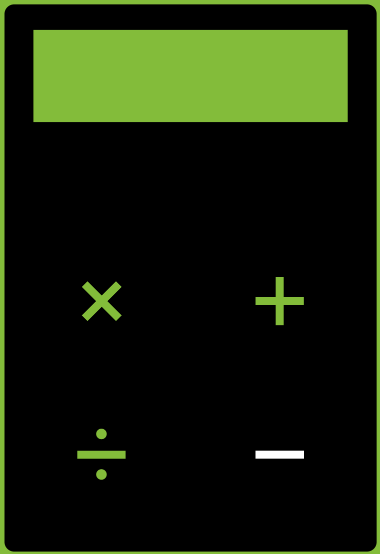
iShares by BlackRock

# KEEP MORE OF WHAT YOU EARN

How advisors can help clients build tax-efficient portfolios



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# SUMMARY

Tax consequences can drag down portfolio returns. In fact, taxes have proven to be more detrimental to long-term returns for taxable equity investors than fund management fees.[1]

For advisors, finding ways to improve portfolio tax efficiency for clients is relevant across asset classes and in all market conditions. While tax considerations are easy to overlook, building tax efficiencies into the portfolio construction process can help clients reach their financial goals.

This paper explores:

**1 Why tax considerations should feature prominently into portfolio construction and fund due diligence**

- U.S. mutual fund assets under management in taxable accounts amounts to nearly $7 trillion.
- The difference between pre- and post-tax returns for U.S. Large-Cap Blend mutual funds managers has been 1.73% annually over the past 10 years — almost twice the average expense ratio of 0.9%.

**2 How ETFs can help reduce the impact of taxes**

- Structure: ETFs tend to be more tax-efficient than mutual funds because of structural attributes.
- Strategy: Indexing is typically a tax-efficient strategy because of low turnover, especially compared with alpha-seeking strategies.
- The result: ETFs accounted for 19% of the $22 trillion in U.S. managed fund assets, but distributed less than 1% of total capital gain distributions in 2019.

**3 Strategies that can help advisors reduce the impact of taxes.**

- Short-term: Tax-loss harvesting can help offset capital gains — fund investors can sometimes overlook their opportunities.
- Long-term: Considerations around asset class, investment vehicle and asset location are important for improved tax efficiency.

**1** BlackRock analysis of Morningstar data that covers January 2000 – December 2019 (as of Dec. 31, 2019).

# TAKE ACTION WITH THE BLACKROCK TAX EVALUATOR

Go above and beyond for your clients. Get a custom report that highlights estimated capital gains distributions, identifies potential loss harvesting opportunities and evaluates fund performance.

**Access capital gains estimates**

**Identify tax loss harvesting opportunities**

**Find an iShares ETF alternative**

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## 1 TAX CONSIDERATIONS SHOULD FEATURE PROMINENTLY INTO PORTFOLIO CONSTRUCTION

Roughly one out of every three dollars invested in U.S. mutual funds was held in a taxable account at the end of 2019, representing $6.8 trillion in assets (Figure 1).

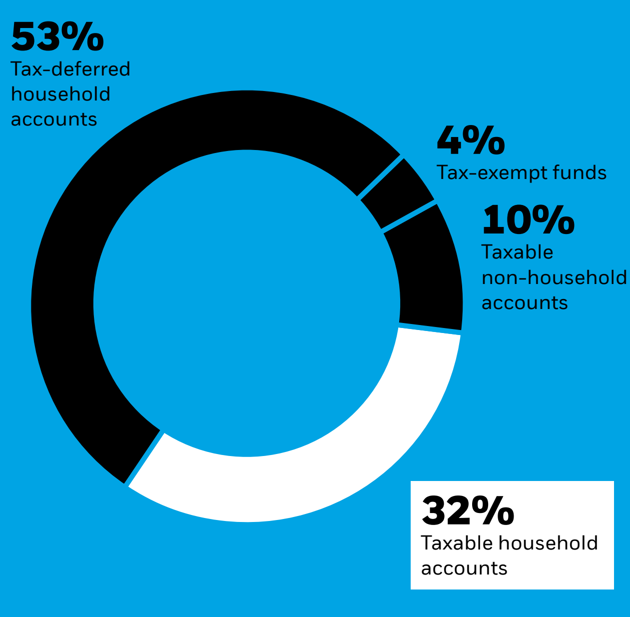
But while many Americans hold funds in investment accounts that are subject to taxes, tax efficiency is not well recognized as a prime investment consideration. One survey found that just 8% of investors completely agreed with the statement that taxes are important considerations for how to invest.[2]

