ETF UNIVERSITY

Explaining ETFs' Greater Tax Efficiency

One of the big selling points for ETFs as investment vehicles is that they're far more tax efficient than competing mutual funds.

If a mutual fund or ETF holds securities that have appreciated in value, and sells them for any reason, they will create a capital gain. These sales can result either from the fund selling securities for a tactical move, due to a rebalancing effort, or to meet redemptions from shareholders. By law, if funds accrue capital gains, they must pay them out to shareholders at the end of each year.

Capital Gains

As a general rule, ETFs do much better than mutual funds when it comes to paying out capital gains. In fact, the vast majority of ETFs don't pay out any capital gains. According to a blog post on the SPDR ETF website, Morningstar data indicates just 6.2% of U.S.-listed ETFs paid out a capital gain in 2018, but more than 60% of mutual funds did so.

Further, during the past decade, the blog notes, the level of ETFs paying capital gains has remained below 10%. Meanwhile, during the same time period, between 16% and 62% of mutual funds have paid out capital gains during those years, and the trend seems to be moving higher over time.

Why such a huge difference? For starters, because they're index funds, most ETFs have very little turnover, and thus amass far fewer capital gains than an actively managed mutual fund would. And, as the blog notes, 70% of mutual funds are actively managed. However, ETFs are also more tax efficient than index mutual funds, thanks to the magic of how new ETF shares are created and redeemed.

When a mutual fund investor asks for her money back, the mutual fund must sell securities to raise cash to meet that redemption. But when an individual investor wants to sell an ETF, he simply sells it to another investor like a stock. No muss, no fuss, no capital gains transaction for the ETF.

Even Better With APs

What happens when an authorized participant (AP) redeems shares of an ETF with an issuer? Actually, it gets better. When an AP redeems shares, the ETF issuer doesn't typically rush out to sell stocks to pay the AP in cash. Rather, the issuer simply pays the AP "in kind"—delivering the underlying holdings of the ETF itself. No sale means no capital gains.

The ETF issuer can even pick and choose which shares to give to the AP—meaning the issuer can hand off the shares with the lowest possible tax basis. This leaves the ETF issuer with only shares purchased at or even above the current market price, thus reducing the fund's tax burden and ultimately resulting in higher after-tax returns for investors.

The system doesn't work so smoothly for all ETFs. Fixed income ETFs, which have more turnover and often have cash-based creations and redemptions, are less tax efficient than their equity brethren.

But all else equal, ETFs win hands-down, with two decades of history showing they have the best tax efficiency of any fund structure in the business.

3 KEY TAKEAWAYS	ONE	TWO	THREE
	Just 6% of ETFs paid out capital gains in 2018. 62% of mutual funds paid out capital gains during the same year.	Most ETFs are index funds, which reduces the odds of them paying capital gains. Most mutual funds are actively managed.	The in-kind redemption mechanism allows ETFs to avoid racking up most capital gains.

SELECTED TERMS

Actively Managed ETF

Most ETFs track an index, in what's known as index-based or passive investing. An actively managed ETF is a fund that literally has a portfolio manager at the helm of the fund, making active allocation decisions rather than passively tracking a benchmark. Active managers have long been plagued with persistence issues—meaning that few outperform indexes, and the ones that do aren't likely to repeat that outperformance consistently—hindering adoption of actively managed ETFs, which are often more expensive to own than their passive counterparts.

Authorized Participant

He or she is the protagonist of the ETF creation/redemption process most investors will never know. Designated by an ETF issuer, the AP is someone with purchasing power who creates and redeems shares of an ETF, keeping the supply elastic to meet demand. When there's new appetite for a given ETF, the AP will create shares of that ETF through the in-kind creation/redemption mechanism, keeping supply ample and helping the ETF trade in line with its net asset value (NAV). Ample supply means no need for steep premiums. When demand dries up and ETF share prices face a discount, the AP can redeem shares of the ETF from the market, reducing supply, allowing the ETF to trade back in line with its NAV. The AP plays a crucial role in ETF liquidity and trading.

Creation/Redemption Mechanism

It's how ETF shares are created and redeemed, in a process that's unique to the ETF structure. When there's demand for new shares of an ETF, an AP buys the securities the ETF holds, and hands that basket of securities to the ETF issuer in exchange for ETF shares. This is known as an in-kind transaction—securities for shares. In the case of a redemption, this process works in reverse. The in-kind nature of the creation/redemption mechanism is crucial to how ETFs trade because it allows them to trade throughout the day in line with the value of their underlying holdings (their NAV).

Custodian

In the ETF ecosystem, the custodian—often a large bank—is responsible for holding all the securities and cash for an ETF. That custody role is crucial to the day-to-day operations of a fund, even if it's a largely overlooked role by most investors. Custodians hardly make headlines, and most investors don't know who custodies the ETFs they own. But occasionally custodians are all the buzz, when companies involved with things like federally illegal marijuana find their way into ETF wrappers. Then suddenly, custody becomes a hot-button issue.