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Tax-Managed SMAs: Better Than ETFs?

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Exchange-traded funds, or ETFs, are popular vehicles for investors seeking passive, index-based market exposures. Yet despite their popularity, there are structural issues that make them less than ideal for many high-net-worth investors. For these investors, a tax-managed separately managed account (SMA) may 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 2% annualized on an after-tax, after-fee basis. Additionally, tax-managed SMAs allow greater control over the underlying securities, which can help make portfolio transitions more tax efficient, enable customization to reflect an individual's investment objectives, and take into account their responsible investing views.

In this paper we give a brief description of ETFs and tax-managed SMAs and then demonstrate the advantages of using tax-managed SMAs due to their tax efficiency and customizability. For many high-net-worth investors, these benefits can be substantial, reinforcing why advisors should consider tax-managed SMAs when selecting a passive market exposure.

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How ETFs Work

ETFs have grown in popularity and assets in recent years. The oldest and largest fund, State Street's SPDR S&P® 500 Fund (SPY), started in 1993 and today has over $250 billion in assets under management. SPY's success paved the way for a multitude of funds to be developed for other market segments, such as US 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 weighted, equal weighted, and low volatility. However, the primary use of ETFs continues to be for passive exposure to a cap-weighted index.

ETFs produce this exposure by replicating the stated index—that is, by purchasing all securities according to their index weight. These tend to be naturally tax efficient due to the low turnover associated with broadly diversified indexes as well as the ability of ETFs to deliver low-basis securities for in-kind withdrawals. However, while ETFs may be appropriate for some investors, high-net-worth investors facing high tax rates and holding a more complex investment portfolio may be better served through a customized tax-managed SMA.

How Tax-Managed SMAs Work

Like an ETF, a tax-managed SMA can also provide investors with an index-based market exposure. The range of indexes available through ETFs is large and includes cap-weighted indexes, such as the S&P 500, Russell 3000, and the MSCI EAFE indexes, as well as alternatively weighted indexes such as the Research Affiliates Fundamental Index. However, an even broader selection of indexes is available for separate accounts, since not all indexes are available in ETF format—for example, the Russell Defensive Equity indexes. In addition, SMAs can target blended benchmarks, and this blend can be changed dynamically over time as the investor's view changes.

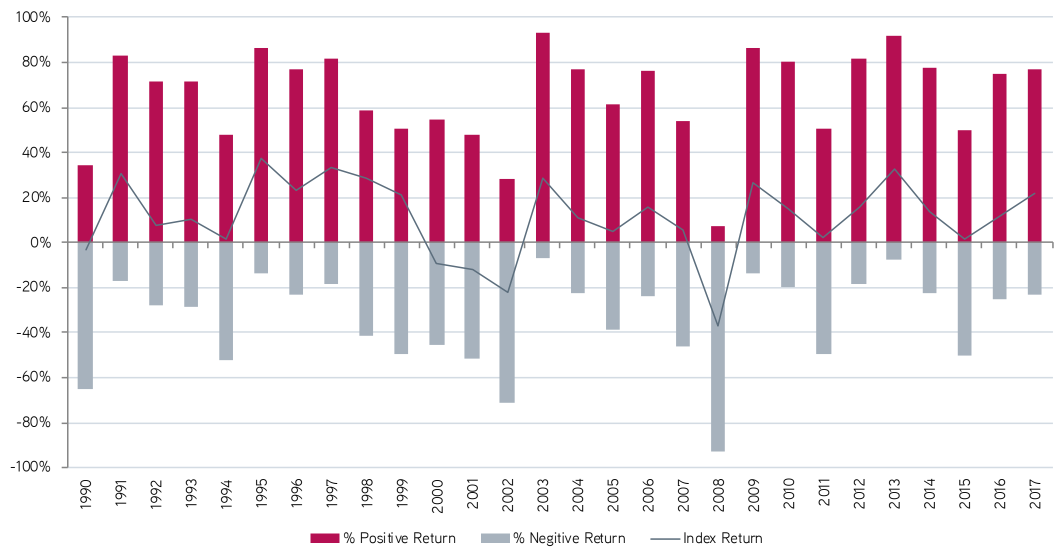
Unlike ETFs, in which the names held are fixed, SMAs can be flexible in their holdings (and still express a low tracking error to the underlying benchmark), which can result in added tax efficiencies. This is because a tax-managed SMA can be designed to seek index returns similar to those of an ETF but with the added ability to harvest losses. Realized capital losses are valuable because they can be used to offset capital gains, thereby reducing an investor's overall tax bill. This is a prime benefit of the tax-managed SMA, since it passes capital losses through to the individual investor, something an ETF can't do.

