PARAMETRIC

April 2017

ETFs are Good, but Tax-Managed SMAs are Even Better

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Exchange traded funds (ETFs) are popular vehicles for investors seeking passive, index-based market exposures. By choosing a separately managed account (SMA), high net worth investors can still achieve the same objective but with added benefits. For these individuals, a tax-managed SMA, can be designed to deliver the same diversified index-like exposure while offering increased after-tax returns. Parametric research has shown that this return advantage can be as large as 1.5% annually on an after-tax, net- of-fee basis for investors facing the highest tax rates.[1]

Perhaps less easy to quantify is the added benefit of customization. SMAs allow an investor full control over the underlying securities, which, in addition to boosting tax efficiency, allows the investor to specify their unique exposure preferences, which can include managing around a concentrated position or adding responsible investing criteria.

Whether the goal is to minimize taxes or tailor the portfolio to suit certain preferences, an SMA has many inherent benefits over an ETF for high net worth investors seeking passive exposures.

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[1] Based on Monte-Carlo simulation assuming 6% market return and 35% security volatility. Net of 35 bps management fee. The value add of tax management depends on market environment and is generally higher in years of lower return.

Overview of ETFs

Since their introduction in the early 1990s, ETFs have enjoyed enormous asset growth and popularity. Today, U.S. ETF assets funds alone exceed $2 trillion. The oldest and largest exchange-traded fund is State Street's SPDR S&P® 500 Fund (SPY). SPY's success paved the way for a multitude of ETFs across market segments, including U.S. small cap, developed international and emerging markets. The most popular of these track well-known capitalization-weighted indexes published by S&P, MSCI, and FTSE-Russell. Newer ETFs move beyond these indexes to include alternatively-weighted and smart beta strategies, such as fundamentally- and equal-weighted, in addition to niches such as single sectors and thematic exposures.

Despite the proliferation of ETFs, their main use continues to be providing passive exposure to a market cap-weighted index. ETFs do so by replicating the stated index and typically purchasing all securities according to their index weight. ETFs are naturally tax efficient due to the low turnover of index constituents and the ability of ETFs to deliver low-basis securities for in-kind withdrawals.

Unique Features of SMAs

For taxable investors, SMAs arguably have an even greater tax advantage than ETFs. By definition, ETFs must hold all names contained within the specified index at their predefined weights. SMAs, however, have greater freedom around what names can be held and at what allocations. This freedom is dictated by an investor's preference for tracking error to the underlying benchmark. The wider the tracking error budget, the more flexible the SMA can be. And this flexibility allows an SMA investor to capitalize on powerful tax-management techniques, such as gain deferral and security-level tax-loss harvesting, that are not possible within the ETF structure.

Gain Deferral

Deferring the payment of a capital gain is similar to an interest-free loan; the longer one puts off paying the tax liability, the larger the value of the deferral. For some investors, this deferral can be particularly valuable if, for example, they are able to take advantage of a future, more favorable tax bracket. An SMA allows an investor to defer taxes at their discretion. This concept has no parallel within a commingled vehicle, such as an ETF. In fact, an ETF investor does not need to sell the fund to realize a gain. While typically less frequent and less significant than mutual funds, investors in ETFs are still subject to capital gain distributions.

Tax-Loss Harvesting

SMAs have another important feature unavailable to ETF investors: targeted tax-loss harvesting. Whereas excess losses in an ETF belong to the fund, an SMA has the ability to pass excess losses through to the investor. Said another way, the ETF can only pair losses against gains within the fund. Capital losses generated in an SMA, however, can be used to offset gains realized elsewhere in the investor's overall portfolio, such as from active investment managers, the sale of real estate, or concentrated stock positions.

Quantifying Tax Efficiency

Passive ETFs are known for their tax efficiency, resulting from low turnover and the delivery of low-basis stocks for large redemptions. However, this tax efficiency is limited to incurring very low taxes for investors in the ETF. Tax-managed SMAs go further by striving to generate net capital losses through a combination of gain deferral and tax-loss harvesting. But how large is this benefit?

