Superior Tax-Efficiency Supports Continued Migration to ETFs

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Summary of Q3 2019 ETF Flows and Trends[1]

- Total US-listed ETF assets reached $4.06 trillion at the end of Q3 2019, an 8.5% year-over-year increase. Estimated net asset flows in Q3 2019 totaled $67.1 billion, compared to $79.7 billion Q2 2019.
- US Equity ETFs received the strongest estimated net inflows in Q3 2019, with a total of $34.8 billion. However, the narrower Sector Equity ETFs category had estimated net outflows of $2.2 billion. International Equity ETFs also had estimated net outflows in Q3 2019, totaling $14.3 billion, the category's largest quarterly outflows on record.
- Taxable Bond ETFs had the second highest estimated net inflows in Q3 2019 with $34.7 billion. Municipal Bond ETFs received $3.0 billion in estimated net inflows in Q3 2019, increasing year-over-year assets by 35.2%.
- Commodities ETFs received estimated net inflows of $8.8 billion in Q3 2019, the most quarterly inflows since Q1 2016.
- Alternative and Allocation ETFs had estimated net inflows of $1.7 billion and $0.6 billion, respectively, in Q3 2019, each rebounding from net outflows in the previous quarter.

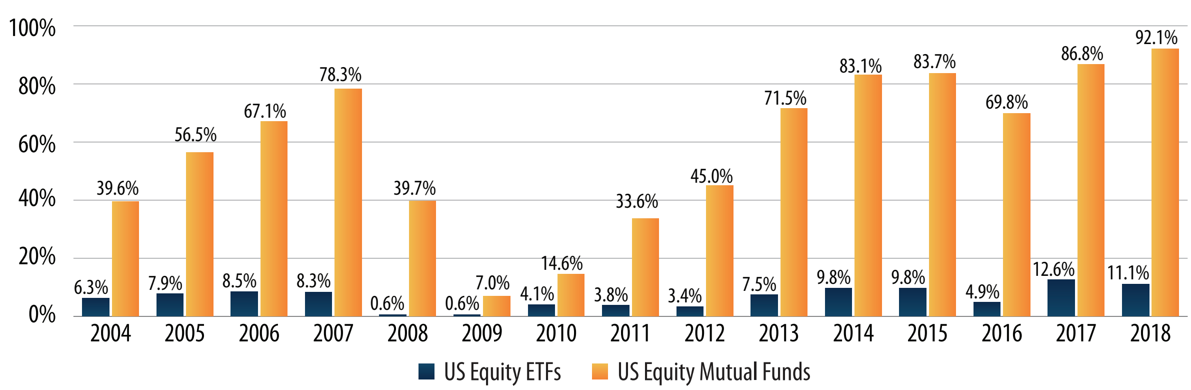
Table 1

	Total US-Listed ETF Assets		Estimated Net Asset Flows	
US Category Group	**As of 9/30/2019**	**Year-over-year % change**	**Q3 2019**	**Prior Quarter (Q2 2019)**
US Equity	$1,941,580,216,946	8.5%	$34,841,300,302	$36,690,699,377
International Equity	$718,385,478,027	0.2%	$(14,299,258,133)	$1,599,744,373
Taxable Bond	$761,945,385,864	27.3%	$34,732,928,214	$38,567,495,667
Sector Equity	$447,126,258,755	-6.6%	$(2,220,274,401)	$510,416,675
Commodities	$82,110,548,652	32.8%	$8,767,169,169	$793,777,200
Alternative	$51,893,614,414	2.6%	$1,726,654,735	$(521,997,208)
Municipal Bond	$43,932,245,173	35.2%	$2,980,229,975	$2,258,051,998
Allocation	$13,047,705,307	-1.4%	$557,041,698	$(164,766,074)
Total	$4,060,021,453,138	8.5%	$67,085,791,559	$79,733,422,008

Source: Morningstar, as of 9/30/19. Includes all US-listed exchange-traded funds, exchange-traded notes and other exchange-traded products. All net inflow and outflow numbers are estimates based on information provided by Morningstar.

