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When Zero Gains are Good

You must pay taxes. But there's no law that says you gotta leave a tip.
 - Morgan Stanley (Advertisement)

John Maynard Keynes, the British economist, observed late in life that “*the avoidance of taxes is the only intellectual pursuit that still carries any reward.*” Of course, Keynes—known for his cynicism—was half-kidding. Clearly, other cerebral activities can have valuable non-pecuniary benefits. However, on the subject of investing, no one disputes the value in pursuing portfolio tax minimization. (Note that Keynes used the word “*avoidance*”, not “*evasion*”. While *ETFocus* has its vices, we do not promote unlawful tax-dodging).

Consider that most money managers are paid to maximize pre-tax returns—the figures published in client performance statements. Yet, as both investors and taxpayers, maximizing investment returns on an after-tax basis should be the ultimate goal. Unfortunately, tax concerns often take a back seat (*that is, until year-end when tax reports are mailed out*).

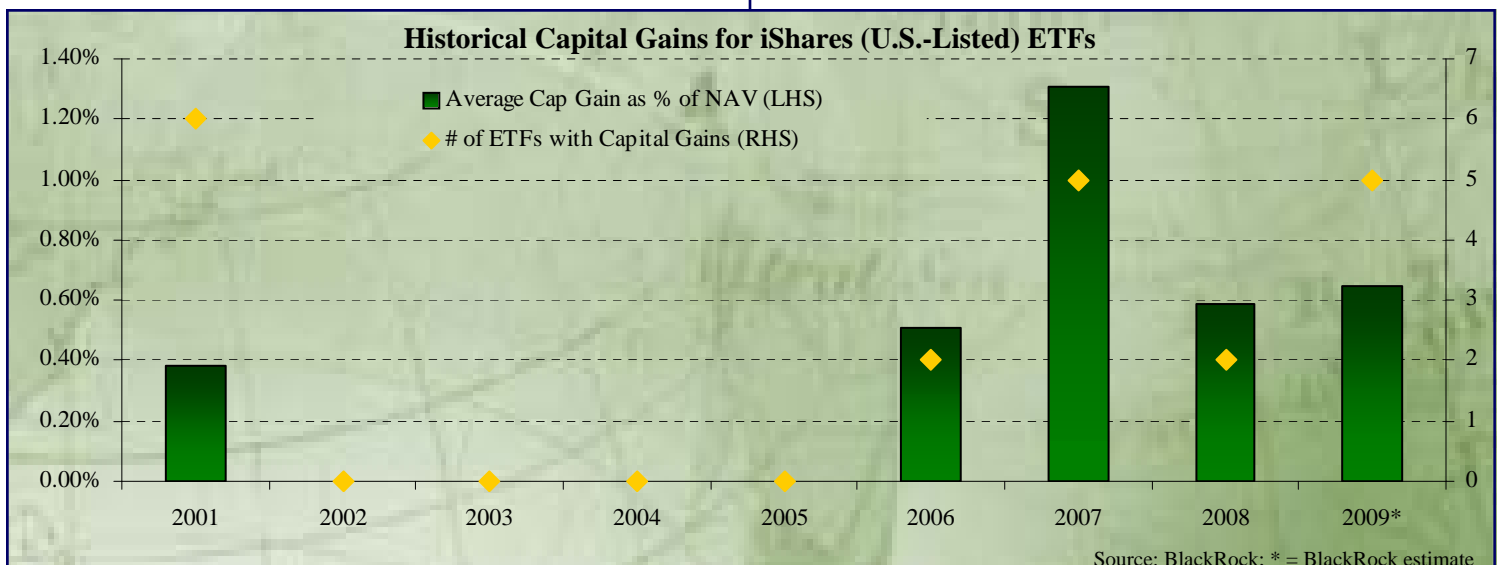
In the world of ETFs, tax efficiency is a key advantage. Most investors understand the advantages of low cost and transparency. But the benefits of ETFs as they relate to tax, can be more difficult to grasp. It's important to understand that

ETFs are not tax-exempt vehicles. Unfortunately, a cure-all for the common capital gains affliction simply does not exist. That means that investors still incur a tax liability when selling an ETF at a profit. That's an unavoidable reality, just as it is for any security.

However, ETFs claim to be successful in limiting the amount of year-end capital gains distributions. To be sure, ETFs are relatively new investment vehicles. For a time, the tax-efficiency claim has been difficult to assess simply due to short track records. With a longer history and a larger sample set, are ETFs substantiating their claims? (*While there are more than 1,800 ETFs worldwide, over 300 have been in existence for five years or more*).

Overall, ETFs have delivered on their promise. Before we assess this further, let's first examine the actual mechanics supporting tax efficiency. Then, we can consult the data to determine if the claims are justifiable.

Tax-Advantaged – When Less is More. While ETFs are not entirely immune to capital gains distributions, they are



significantly more tax efficient than traditional mutual funds for a few key reasons:

#1 — ETFs Trade on Listed Markets. Unlike mutual funds, ETF investors are insulated against the activities of other unitholders. Significantly, ETFs trade exactly like publicly-listed stocks. As such, retail ETF investors do not transact directly with the ETF company, but rather buy and sell on stock exchanges ... this is why they are called “exchange-traded” funds.

