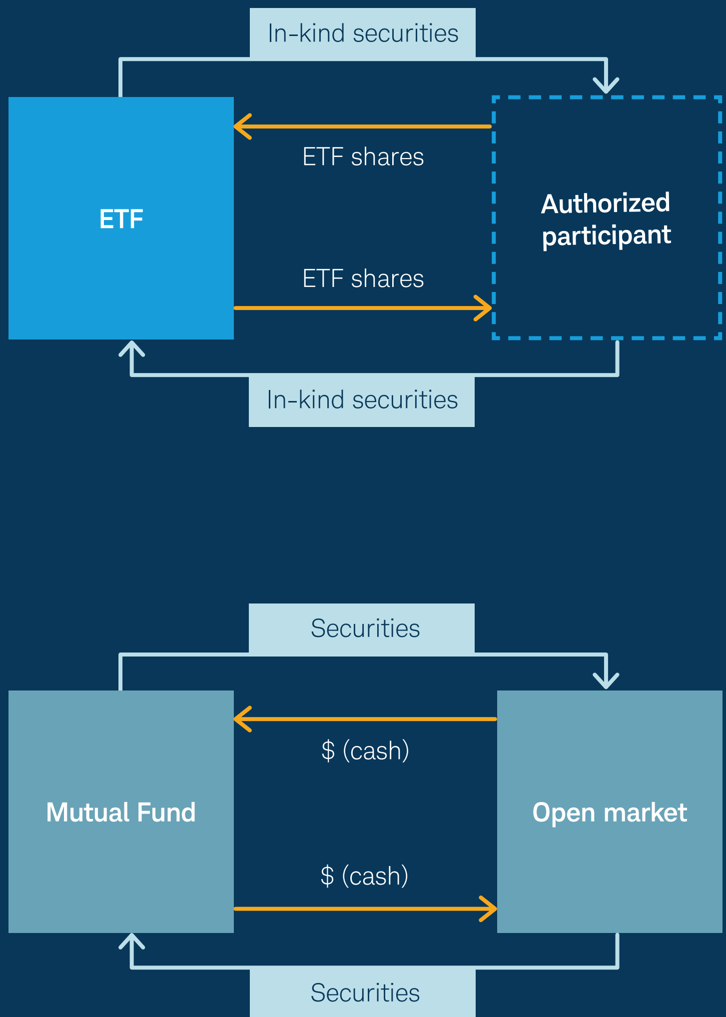
When an ETF removes securities through an in-kind exchange (also known as an in-kind redemption), no capital gains are realized at the portfolio level—even if the exchanged securities exited the portfolio at a profit compared with their cost basis—and therefore end investors do not receive a capital gains distribution. Rather, the value of the capital gain is embedded into the share price of the ETF. When shares of the ETF are eventually sold by the investor, to the extent that the sale price is higher than the purchase price, a capital gain will be realized and taxes will be due. This nuance may allow shareholders of ETFs to have more control over the timing of their taxable liabilities than mutual fund investors.

Why deferred gains have a compounding effect

There's also a compounding dynamic to be considered. Even mutual fund shareholders who have elected to automatically reinvest all distributions will need to pay the taxes due on any capital gains distributed. Money used to pay taxes is money not invested that can potentially grow. ETFs that are able to avoid generating capital gains allow money to stay in the investment and take full advantage of potential compounding interest and gains until the ETF is sold.

Exhibit 1: Rebalance methodologies of mutual funds vs. ETFs

In-kind exchanges: Any transaction that is "in-kind" refers to an exchange of goods or services, rather than money. In an ETF, that means the ETF can exchange one security for another with an authorized financial intermediary; they don't have to sell the security for cash, then use the cash to buy a new security.



For illustrative purposes

[1] Note: The ETF shares must be in creation unit increments, which are typically at least 25,000 shares.

A case study: U.S. small-cap funds in 2018

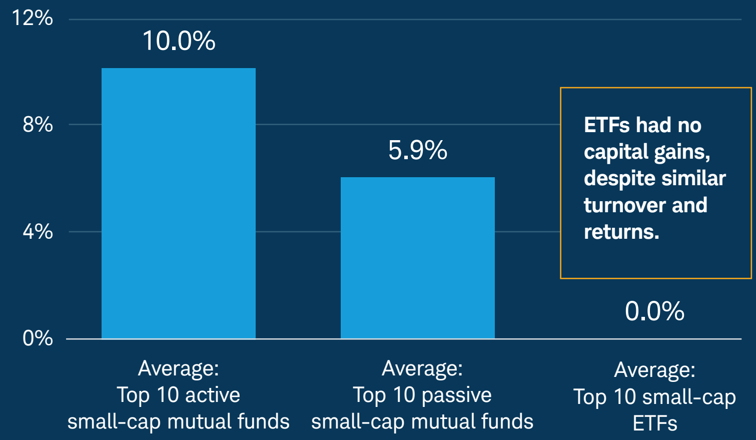
During 2018, a number of passive and active small-cap mutual funds experienced an elevated level of capital gains distributions even though this segment of the market had a negative annual return.[2] Small-cap ETFs, however, generally did not distribute capital gains over this same period.