To answer this, we compare the economic performance of a tax-managed SMA versus a buy-and-hold ETF portfolio over the same 10-year period. In this analysis, we assume a $1 million initial investment in both the SMA and ETF. Both portfolios are designed to provide U.S. large-cap exposure; specifically we assume the ETF is SPY. The tax-managed SMA portfolio is loss harvested and the annual tax savings are assumed to grow at the same rate as the portfolio. In both, dividends are reinvested. At the end of the period, we add the cumulative tax savings to the ending market value of the tax-managed SMA and compare this to the value of the ETF. Figure 2 shows the results of this analysis.

Figure 1: 10-Year Backtest Comparing Tax-Managed SMA to ETF Portfolio – Pre Liquidation

	Tax-Managed SMA	SPY	Difference
Pre Liquidation Starting Market Value	$1,000,000	$1,000,000	
Ending Market Value	$1,972,683	$1,940,737	
Value Add of Loss Harvesting	$323,881	$0	
Total Value	$2,296,564	$1,940,737	$355,827
After-Tax Annualized Return	8.7%	6.9%	1.8%

Source: Parametric, Bloomberg, 2017. Assumes a management fee of 35 bps, two-way turnover transaction costs of 10 bps, and highest marginal federal tax rates. The backtest spans the 10-year period ending 12/31/2016. Back tested performance is hypothetical and provided for illustration purposes only. It does not reflect the experience of any actual investor and should not be relied upon to make investment decisions. Actual results will vary. Not a recommendation to buy or sell any security. All investments are subject to the risk of loss.

Notice that before adding in the value add of loss harvesting, the ending market values of the tax-managed SMA and SPY portfolios are similar at the end of the 10-year period. This is expected because the tax-managed SMA is constructed to provide the same market exposure as the ETF. However, unlike the ETF, the SMA is systematically loss harvested. The harvested losses can be used to offset capital gains resulting in tax savings. We account for this tax savings in the row titled "Value Add of Loss Harvesting." This tax benefit is assumed to grow at the market rate of return. When we account for the value of loss harvesting, we see that the tax-managed portfolio had about a 1.8% return advantage over the ETF on an after-tax basis.

When evaluating investments on an after-tax basis, it's important to consider both pre- and post-liquidation results. When one ultimately sells an investment, the capital gain tax associated with the sale is called the liquidation tax. As shown in Figure 3, the ultimate liquidation tax cost of a tax-managed portfolio is higher than the ETF portfolio. This is a result of both systematic loss harvesting and tax deferral. The process of loss harvesting in a tax-managed-portfolio results in a lower cost basis and higher liquidation tax cost compared to an unmanaged ETF. However, loss harvesting allows the investor to defer payment of current taxes. The value of the deferral depends on the growth rate used on the tax benefit, and the length of time of the deferral. After accounting for liquidation taxes, however, the SMA still has a return advantage of around 1.2% on an annualized basis.

Figure 2: 10-Year Backtest Comparing Tax-Managed SMA to ETF Portfolio – Post Liquidation

	Tax-Managed SMA	SPY	Difference
Post Liquidation Ending Cost Basis	$849,644	$1,245,153	
Ending Market Value	$1,972,683	$1,940,737	
Value Add of Loss Harvesting	$323,881	$0	
Liquidation Taxes	-$267,283	-$165,549	
Total Value	$1,981,086	$1,775,188	$205,898
After-Tax Annualized Return (Post-Liquidation)	7.1%	5.9%	1.2%

