

Portfolio Insights

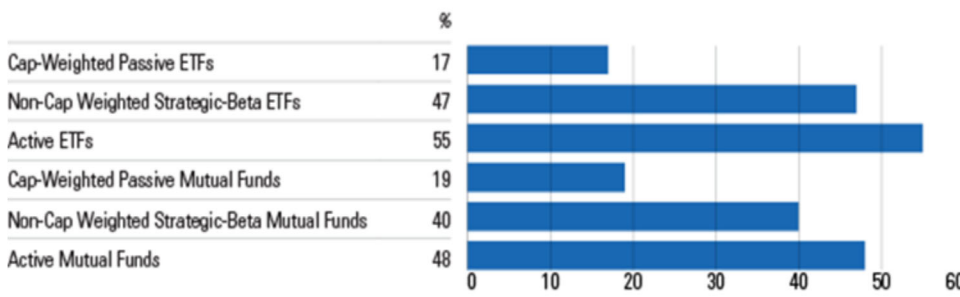
Capital Gain Distributions

As we approach year-end, investors need to be aware of upcoming capital gain distributions. In addition to realizing capital gains through selling securities that have appreciated, investors can be blindsided when their funds distribute capital gains to their investment account. These gain distributions will add to the investors tax liability unless the funds are held in a tax deferred account such as an IRA.

Capital gain distributions can come from ETF's and mutual funds but are typically a much bigger problem for mutual funds. To understand why this is the case we need to look at the main drivers of capital gain distributions which are portfolio turnover and the creation/redemption process.

Most ETF assets are held in market cap weighted passive strategies and thus have very little portfolio turnover. The small amount of buying and selling within the fund leads to fewer taxable events which reduces the likelihood of capital gain distributions. Conversely, high-turnover strategies (Active & Strategic Beta) can lead to more taxable events which increases the likelihood of capital gain distributions. The figure below details the 3yr turnover numbers for ETF's and mutual funds by their investment strategies: cap-weighted, non cap-weighted strategic beta, and active. As you can see below, the amount of turnover is not a key differentiator between ETF's and mutual funds, so if ETF's are more tax efficient we need to look at the structural differences between the two.

Median Turnover Trailing 3-Years (%)



Source: Morningstar Direct.

The second driver of capital gain distributions is the creation/redemption process for the fund, specifically when it comes to outflows. Significant outflows out of index mutual funds can lead to capital gain distributions despite the fund having a low turnover strategy. The reason for this is found in the structural difference between mutual funds and ETF's.

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The open-ended mutual fund structure is relatively straightforward and is shown in the figure below. The investor gives the fund cash, the fund buys securities for the fund, and the fund delivers shares to the investor. The process is the opposite for an investor wanting to redeem shares: the investor gives shares of the fund back to the fund and the fund sells securities or uses cash on hand to distribute cash to the investor. If the fund is met with significant redemptions, the fund will have to liquidate securities to free up enough cash for investors. The selling of securities is what triggers capital gains being realized and thus will be passed on to all owners of the fund typically near year end.

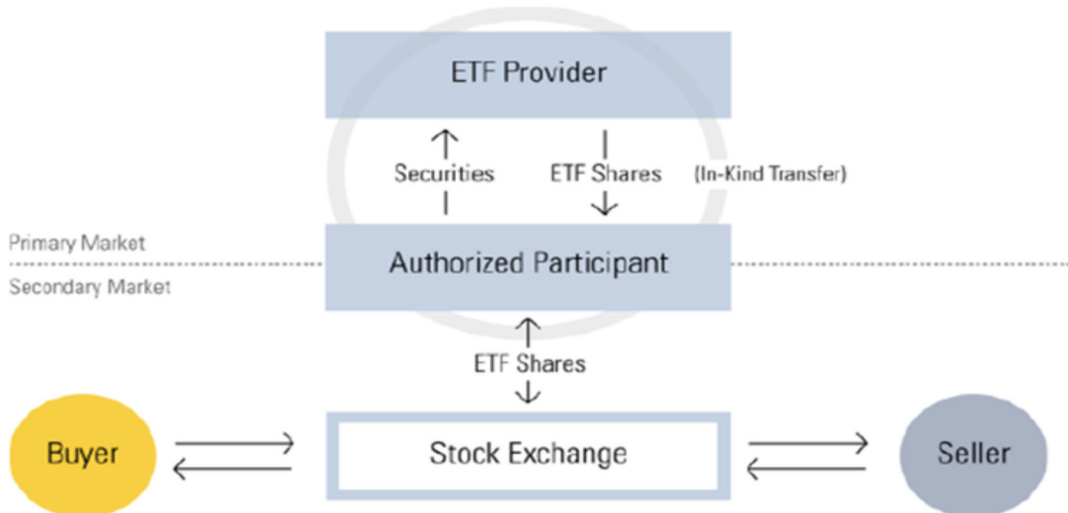
Mutual Fund Investors Transact Directly With Funds



Source: Morningstar.

