INVESTING INSIGHTS

Minimize Your Taxes!

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Investors want to reap returns from their portfolios, so they measure their performance carefully. Taxable investors know that making money and paying taxes goes "hand in hand". Too often, they look only at pre-tax return while the more important number is after-tax return. What you get to keep after taxes is what pays your bills!

For our taxable clients, HPA is doggedly focused on maximizing after-tax returns. To do this, we use ETFs as much as possible within our portfolios. However, surprisingly few investors or investment professionals understand the advantages available through investing in Exchange Traded Funds (ETFs). ETFs provide the best option to minimize costs and maximize returns, especially for taxable investors.

AN INTRODUCTION TO ETFs

Traditional open-ended mutual funds got their start in the 1920s. An investor purchases shares of these funds and they get a proportionate interest in a portfolio of underlying publicly traded securities (stock or bonds). The shares of the fund are valued at the end of each day based on the closing price of the underlying investments. Investors can buy or sell the shares of the fund only after the close of the market based on the end of the day valuation of the underlying portfolio.

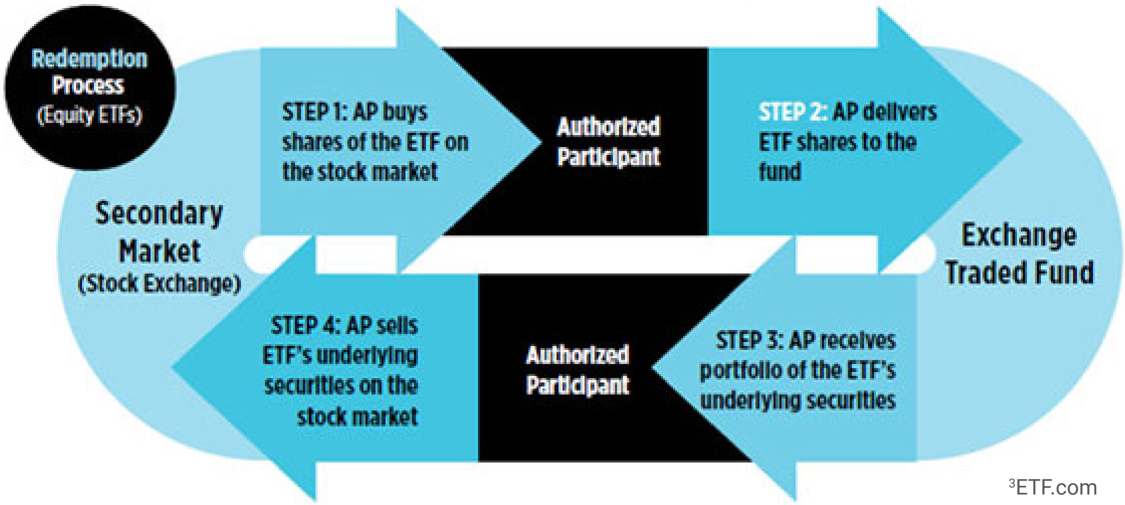
The advent of cheap, high speed computing power in the 1990s ushered in a new product in the mutual fund industry. The stock exchanges keep the stock, bond and options transaction ledgers in "real time" – that is, instantaneously as they occur. Thus, the computerized linking of the prices of all the underlying investments in a portfolio allows us to get a "real time" valuation on the entire portfolio. With the portfolio value known in real time throughout the day, mutual fund shares could be traded on the exchange (thus the name, Exchange Traded Funds) throughout the day, not just after the market close. The first ETFs were based on passive index funds such as the S & P 500. In subsequent years, factor-based and actively managed ETFs arrived on the scene. Bond funds, commodity funds and options-based ETFs also have been introduced and embraced by investors.

As compared to traditional mutual funds, ETFs obviously offer greater convenience in trading. In addition, ETFs' internal fees are generally cheaper than comparable traditional mutual funds. Finally, ETFs are far more tax efficient than traditional mutual funds. These advantages caused investors to embrace ETFs in significant fashion. Over $3.4 trillion is now invested in ETFs, while traditional funds hold $17.1 trillion.[1] According to BlackRock, ETF assets grew at 19% per year from 2009 through 2017, while traditional funds grew at 4.8%.[2]

THE MAGIC OF ETFs

Why are ETFs more tax efficient? Due to a significant difference in the mechanism that ETF managers can use to trade their underlying holdings. ETFs are traded through a handful of broker firms that "make a market" in the shares of the ETF. These market makers are officially known as "Authorized Participants" in the ETF. When a shareholder of the ETF decides to sell, the sell order is routed through one of these Authorized Participants (AP).