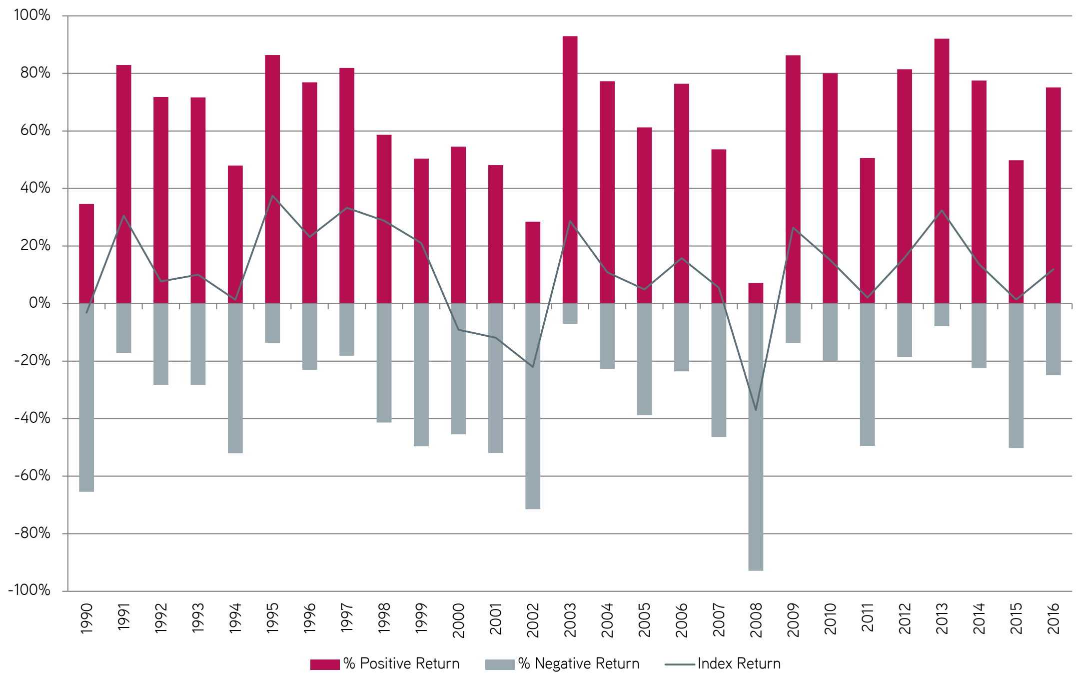
Source: Parametric, Bloomberg, 2017. Assumes a management fee of 35 bps, two-way turnover transaction costs of 10 bps, and highest marginal federal tax rates. The backtest spans the 10-year period ending 12/31/2016. Back tested performance is hypothetical and provided for illustration purposes only. It does not reflect the experience of any actual investor and should not be relied upon to make investment decisions. Actual results will vary. Not a recommendation to buy or sell any security. All investments are subject to the risk of loss.

There are a few additional things of note here – one is that the SMA appeared to "outperform" the ETF before taking into account the value add of loss harvesting. This difference, though small, is simply the result of the backtest, and not meant to imply anything about the performance of the SMA versus the ETF. In other words, the SMA could have just have easily slightly underperformed the ETF portfolio before taking into account loss harvesting. Had this been the result of the backtest, this would have a modest dampening impact on the SMA's return.

One other note is that for simplicity, we assume that the ETF portfolio was not loss harvested. However we acknowledge that it is possible to loss harvest an ETF portfolio, which would require finding an adequate substitute for the entire fund. If the ETF portfolio had an opportunity for successful loss harvesting, the difference between the after-tax performance for the SMA versus the ETF would have been narrowed somewhat.

But just how typical are opportunities to loss harvest an ETF versus an SMA? Below we show the percentage of winners and losers within the S&P 500 Index year-by-year. Notice that in all years there are stocks that end the year with a negative return, but only a handful of years where the entire index return was negative, implying that harvesting opportunities are more limited for the ETF.

Figure 3: Winners/Losers in the S&P 500 Year-By-Year



Source: Parametric, Factset.

It is important to keep in perspective that the primary goal of the portfolio is to capture the index return – not to generate losses. That said, systematic loss harvesting takes advantage of opportunities as they appear throughout the year. In the end, the goal is for the portfolio to track its target index while helping investors pay fewer taxes, which allows more of their money to remain invested. The compounding effect of this tax deferral can be quite powerful over time and add meaningful value for high net worth investors.

Additional Benefits of Tax-Managed SMA

In addition to gain deferral and tax-loss harvesting, SMAs offer other opportunities to provide additional tax efficiencies, including portfolio transition, tax efficient rebalancing and charitable gifting.