ETF trading activity has soared in recent years. According to BlackRock, average daily ETF trading volume around the world is equivalent to USD 74.4 billion (*figures as of October 31, 2009*). In general, higher trading has been associated with lower returns. But does turnover really harm the long-term ETF holder?

Certainly, turnover within the underlying securities of an ETF may cause undesirable tax liabilities. But, since ETFs are exchange listed, another investor’s buy or sale will not directly trigger tax consequences for existing unitholders. Mutual fund shareholders, on the other hand, may face negative tax consequences both when the portfolio manager trades in the underlying securities and when existing shareholders make redemptions from the fund.

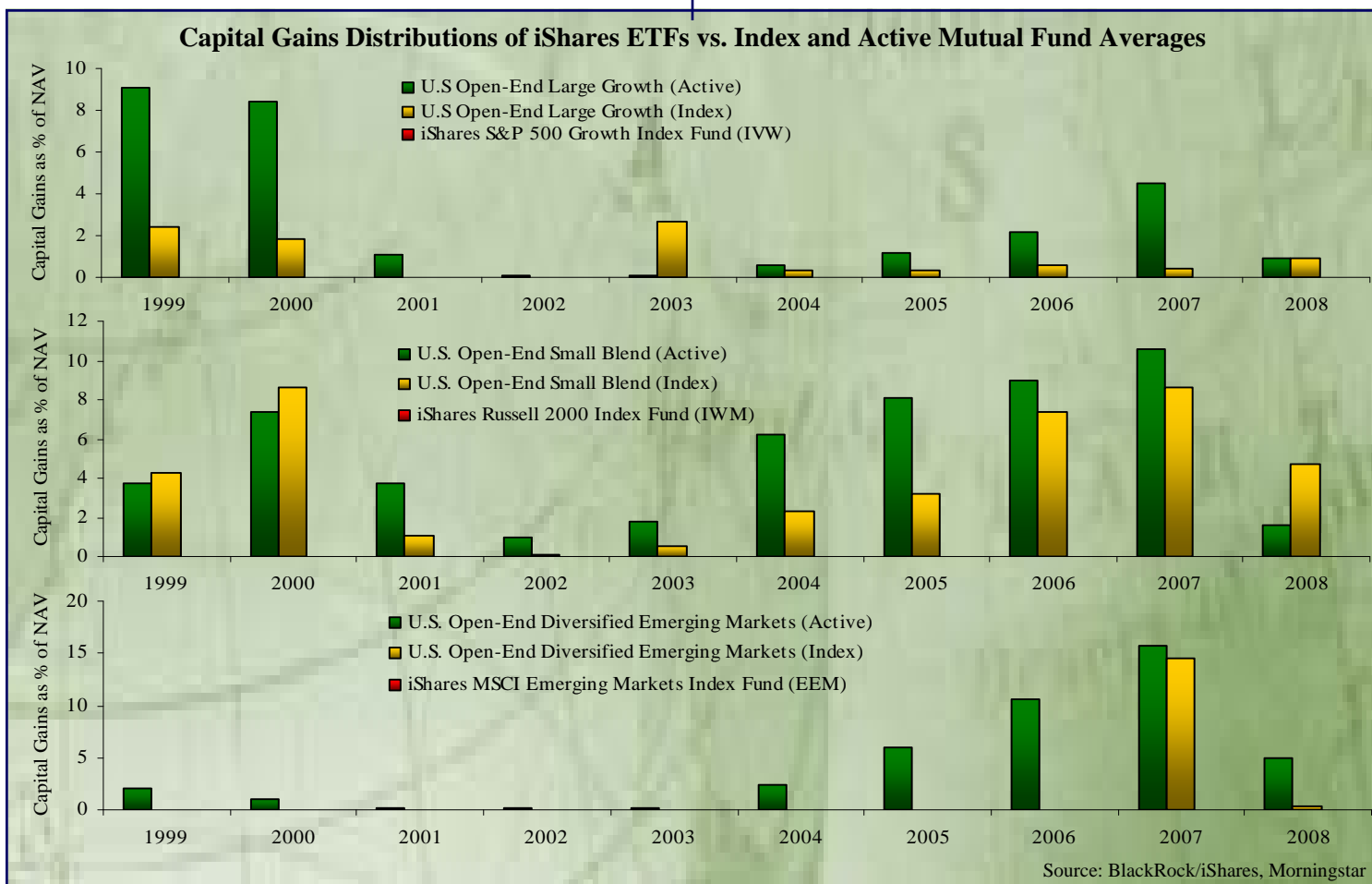
#2 — “In-Kind” Redemption Process. One of the unique

features of ETFs is their “in-kind” creation and redemption mechanism. This process holds the key to ETFs’ primary advantage over mutual funds and closed-end funds. To understand the importance of this process, consider a simplified illustration comparing the creation and redemption of new ETF and mutual fund shares.