For example, consider a tax-managed portfolio benchmarked to the S&P 500 Index. Initially the portfolio is invested in about 250 securities selected to mimic the index in terms of sector and industry weights, with low tracking error. Care is also taken to ensure that the portfolio resembles the index in terms of risk factors such as yield, beta, and market capitalization. After the initial portfolio is invested, it's monitored for risk and tax-loss harvesting opportunities. With a portfolio of 250 securities, some equity prices will rise and some will fall. Securities with prices that have fallen below their cost basis present loss-harvesting opportunities. When such opportunities arise, the portfolio is loss harvested. The tax lots exhibiting a loss are sold, and a replacement set of securities is bought. Care is taken not to violate wash-sale rules. The intended result is a portfolio designed to closely track the index on a pre-tax basis while also producing excess realized losses.

Excess losses realized in the portfolio can also be used to offset gains that exist elsewhere in the investor's overall portfolio. Taxable gains may be generated from the investor's active manager investments, from the sale of real estate, or from selling concentrated stock positions. In the end, the goal is for the portfolio to track its target index while helping investors pay less in taxes, which allows more of their money to remain invested. The compounding effect of this tax deferral can be quite powerful over time.

Of course, the primary goal of the portfolio is to capture the index return, not generate losses. But systematic loss harvesting takes advantage of the loss opportunities as they appear throughout the year. Below we show the percentage of winners and losers in the S&P 500 Index over the years. Notice that in all years there are stocks that end the year with a negative return:

Figure 1: Winners and Losers in the S&P 500, 1990–2017



Sources: Parametric, Factset 2018

Tax Efficiency of Tax-Managed SMAs vs. ETFs

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

To analyze the economic advantages of using a tax-managed SMA, we compare a tax-managed portfolio to a buy-and-hold ETF portfolio in a back test. In the analysis we assume that $1 million is invested in a tax-managed SMA. Initially we assume no management fees are charged, to more clearly examine the benefit of tax management. Throughout the back test, the tax-managed portfolio is loss-harvested and the annual tax benefit is assumed to grow at the same rate as the portfolio. At the end of the period, we liquidate the portfolio and subtract the associated tax cost. For the ETF portfolio we assume an initial $1 million investment in the SPY (S&P 500 ETF). Dividends are reinvested into the ETF, and the portfolio is liquidated at the end of the period. The results of the back test are shown below.

Figure 2: Hypothetical Back Test Comparing a Tax-Managed SMA to an ETF Portfolio over 10 Years Ending 12/31/2017 (Gross of Management Fees)

	Tax-Managed SMA	SPY
Starting Market Value	$1,000,000	$1,000,000
Ending Market Value	$2,334,621	$2,159,135
Cost Basis	$861,367	$1,197,831
Value Add of Loss Harvesting	$534,814	$0
Liquidation Taxes	$350,635	$228,791
Annualized Tax-Managed SMA Benefit over ETF		
Pre-Liquidation	3.1%	-
Post-Liquidation	2.5%	-

Sources: Parametric and Bloomberg 2018. Hypothetical performance is for illustrative purposes only, does not represent actual returns of any investor, and may not be relied upon for investment decisions. Actual client returns will vary. All investments are subject to loss. Please refer to the last page for important information and disclosure. Assumes highest marginal federal tax rates. For short-term gains, the highest US federal marginal income tax rate is 39.6% plus the 3.8% net investment income tax, for a combined rate of 43.4%. For long-term gains, the highest US capital gains tax rate is 20% plus the 3.8% net investment income tax, for a combined rate of 23.8%.

As shown in the table above, the ultimate liquidation tax cost of a tax-managed portfolio is higher than that of the ETF portfolio prior to the application of management fees for the tax-managed SMA. This is the result of 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 with 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. We describe loss harvesting in an index portfolio as a form of tax deferral because some investors will eventually pay the tax upon liquidation of the portfolio.[1] For these reasons it's important to consider the value of tax deferral balanced against the cost of liquidation. Nonetheless, the back test results show that the tax-managed SMA realized a higher post-liquidation annualized growth rate than the ETF portfolio.