Transitions

When the ETF investor decides to make a style change, this transition can be quite tax inefficient. For example, in a switch from large-cap to large-cap value, the investor is forced to liquidate their large- cap ETF shares to fund a position in a large-cap value investment. If the position has appreciated, the liquidation of the shares comes with a tax cost.

Alternatively, with a tax-managed SMA, the investor has the ability to more smoothly transition the holdings within their existing account to the new investment mandate. The tax-managed SMA manager can identify security positions which overlap between the old and new mandates. Overlapping securities will be held through the transition, avoiding unnecessary tax and transaction costs.

Tax Efficient Rebalancing

The position level and tax-lot level access provided by a tax-managed SMA also allows for potential cost savings during portfolio rebalances and transitions. If the investor decides to trim their equity exposure, the portfolio manager can select the most tax-efficient basket of tax lots to sell, which will help to minimize the tax impact of the changes. An investor using ETFs may also choose specific tax lots, but only at the ETF level – not at the individual company level. It is access to individual securities and tax lots within the SMA structure that provides this higher level of granularity and potential for tax efficiency than a comparable ETF.

Charitable Gifting

Tax-managed SMAs can also be used as a vehicle for tax-efficient charitable gifting. Within any broadly diversified portfolio, some positions can become highly appreciated. These highly appreciated positions can be selected for charitable gifts. Gifting highly appreciated tax lots enables the investor to fulfill their charitable gifting goals while potentially reducing their current and future tax liability. Since ETFs do not provide access to underlying positions, investors can only choose to gift the entire fund rather than individual positions.

Customization of a Tax-Managed SMA

SMAs can also be used to reflect the unique situations and viewpoints of the individual investor, in addition to incorporating tax management.

Control Over the Underlying Exposure

The underlying index decision for an ETF is under the ETF sponsor's discretion. If an investor disagrees with changes in the underlying exposure, they may face a large tax hit from selling out of highly appreciated ETF shares. As an example, a few years ago Vanguard decided to add Chinese A-shares to their emerging markets ETF – a decision with which not all investors agreed. A long-time investor is caught between his dislike of incurring taxes on gains and his apprehension about including A-shares in his portfolio. With a tax-managed SMA, that exposure decision lies entirely with the owner of the account.

Concentrated Stock Holdings

Investors with concentrated stock holdings in a single company can choose to diversify their holdings by selling some of their stock and buying a diversified ETF. However, buying an index ETF that invests in the same stock, industry and sector as the concentrated stock position can be counterproductive in terms of maximizing diversification. Instead, the investor can design a custom tax-managed account that reduces overlap with their concentrated stock holding by excluding that stock, industry or sector, improving overall diversification. A careful analysis of correlation is required to select the proper exclusions. In addition, the tax-managed account can use harvested losses to help offset the gains that accompany the sale of concentrated stock positions.

Responsible Investing

Investors can also customize their index exposure in order to express social views through their portfolio. A tax-managed SMA can be customized to exclude securities issued by companies that engage in businesses which conflict with the investor's personal social views. For example, faith-oriented investors may choose to exclude companies involved in adult entertainment or abortion providers. Other investors interested in being active shareowners will enjoy the freedom of being able to vote proxies and file shareholder resolutions.

Conclusion

While both ETFs and tax-managed SMAs can provide transparent market index equity exposure, the structure of SMAs offer certain advantages over ETFs. Loss harvesting within an SMA potentially adds up to 1.5% of after-tax value annually. Additional tax efficiency is possible through opportunities for charitable gifting of highly appreciated securities and tax-efficient rebalancing and transition. Further, customization of separately managed accounts enables investors with concentrated stock holdings to enhance overall diversification, and to express their social views in the portfolio by using social screens and optimization. While smaller accounts may be well-served by a simple ETF solution, investors with larger accounts should consider the additional benefits of a tax-managed SMA.

Parametric is located at 1918 8th Avenue, Suite 3100, Seattle, WA 98101. For more information regarding Parametric and its investment strategies, or to request a copy of Parametric's Form ADV, please contact us at 206.694.5575 or visit our website, www.parametricportfolio.com.