If the AP has a simultaneous buy order (this is a frequent occurrence), the orders are matched and the ETF shares trade hands without any impact on the underlying ETF portfolio. If there are more sell orders than buy orders, the AP lets the ETF manager know. The ETF manager then can "deliver out" a portion of their underlying holdings to the AP, who immediately sells those stocks or bonds and the cash is delivered to the sellers. The key part of this transaction is that the ETF doesn't sell their underlying holdings to create cash to be delivered to the seller...the ETF delivers "in kind" holdings. Thus, the ETF doesn't have a realized gain or loss on those holdings because they are sold by the AP outside of the Fund.



[3]ETF.com

Traditional open-end mutual funds can't utilize this method of cashing out shareholders; the Fund managers must sell some of their holdings inside the fund during trading hours, then deliver out cash when the shares change hands follow the day's close of trading.

The "in kind" mechanism also aids ETFs when the Fund managers need to sell and buy securities to implement strategy. Consider two funds with identical holdings, but one is an ETF while the other is a traditional mutual fund. Both Fund managers decide to sell their position in Microsoft (MSFT) and use the proceeds to buy a new position in Intel (INTC). Both funds have significant long-term capital appreciation in the Microsoft shares.

FOR THE TRADITIONAL MUTUAL FUND, the MSFT sell order and the INTC buy order are given to a broker, then the trades are done. The MSFT sale results in a large capital gain that will be passed through to all shareholders of record on the last day of the Fund's fiscal year. For most funds, that is the end of October. It could be that the MSFT sale was in April, but all shareholders of record at October 31 will receive a tax liability passed through. This is true even if you bought in September, well after the date of MSFT sale and any benefit from the capital appreciation. That doesn't seem fair, but it is the law. All capital gains are passed through once per year. If you are a shareholder at year end, you will get the tax liability from all trades. Income is usually passed through quarterly or sometimes monthly, so the impact of taxes on this income pass through is more representative of the actual investor's experience.

FOR THE ETF, the shares of Microsoft are given to the Authorized participant (broker) in exchange for shares in Intel. The number of shares is calculated to represent equal dollar amounts. Thus, once again the ETF has exchanged MSFT shares and not sold them. The sale is made on the books of the Authorized Participant after the exchange of the MSFT shares for INTC shares. No gain on the sale of the MSFT shares passes through to shareholders of the ETF.

YOUR POCKET

These differences between traditional mutual funds and ETFs are significant to a taxable investor's bottom line. Morningstar tracks the before and after-tax returns on mutual funds and ETFs. The table below shows Morningstar's data as of May 2019 on a few traditional mutual funds as compared to a few ETFs. You can find this data for any fund on the Morningstar website by searching for the fund and then clicking on the "tax" category on the upper right side of the menu bar.