When an investor buys shares in a conventional mutual fund, the fund manager receives the investor’s money and buys securities on the open market. When the same investor liquidates those shares, the process is reversed, with the fund company typically selling assets to fund the redemption. The key drawback is selling those securities in the fund may generate taxable gains that can ultimately result in taxable distributions to remaining or future shareholders.

With ETFs, the process is distinctly superior. To understand why, note that ETF shares are created by “designated participants” (DPs) — large institutional investors who are contracted by the ETF provider to continuously “create” and “redeem” shares of ETFs.

When imbalances in supply and demand for ETF shares cause prices to trade at premiums or discounts to the underlying net asset values (NAVs), an arbitrage opportunity exists. In the case of a price premium, DPs may sell units to capture a profit (*and vice versa*). This continual creation/redemption process helps keep ETF market prices in line with their underlying index



NAVs.

Let's look at an example. Suppose a DP creates shares of an ETF tracking the S&P/TSX 60 index. First, the DP purchases (or borrows) all the companies in the S&P/TSX 60 index in exact proportions. From there, the securities are placed in a trust and used to form "creation units". In turn, the trust provides ETF shares to the DP which are then sold to the public on the TSX just like shares of stock.

When DPs redeem shares, the process is reversed. The DP simply returns the ETF shares to the trust in exchange for the underlying securities. Crucially, because this is an "in-kind" barter — i.e. no cash changes hands — there are no tax implications. This is the fundamental tax advantage of ETFs over mutual funds, which have to liquidate securities in the fund to meet cash redemptions. What's more, DPs are also able to eliminate securities with the largest unrealized gains during redemptions, further limiting capital gains exposure.

#3 — Low Portfolio Turnover in Passive Indices. Since most ETFs are designed to track "passive" indices, they tend to have lower portfolio turnover than actively-managed funds, minimizing realized gains. To be sure, ETFs are not impervious to capital gains leakage. Occasionally, ETFs must sell securities when the underlying indices rebalance ... that is, when a security is added or deleted from the index.

And, the turnover issue has become more complex in recent years. New types of ETFs have come to market. Different index-weighting methodologies have blurred the line between active and purely passive approaches (e.g. *rules-based, quantitatively-driven, dividend, fundamental and other quasi-active indices*). As compared to traditional market-weighted indices, these "alternative" indexing styles may increase portfolio turnover ... increasing the potential for undesirable tax liabilities.

Zeroing In — Stress-Testing ETF Tax-Efficiency. How successful have ETFs been in limiting capital gains distributions in the real world? To answer that question, let's look at historical distributed gains from the largest ETF provider worldwide, BlackRock's iShares suite (as of October 2009, iShares represented some 400 ETFs worldwide and 48.4% of total ETF assets under management). The results have been impressive. During the period 2002 to 2005, U.S. iShares ETFs distributed 0% capital gains. Since then, distributions have been very modest (see the chart on the first page for further detail).

Generally, other ETF providers have shown a similar experience. Even heavy volatility and unprecedented market events have not undermined ETFs' tax advantages. During 2008, a year when many mutual fund investors got blindsided with unexpected capital gains, the large majority of ETFs distributed no gains. For example, just four of State Street's 80 SPDR ETFs realized negligible capital gains in 2008 (*State Street is the second largest provider of ETFs worldwide*). Only 2 of the 178 U.S. iShares declared distributions for 2008. Vanguard — another leading ETF provider — did not distribute

gains for any of their 38 ETFs that year.

Not all ETFs can boast better tax efficiency. However, these exceptions have been limited to a small handful. In some rare instances, when trading liquidity has been poor or where the underlying index has had higher than average turnover, some small capital gains have been realized. In these cases, investors need to be vigilant to these risks ... selecting the best ETFs to represent actionable strategies.

In other cases, where underlying securities are derivatives rather than single stocks (as in the case of *inverse ETFs*), the redemption process is different. If an inverse ETF faces redemption and must reduce the asset base, the ETF will need to liquidate the derivatives used to replicate the benchmark ... instead of using the "in-kind" facility. This can lead to taxable consequences and therefore some sizeable distributions. Of course, reduced tax efficiency should not be a reason to avoid these types of ETFs. Benefits of intra-day trading, lower cost and hedging flexibility are the main utilities in these types of ETFs. Mutual funds holding derivatives would face the same tax liabilities.

Looking to year-end 2009, *ETFfocus* expects more good news on the ETF tax front. Preliminary estimates from the largest 3 ETF providers — iShares, State Street and Vanguard — all indicate modest distributions. Even Proshares, the world's largest manager of leveraged and inverse funds, announced that it expects to pay zero 2009 year-end capital gain distributions on all of its 77 ETFs.

Conclusions. Admittedly, talking tax is not the favourite past-time of most investors. *ETFfocus*, too, would rather devote energies to "global macro" money-making discussions, rather than poring over the finer details of tax codes. However, we do get excited when discussing the ETF tax advantage. Compared to traditional mutual funds in the same asset classes, ETFs are solidifying their place as tax-efficient investment vehicles. Keynes would approve of the trend.





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