The Taxing Debate over ETFs versus Mutual Funds

By Martha Papariello

Exchange-traded funds (ETFs) are promoted widely as a lower-cost, more tax-efficient investment product than mutual funds. This claim has helped to propel growth in the ETF marketplace to a $1.5-trillion global industry, with 24 different investment firms offering more than 800 ETF products. However, is this panoply of ETF products in fact more tax-efficient than conventional mutual funds? The answer may be surprising.

The current fixation on the “battle” between ETFs and mutual funds is somewhat misguided because ETFs are themselves mutual funds—predominantly index mutual funds. The major difference between ETFs and conventional index funds is how they are distributed. ETFs are bought and sold on an exchange and are priced throughout the day, while conventional index funds are bought from an investment provider and are priced only at the market close.

From a tax perspective, conventional index funds and ETFs are quite similar. ETFs are governed by the same IRS regulations as conventional index mutual funds. Techniques to generate a high level of tax efficiency are available to both ETFs and conventional index funds. In most cases, the differences between the two products and how they manage their taxable gains and distributions are not enough to merit choosing one over the other to achieve meaningful tax advantages. Therefore, the question is not whether an ETF or mutual fund is a better choice as a tax-efficient investment but whether an index product or an actively managed product is a better choice in a taxable account.

Much of the touted tax efficiency of ETFs is simply due to the inherent tax-efficiency of an indexed investment approach. Index funds, and their ETF brethren, track specific indexes and maintain a low-turnover, buy-and-hold investment approach. Beyond that, the tax efficiency of a particular ETF or index fund rests largely on the portfolio’s management strategy (broad index, narrow index, growth, value, and so on). Actively managed funds of all styles generally have higher turnover and poorer tax efficiency.

If traditional index funds have the same tax advantages as ETFs, why have the latter earned such a distinguished reputation as tax-frugal vehicles? ETF providers point to a tax-sensitive portfolio management technique in which low-basis shares of stocks are removed from the ETF by institutional investors. Here’s how it works: ETFs issue a block of shares known as a “creation unit” to large institutional brokerage houses in exchange for a basket of stocks that generally matches the holdings of the ETF. Likewise, a brokerage house redeeming its creation units then receives a basket of stocks equal to the value of the redeemed units. These in-kind distributions of stocks do not trigger capital gains or loss realizations for the fund. The ETF fund manager also can deliver shares of those stocks with the lowest tax-cost basis to the redeeming brokerage house. Therefore, only the highest cost shares remain in the fund portfolio, minimizing the risk of future capital gains.

What’s less well-known is that this tax advantage applies to all registered investment companies, including conventional mutual funds, which also have the ability to make in-kind redemptions and thus reduce shareholder capital gain realizations. However, conventional mutual funds rarely utilize this technique.

ETFs have been remarkably tax-efficient, but they are certainly not tax-free. In 2007, nearly 18 percent of ETFs tracked by Morningstar distributed taxable capital gains, although that number fell in 2008 as the declining markets helped to erode gains on stocks. Unfortunately, a few investors in more specialized ETF products—most notably leveraged, inverse, and commodity-themed ETFs—received gigantic capital gains distributions in 2008.
A newer development that may erode the tax-efficient reputation of ETFs is the introduction of actively managed ETFs. ETFs are lauded for their low costs, tax-efficiency, and broad diversification, yet these advantages derive mostly from the fact that ETFs were, at their core, index funds. Now that ETFs come in an active flavor, they are subject to all of the performance restrictions of other actively managed funds, including higher costs and less tax efficiency. It is also not clear how the in-kind distribution mechanism that leads to ETF tax efficiency will work within an actively managed product.

Although conventional index funds do not generally distribute stock in-kind when investors redeem shares, they do have a tool that aids in tax management and reduces the need to distribute gains. That tool is the specific identification of shares, which enables fund managers to select the highest cost lots to apply to sales, which frequently will result in realizing a capital loss that can be used to offset gains and thus minimize or eliminate future taxable capital gains distributions.

If the playing field for index funds and index ETFs is generally level, how should wealth managers evaluate which is a better product for a client’s portfolio? Although it is important to look at the obvious signs of tax efficiency, such as a fund’s or an ETF’s history of paying capital gains, we think investors should take a more holistic approach to tax efficiency by focusing on after-tax returns. It’s seeing the forest through the trees.

Tax efficiency isn’t just about capital gains; it’s also about portfolio managers taking advantage of lower tax rates for qualified dividend income, and about managing tax lots wisely, as described earlier. However, a fund or ETF manager can operate in a tax-efficient manner, taking advantage of all available tools, and a fund will still track its benchmark poorly because of high costs or poor management. Tax-efficiency is moot if the fund is underperforming its benchmark by 700 basis points.

The growing recognition of indexing, and coincident expansion of ETFs, is a positive development for advisors and their clients. They now have more opportunities to develop broadly diversified portfolios, and ETFs offer a simpler, more cost-effective, and more diversified alternative to holding a portfolio of individual securities. However, wealth managers cannot assume that any one product is a tax panacea. It’s critical to understand the true nature of the products and ensure that clients invest in the ETFs or conventional index funds with the lowest costs, highest after-tax returns, and tightest benchmark tracking.

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