Exhibit 2 shows the average taxable gains realized for the top-10 small-cap funds by assets under management (AUM) in the following categories: active mutual funds, passive mutual funds, and ETFs. The data demonstrates that shareholders of the active mutual funds were liable at year-end for average taxable capital gains of 10.0% of net asset value (NAV). For a shareholder with $10,000 invested, that's a taxable gain of $1,000. The shareholders of the passive mutual funds had a slightly improved scenario, with average taxable capital gains of 5.9% of NAV, or about $590 for a shareholder with $10,000 invested. Meanwhile, the ETF shareholders realized $0 of taxable gains in the same year. The ETFs had portfolio-holdings turnover during the course of 2018; but likely due to the in-kind exchange process, capital gains were not realized at a portfolio level and were not distributed to shareholders.

Although small-cap funds are especially notable because this sub-asset class had atypically high capital gains during a year in which the total return was negative—we note that U.S. equity mutual funds generally had above-average taxable capital gains in 2018 (see Exhibit 3). Thanks to a long-running bull market, most mutual funds and ETFs accumulated capital gains.

[2] The Dow Jones Wilshire U.S. Small-Cap Total Return Index declined 11.78% between December 29, 2017, and December 31, 2018, according to Bloomberg.

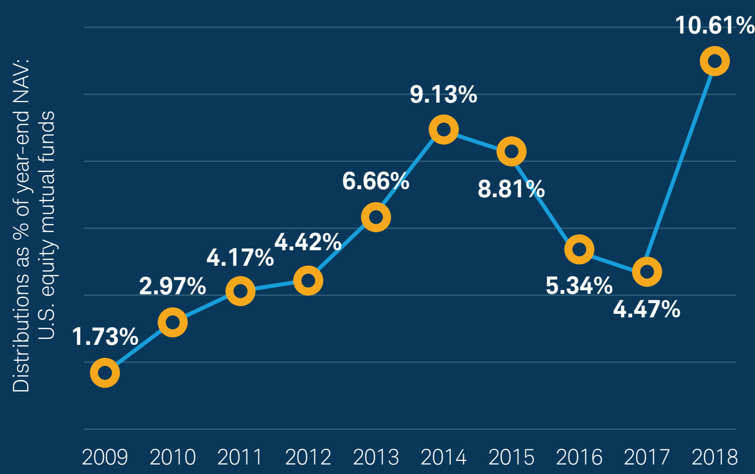
Exhibit 2: 2018 taxable capital gains by small-cap fund vehicles



Source: Morningstar Direct as of 12/31/2018. Top 10 based on AUM.

Exhibit 3: Unusually high capital gains in 2018

U.S. equity mutual funds had above-average taxable capital gains in 2018.



Source: Morningstar

The finer points

The ETF structure does not guarantee deferral of capital gains. These vehicles often use the in-kind redemption process to reduce unrealized gains in the portfolio, but there are practical constraints that can limit a portfolio manager's ability to implement this process uniformly. For instance, some international markets, such as South Korea and China, do not allow for the in-kind transfer of securities from one owner to another. There are also some fund strategies and asset classes (such as currency-hedged), which use derivative contracts that cannot benefit from the in-kind exchange process. Under these circumstances, portfolio repositioning is done with open-market trades and can trigger taxable events, just as in mutual funds.

In summary

ETFs can often deliver tax efficiency by deferring capital gains distributions. This can be a meaningful advantage for long-term investors holding these products in taxable accounts. While ETFs don't avoid taxes, they may give an investor more control over the timing of their tax liabilities. This benefit should be well understood. It's one of the contributing factors to the growth of ETFs, particularly among advisors seeking to optimize their investors' long-term returns.

About the author

D.J. Tierney is a Managing Director and Client Portfolio Strategist at Charles Schwab and Co., Inc. supporting Charles Schwab Investment Management, Inc. (CSIM). In this role, he represents Schwab ETFs™ to sales channels, clients, and the media. He also works with CSIM's product team to optimize Schwab's ETF offerings. Mr. Tierney assists in managing relationships and communications for Schwab ETFs with authorized participants, broker-dealers, and regulatory agencies. Prior to joining Schwab in December 2016, Mr. Tierney spent 16 years with Morgan Stanley as a senior institutional sales, trading, and relationship management professional. Mr. Tierney earned a BA in economics from the University of California, Los Angeles, and an MBA from the University of California, Berkeley, Haas School of Business.

charles SCHWAB Investment Management