Next we incorporate management fees for the tax-managed SMA. Fees for tax-managed SMAs are generally higher than those for ETFs. While passive exposure for US large cap and developed international equity ranges from 0.03% to 0.34%, management fees for a tax-managed SMA are typically around 0.35% but can be lower for larger accounts. Note that we're being conservative in our analysis by applying a 0.35% charge to the tax-managed SMA while comparing it with one of the least expensive ETFs available (currently 0.09%). Based on the above back-test results and 0.35% tax management account fee estimate, the table below shows the estimated net benefit advantage over the ETF on a pre- and post-liquidation basis.

[1] Some portfolios will experience a cost-basis step-up for which the tax deferral will become permanent.

Figure 3: Hypothetical Annualized Return Advantage of Tax-Managed SMAs over ETFs over the Past 10 Years (Net of Management Fees and Transaction Costs)

Pre-Liquidation	2.7%
Post-Liquidation	2.1%

Source: Parametric. Net of 0.35% management fee. Hypothetical performance is for illustrative purposes only, does not represent actual returns of any investor, and may not be relied upon for investment decisions. Actual client returns will vary. All investments are subject to loss. Please refer to the last page for additional important information and disclosure.

As can be seen, the effects of tax management can be powerful. The benefits are best achieved with a long-term horizon to take advantage of both market volatility and the compounding effects of tax deferral. However, there exists a wide spectrum of additional features besides higher after-tax return that can benefit users of tax-managed SMAs.

Additional Benefits

In addition to passing through losses, SMAs offer other potential tax advantages:

Transitions. When an ETF investor decides to make a style change, this can be quite tax inefficient. For example, in a switch from large cap to large cap value, the investor is forced to liquidate 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 can more smoothly transition the holdings in existing accounts to the new investment mandate. The SMA manager can identify security positions that overlap between the old and new mandates. Overlapping securities will be held through the transition, avoiding unnecessary tax and transaction costs.

Asset class 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 equity exposure, the portfolio manager can select the most tax-efficient basket of tax lots to sell that will help minimize the tax impact of the changes. An ETF investor may also choose specific tax lots, but only at the ETF level and not at the individual company level. Access to individual securities and tax lots within the SMA structure provides a higher level of granularity and potential for tax efficiency than a comparable ETF.

Charitable gifting. Investors can also use tax-managed SMAs as a vehicle for tax-efficient charitable gifting. In any broadly diversified portfolio, some positions can become highly appreciated. Gifting highly appreciated tax lots enables the investor to fulfill charitable-gifting goals while potentially reducing current and future tax liability. ETFs don't provide access to underlying positions and can't be used for this purpose.

Investors can also use SMAs to design a customized portfolio to reflect their unique situations and viewpoints:

Control over the underlying exposure. The underlying index decision for an ETF is typically under the ETF sponsor's discretion. If an investor disagrees with changes in the underlying exposure, he or she may face a large tax hit from selling out of highly appreciated ETF shares. As an example, Vanguard recently decided to add China A-shares to its emerging markets ETF—a decision with which not all investors agree. A longtime investor is thus caught between a dislike of incurring taxes on gains and an apprehension about including A-shares in his or her portfolio. With a tax-managed SMA, that exposure decision lies entirely with the owner of the account, and such dramatic shifts can happen only with the investor's consent.

Concentrated stock holdings. Investors with concentrated holdings in a single company can choose to sell some of their stock and buy 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 the concentrated stock holding by excluding the 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. In a tax-managed SMA, investors can customize their index exposure to align their investments with their social and ethical principles and exclude securities issued by companies whose business practices conflict with them. For example, certain Catholic investors may choose to exclude companies involved in adult entertainment or that support abortion providers. Other investors have chosen to divest from companies involved in fossil fuels. Whatever their views, through a tax-managed SMA investors can design their exposure to exclude the selected companies and then rely on the SMA manager to optimize the portfolio to capture the index return as closely as possible.

Conclusion

Although both ETFs and tax-managed SMAs can provide transparent market index equity exposure, the structure of separate accounts offers certain advantages over ETFs from both tax-efficiency and flexibility perspectives. Loss harvesting within an SMA potentially increases annualized after-tax return by up to 2%. Additional tax efficiency is possible through opportunities for charitable gifting of highly appreciated securities and tax-efficient rebalancing and transition. Further, customization of SMAs 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.