Differences in tax-efficiency between ETFs and traditional mutual funds can be significant. In many categories, such as US equities, the disparity has grown starker in recent years, as the percentage of mutual funds making capital gains distributions has trended higher (see Chart 1 below). Considering the relatively strong performance for US equities over the past decade, coupled with accelerating mutual fund outflows, we believe these trends are likely to persist.

Chart 1: Percentage of US Equity ETFs and Mutual Funds that made Capital Gains Distributions by Year



Source: Morningstar. For each calendar year, only data from mutual funds and ETFs with full calendar year returns are included. Includes mutual funds' oldest share class only.

Trends in Mutual Fund Tax-Efficiency

Capital gains distributions have often been considered a proxy for tax-efficiency, because investors face tax consequences—unless gains are in a qualified account—when a mutual fund or ETF makes such distributions. Moreover, these distributions may result from gains that occurred before an investor owned shares of the fund. Capital gains distributions can be particularly distasteful to investors when they occur during negative return years. For example, in 2018, while just 9% of US equity mutual funds achieved positive annual returns, 92.1% made capital gains distributions.[2]

To be clear, if investors decide to sell shares of mutual funds or ETFs at a gain, they may be liable for capital gains taxes, assuming shares are held in a taxable account. But when mutual funds or ETFs make capital gains distributions, the timing of these is outside investors' control, potentially triggering tax liabilities at inopportune times, and leaving them with fewer assets to invest. Additionally, if distributions are not reinvested, they may miss out on important market opportunities, such as the rebound enjoyed by US equities so far in 2019.

While capital gains distributions are nothing new for mutual funds, the percentage of mutual funds making distributions has trended higher over the past decade (see Chart 1 on the previous page). During the stock market downturn that accompanied the 2008-2009 financial crisis, many mutual funds sold securities and realized capital losses that could be carried forward into future years to offset realized capital gains. In 2009, while the S&P 500 posted a 23.5% price-only return (does not include dividends), just 7.0% of US equity mutual funds made capital gains distributions. However, as the equity bull market has continued, the evidence suggests many carried forward losses have been used up. Over the past 5 calendar years, an average of 83% of US equity mutual funds made capital gains distributions.

ETFs Have Tended to Be More Tax-Efficient

Over the past couple decades, tax-efficiency has often been touted as one of the most attractive attributes of ETFs. While not all categories of ETFs are equally tax-efficient, some of the most popular categories, such as US equities, have been substantially more tax-efficient than comparable mutual funds. In fact, an average of just 7% of US equity ETFs have made capital gains distributions over the past 15 calendar years.

One of the most important reasons that ETFs have remained relatively tax-efficient has to do with how ETF shares are created and redeemed. Unlike mutual funds, which typically buy and sell underlying securities for cash to meet inflows and outflows, most ETFs create and redeem shares "in-kind". This transaction is facilitated by institutional investors, called authorized participants (APs). Essentially, it involves an exchange of a large block of ETF shares for the underlying securities that comprise those shares. As such, when redemptions are done in-kind, ETFs typically don't sell underlying securities, which could result in capital gains.

Of course, most investors simply buy and sell ETF shares on stock exchanges, and a relatively small amount of this trading activity has tended to compel APs to create or redeem shares. But even when investors sell out of an ETF en masse, the in-kind redemption process helps facilitate its tax-efficiency.

In recent years, relatively strong returns for US equities, combined with huge outflows for US equity mutual funds, has been a consistent recipe for mutual fund capital gains distributions. While many funds have not yet declared capital gains distributions for 2019, with the S&P 500 Index up 18.7% year-to-date (price only, through Q3), and with $116 billion in estimated net outflows for US equity mutual funds year-to-date, we expect this to hold true again in 2019.[3] Assuming ETFs maintain the relative tax-efficiency they have enjoyed over the past several years, we believe tax-sensitive investors may continue to migrate from mutual funds to ETFs.

[1]Based on Morningstar data, as of 9/30/19. Includes all US-listed exchange-traded funds, exchange-traded notes, and other exchange-traded products.

[2]Source: Morningstar. Only data from mutual funds and ETFs with 2018 calendar year returns are included. Includes mutual funds' oldest share class only.

[3]Source: Morningstar, as of 9/30/19.