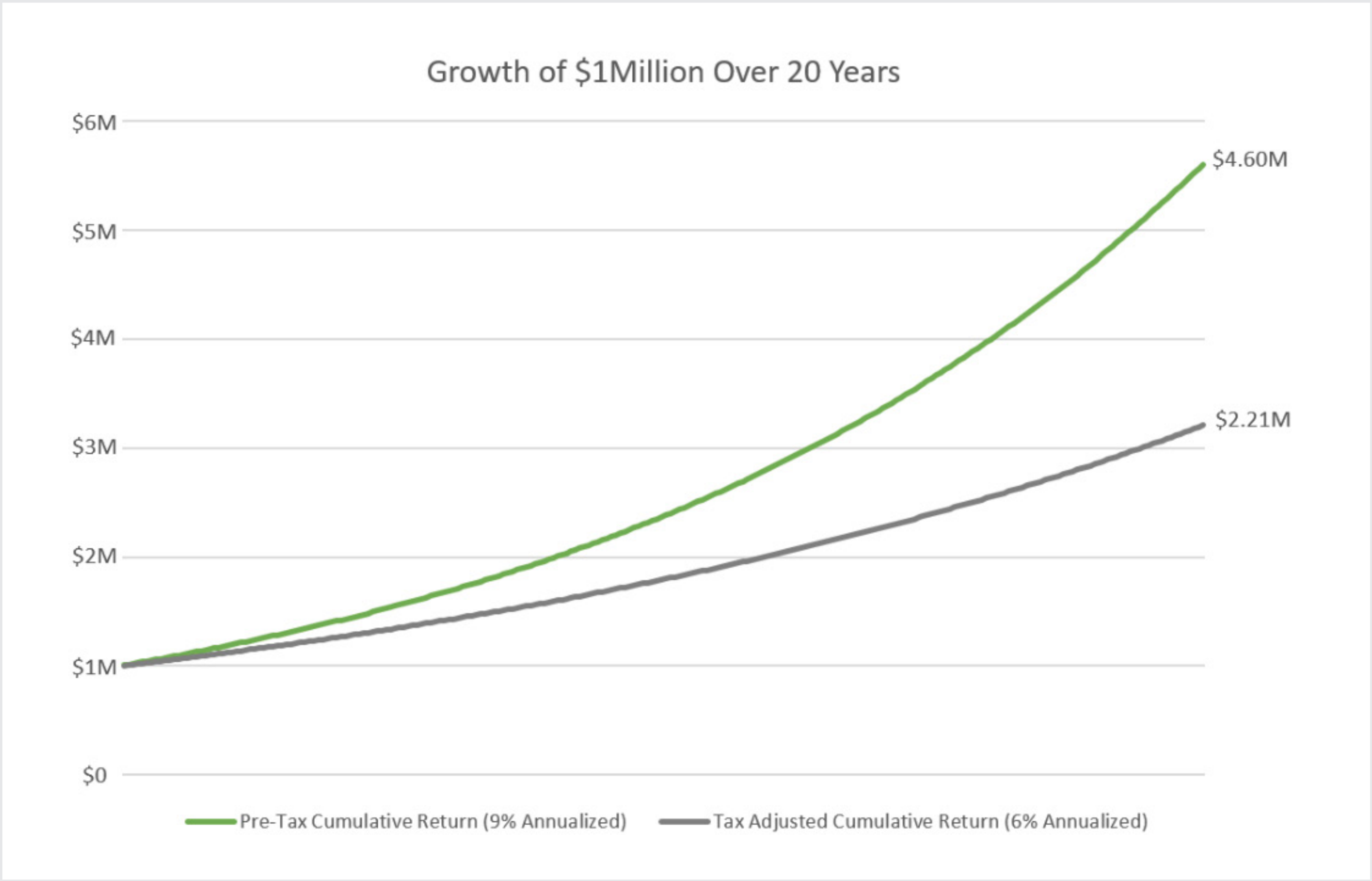
Ticker	Fund Type	Name	Pre-Tax Return (Last 5 Years)	Tax-Adjusted Return (Last 5 Years)	Return Lost from Tax Inefficiency
FMSTX	Mutual Fund	Federated MDT LC Value	5.80%	2.83%	-2.97%
JAGTX	Mutual Fund	Janus Hederson Global Tech.	17.46%	14.95%	-2.51%
EXEYX	Mutual Fund	Manning & Napier Core Equity	7.99%	3.20%	-4.79%
FMAGX	Mutual Fund	Fidelity Magellan Fund	10.24%	8.27%	-1.97%
SPY	ETF	SPDR S&P 500	9.56%	8.79%	-0.77%
QQQ	ETF	Investco QQQ Trust (100 NASDAQ)	14.88%	14.53%	-0.35%
USMV	ETF	iShares Edge MSCI Min Vol USA	12.10%	11.48%	-0.62%

The "Pre-Tax" return is the performance figure typically reviewed by investors, presented by investment professionals and used by the industry to rank mutual fund and ETFs.

The "Tax-Adjusted" return is calculated by applying top level personal tax rates to income and capital gains distributions for each fund. ETF investors pay taxes on dividend income- but because there are no capital gains distributed, there is no tax to be paid on the gains. The tax impact to ETF investors is small. For traditional mutual fund investors, taxes are paid each year on income plus the short- and long-term capital gains realized by the fund each year. The difference in after-tax returns is stunning!

Actively managed separate accounts have the same problem as traditional mutual funds. The investment manager is tasked with "beating the market", which means actively moving in and out of various stocks or bonds. That movement results in a direct tax impact to investors. Since most active managers fall short of beating the market before taxes, the after-tax impact is a further drag on already lagging results.

The graphic below shows the net difference to a taxable investor if a 9% pre-tax return is reduced by 3% due to annual taxes. The compounding effect is significant.



Of course, ETF investors will pay capital gains when they sell their shares of the fund. However, the investor is in control of when the sales are made and when the tax is incurred. Ideally, an investor should own solid, long-term ETF investment vehicles. Then, most of the taxes can be deferred to times when the investor's tax rate is lower (e.g. retirement) or passed on to an estate without ever incurring the tax.

FREE LUNCH

Yes, there is no such thing as a free lunch. However, when taxable investors consider the option of investing ETFs versus traditional mutual funds or active management separate accounts, the tax efficiency of ETFs is pretty close! Add in the lower expense ratios and it's easy to see why ETFs have become the vehicle of choice for taxable investors. At HPA we utilize ETFs whenever possible to pass this advantage on to our clients.

[1]Szmigiera, M. (2019, May 10). Total net assets of U.S. ETFs 2002-2018 | Statistic. Retrieved from https://www.statista.com/statistics/295632/etf-us-net-assets/

[2]Small, M., Cohen, S., & Dieterich, C. (may 2018). *Four Big Trends to Drive ETF Growth* (pp. 1-30, Publication). BlackRock. doi:ICR0518U-509186-1599831

[3]ETF.com. (2019). What Is The Creation/Redemption Mechanism? [Digital image]. Retrieved from https://www.etf.com/etf-education-center/7540-what-is-the-etf-creationredemption-mechanism.html

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