

# ETF Tax Efficiency 101

## Structural Differences in ETFs May Lead to Tax Efficiency Relative to Mutual Funds

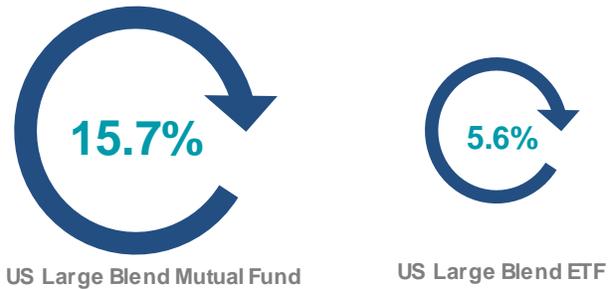
In 2018, 61% of mutual funds paid out capital gains to investors compared to just 10% of ETFs. Mutual funds paid an average of 4.5% capital gains as a % of their NAV (net asset value) while ETFs were at just 0.2%. ETF tax efficiency arises from multiple structural elements: turnover in passive strategies being lower than that in active, the ability to trade on the secondary market, and the structural tax benefit of in-kind redemptions. Consequently, ETF investors can better control when they pay taxes, or in other words, pay when they sell their shares rather than when other shareholders buy and sell.<sup>1</sup>

### Passive Turnover

89% of ETFs are passive while only 4% of mutual funds are passive. Overall, at the portfolio level, passive strategies generally have lower turnover than do active ones.<sup>2</sup>

This lower turnover lessens the instances of securities sold at a gain and hence the potential for paying out capital gains to shareholders.

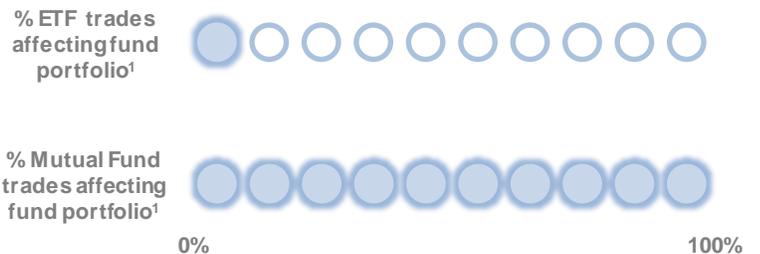
*In 2018, the average US large blend mutual fund had a turnover almost 3x that of the average US large blend ETF<sup>1</sup>*



### Secondary Market Trading

Unlike mutual funds, ETFs trade on a secondary market (stock exchanges). Only 10% of ETF trades affect the underlying portfolio (primary market) and instead occur between market participants such as investors and dealers; in open-end mutual funds, all activity takes place in the primary market and affects the underlying portfolio.

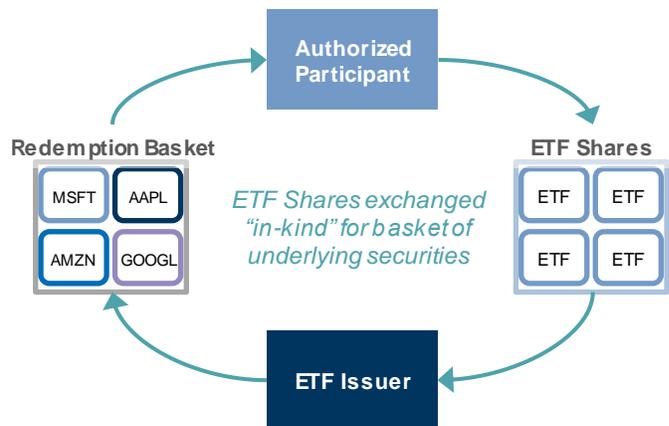
This structural difference greatly reduces the amount of capital flowing in and out of the ETF at the fund level and can reduce the potential of the fund paying out capital gains.<sup>1</sup>



### In-Kind Redemptions

In the ETF primary market, the ETF issuer has the opportunity to satisfy redemptions and portfolio rebalances in-kind (exchanging securities for ETF shares) rather than selling securities for cash.

This **in-kind activity does not trigger a taxable event for the fund** and can insulate shareholders of the fund from capital gains arising from the buying and selling actions of other shareholders.