The structure of an ETF is a bit more complex but it is important to understand where the tax efficiency truly lies as shown below. Typically, when an investor wants to buy or sell shares of an ETF, they simply trade on an exchange just like a stock. There is no need for the fund to sell underlying securities and therefore no capital gains are realized by the transaction. When there is an excess supply or shortage for ETF shares, the Authorized Participant (AP) will get involved to create or redeem shares. The Authorized Participant can be a market maker, specialist, or large financial institution tasked with being able to provide liquidity through the creation and redemption process with the ETF provider. When an AP needs to redeem ETF shares to the ETF provider, the ETF provider will deliver a basket of the underlying securities to the AP. This is important because the ETF provider is not selling the underlying securities, but rather providing them to the AP via an in-kind transfer, therefore, no capital gains are being realized in the process. In addition, the ETF provider can also select the specific holdings to give to the AP, meaning they can give their lowest basis holdings. It is in this process where ETF's truly gain a greater tax efficiency than mutual funds. Please note that while ETF's are more tax efficient, this does not make them tax immune, meaning there are still ETF's can give off capital gain distributions, but this is infrequent.

ETF Investors Typically Buy Shares on the Secondary Market



Source: Morningstar.

Morningstar conducted a study to determine the significance of tax efficiency between mutual funds and ETF's. The study looks at 4 categories sorted by asset class: 1) Active Open-End Mutual Funds 2) Passive Open-End Mutual Funds 3) Active ETF's 4) Passive ETF's. The study looked at capital gain distributions as a percent of the funds' NAV (Net Asset Value) from 2004 through 2018. The results below show the difference in average capital gain distribution percentages between the different categories. Looking at the first column for Large Blend (US Large Cap Companies), you can see that active open-end mutual funds historically had an average capital gain distribution that was 3.44% greater than the passive ETF's for that asset class. The last two columns strictly focus on the capital gain distribution difference by fund structure keeping the strategy (active/passive) the same.

Difference Between Average Capital Gains Distribution/NAV (%)					
	Active OE— Passive ETF	Active OE— Passive OE	Active ETF— Passive ETF	Passive OE— Passive ETF	Active OE— Active ETF
Large Blend	3.44	1.93	0.24	1.51	3.26
Large Growth	4.15	2.14	1.50	2.01	3.55
Large Value	3.14	1.28	0.83	1.86	3.83
Mid Blend	4.03	0.52	-0.34	3.52	6.53
Mid Growth	4.68	2.51	-0.17	2.18	7.19
Mid Value	4.27	0.81	-0.20	3.46	5.44
Small Blend	5.02	0.81	—	4.21	—
Small Growth	5.47	4.26	—	1.21	—
Small Value	5.03	3.32	—	1.71	—
Foreign Large Blend	1.69	1.31	0.56	0.87	0.68
Diversified Emerging Markets	2.95	2.58	0.20	0.10	0.67
Intermediate-Term Bond	0.32	0.15	0.46	0.15	-0.11
High Yield Bond	0.34	-0.22	-0.06	0.30	0.42

Source: Morningstar, Analyst's Calculations. Data as of 12/31/2018.

Clients of Clearwater Capital Partners know and understand our bias for ETF's. Tax efficiency is just one of those reasons. For investors with mutual funds in taxable accounts, most fund companies will detail upcoming capital gain distribution information on their website. We understand that investors may have been invested in mutual funds for long periods of time, and therefore selling the mutual fund to avoid capital gain distributions may not be advisable. Of course, any decision to sell or buy should be evaluated on the merit of the investment in addition to the tax consequences. However, you may wish to evaluate the mutual fund investment to determine if the capital gain distribution should be reinvested into a more tax-efficient fund.

For any questions, please contact Clearwater Capital Partners.

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