

# ETFs

## Increase After-Tax Returns



William Hammer, Jr.

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*"The avoidance of taxes is the only intellectual pursuit that carries any reward."*

- John Maynard Keynes

**W**hether we are listening to the government's plans to raise taxes or dealing with the chaos of tax season, we are constantly reminded that Uncle Sam is a silent financial partner in everything that we do.

Our wealthiest clients, in particular, hate taxes because significant portions of their net worth end up in taxable accounts after they sell illiquid assets such as business interests, real estate, or stock options.

While taxes on investments are not the dog but the tail, we must carefully consider tax consequences when investing in taxable accounts. For example, a 10% return in short-term capital gains would be a 5.6% after-tax return for a client in the highest federal and New York State tax brackets.

A great way to increase after-tax returns for high net worth clients is by using exchange-traded funds. ETFs are index-based mutual funds that trade like common stocks on major exchanges. They combine the advantages of traditional index funds with the trading flexibility of individual securities.

Like traditional index funds, ETFs are much more tax-friendly than traditional mutual funds because of low portfolio turnover. The average holding period for securities held inside retail mutual funds is under a year, according to Morningstar. Thus, capital gains are short-term on average and the high transaction costs are passed on to shareholders. By comparison, the gap between pre-tax and after-tax returns with ETFs is narrow because of the longer holding periods.

What's more, ETFs have further improved on their tax advantage through a mechanism called in-kind redemption. This enables ETFs to create and redeem shares from baskets of their underlying securities, not cash.

Only certain institutional investors are able to purchase or sell shares of ETFs directly. And they either provide securities when they buy shares or are given securities by the ETF when they sell shares. These cashless transactions mean that the ETF does not incur transaction costs or realize capital gains. Unlike a traditional mutual fund, there is typically no taxable event when there is selling within an ETF portfolio.

Many ETFs haven't distributed capital gains in recent

years; some not even since their inception. This is astonishing considering the returns that some of these funds provided to shareholders.

ETFs can also help us avoid the mutual fund industry's failure to achieve market-beating returns. A recent study showed that over a period of 20 years, 78% of actively managed funds underperformed a benchmark index fund on a pre-tax basis and 86% underperformed after-tax. Winners outperformed by a little over 1.25% annually, while the losers underperformed by roughly 3% annually.

This proves that, in the long run, with actively managed funds, heads you outperform a little, tails you underperform a lot. In fact, the study would probably have had even more startling findings if the benchmark index fund used had possessed the tax advantages of an ETF.

Besides the incredible tax and performance advantages of ETFs, there are other compelling reasons to use them. Because of our wealthiest clients' large illiquid holdings, they need us to protect the liquid portion of their net worth by taking as little risk as is necessary.

**We can lower risk through broad, deep diversification** by spreading clients' assets across a variety of asset classes and having each class represented by a large number of securities. ETFs also provide an incredible range of specialized fund offerings that allow us to customize portfolios based on unique needs.

Our wealthiest clients come to us to streamline their financial affairs, model life and business possibilities through Monte Carlo analysis, or to plan for retirement. No matter what their goals, thoughtfulness and professionalism in investing their wealth is an essential element of our service to them.

Do you need more reasons to design portfolios using ETFs? Consider that Nobel Prize winners in Economics, Warren Buffett, Charlie Munger, Bill Miller, and Yale University's David Swensen all recommend investing with index funds?

That's the kind of company I like to keep. **FA**

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