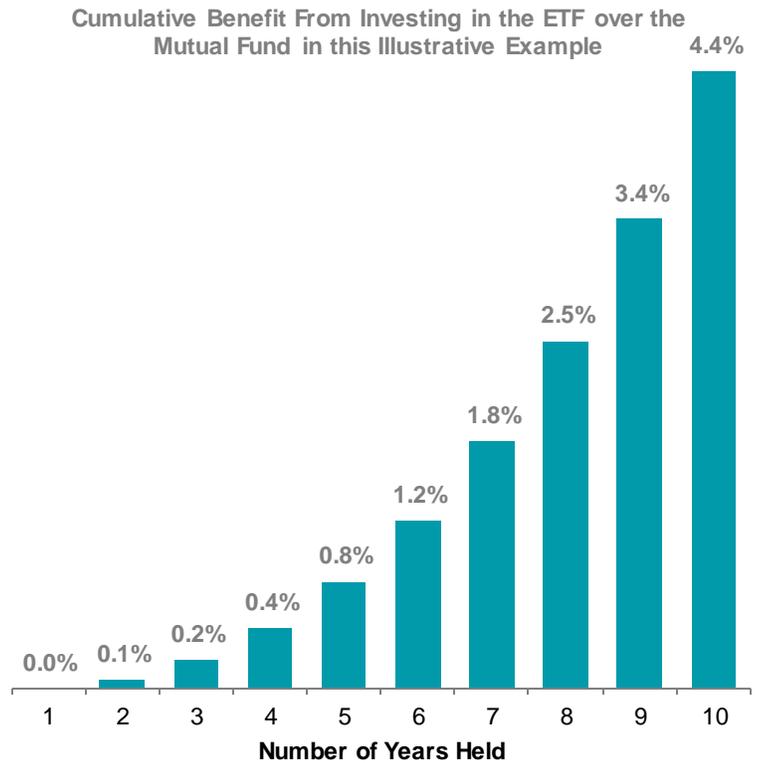
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## Example: Excess Benefit of Tax Deferral

Tax efficiency can add incremental return to investors' portfolios over time. By paying taxes early, an investor loses out on reinvesting their tax payment and earning compounded return on that. The efficiency of deferring tax payments accelerates as the holding period increases.

This graph provides an illustrative example of the cumulative benefit of deferring taxes. We assume an investor can earn an annual return rate of 8% and has a tax rate of 23.8%<sup>1</sup> on investment returns. The investor is deciding between a mutual fund that pays 58% of its returns as capital gains every year (5-year asset-weighted average for all mutual funds) and an otherwise identical ETF that pays 1% of its returns as capital gains every year (5-year asset-weighted average for all ETFs).<sup>2</sup>

By investing in the ETF that pays less capital gains, the investor could see incremental cumulative returns of 4.4% over 10 years. By paying taxes early, an investor loses out on reinvesting their tax payment and compounding their returns.



## GSAM ETFs Capital Gains Track Record

When selecting an investment vehicle, investors should consider the relative tax efficiency of their options as well as the historical track record of capital gains paid.

In 2018, 100% of the 18 GSAM ETFs did not pay cap gains. In the market more broadly, 90% of ETFs did not pay cap gains compared to 39% of mutual funds.<sup>2</sup>



## GSAM in Your Portfolio

For more information on how to put Goldman Sachs ETFs to work in your portfolios, contact your financial advisor or visit [gsam.com/ETFs](https://gsam.com/ETFs).

<sup>1</sup>20% LT rate + 3.8% Medicare surtax. <sup>2</sup>Morningstar as of December 31, 2018. Given the model only took in annual data on capital gains, NAV, returns, etc., to avoid any bias in the data, the capital gain was divided by the NAV + capital gain at the end of the year (the capital gain is paid out of the NAV). For years in which a fund paid out a capital gain but did not have an end of year NAV because the fund had closed within the year, we took the NAV at the end of the previous year as a proxy (this was an infrequent occurrence in the data).

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**Tax Efficiency** means better tax consequences for investors and results from investors efforts towards reducing unwanted tax payouts

**Important Considerations between ETFs and mutual funds** - ETFs generally have lower expenses than actively managed mutual funds due to their different management styles. Most ETFs are passively managed and are structured to track an index, whereas many mutual funds are actively managed and thus have higher management fees. In addition, unlike ETFs, actively managed mutual funds have the ability to react to market changes and the potential to outperform a stated benchmark. Since ordinary brokerage commissions apply for each ETF buy and sell transaction, frequent trading activity may increase the cost of ETFs. Furthermore, ETFs can be traded throughout the day, whereas mutual funds are traded only once a day. While extreme market conditions could result in illiquidity for ETFs, typically, some are more liquid than most traditional mutual funds because they trade on exchanges.

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Net Asset Value is the market value of one share of the Fund. This amount is derived by dividing the total value of all the securities in the fund's portfolio, less any liabilities, by the number of fund shares outstanding. Market Price is the price at which the Fund's shares are trading on the NYSE Arca. The Market Price of the Fund's shares will fluctuate and, at the time of sale, shares may be worth more or less than the original investment or the Fund's then current net asset value. The Fund cannot predict whether its shares will trade at, above or below net asset value.

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