Tax-related blind spots may affect millions of American households that own funds in taxable, non-retirement accounts. Taxes on distributions shaved 1.73 percentage points off the average annual performance of alpha-seeking (actively managed) U.S. Large-Cap Blend mutual funds for taxable investors in the decade ended in 2019. That figure is nearly double the 0.90 percentage point average expense ratio charged by those same funds in 2019 (Figure 2).

In short, while many investors have been (rightly) trained to prioritize low fund fees in their fund-selection processes, overlooking the potential effects of taxes can be more detrimental to portfolio returns than fees. The key is to focus not only on the tip of the iceberg but also on what lies beneath the surface.

**Figure 1: 32% of U.S. mutual fund assets were held in taxable accounts at the end of 2019**

Percentage of total net assets, year-end 2019




**Mutual fund total net assets: $21.3 trillion**

Source: Investment Company Institute Fact Book (2020).

**Figure 2: Big bite: Capital gains distributions mattered more than fund expenses for stock funds in the 10 years ended in 2019**

Top figure: Difference between total annualized pre- and post-tax returns over 10 years. Bottom figure: Average expense ratio.

| | Value | Blend | Growth |
|---|---|---|---|
| Large | -1.77%<br>0.86% | -1.73%<br>0.90% | -1.80%<br>0.95% |
| Mid | -1.76%<br>0.93% | -1.71%<br>1.08% | -1.84%<br>1.06% |
| Small | -1.73%<br>1.11% | -1.80%<br>1.05% | -2.00%<br>1.16% |

Source: Morningstar (as of Dec. 31, 2019). U.S. style box funds are those funds categorized by Morningstar as US Large Cap Growth / Blend / Value, US Mid Cap Growth / Blend / Value or US Small Cap Growth / Blend / Value. Data calculated using the oldest share class of all Active US Equity Open-End Mutual Funds available in the U.S.

**2** BlackRock ETF Pulse ETF investor survey, 2019. Nationally representative online sample of household financial.

## Where do tax costs come from?

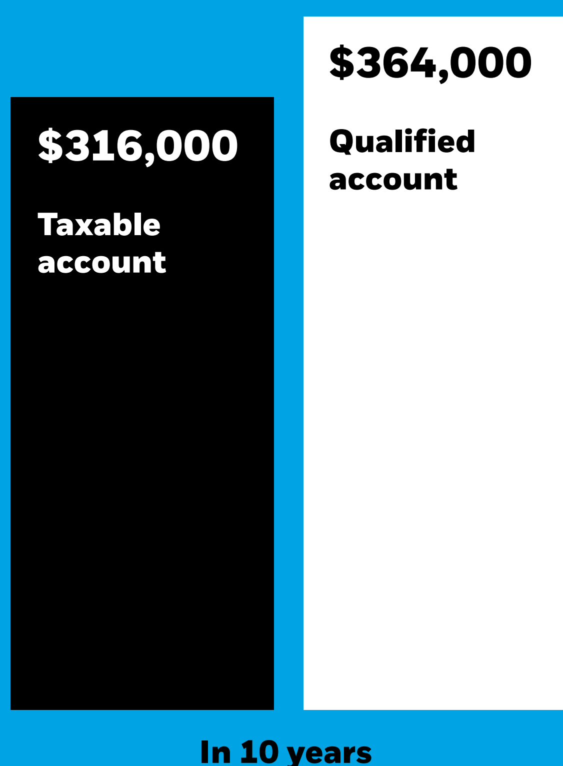
There are two primary sources of taxes for investors. The first is income taxes due on dividends or interest. The second is capital gain taxes resulting from the sale of a security that has appreciated in value. Neither is typically an immediate concern for U.S. fund investors with qualified accounts, which are not subject to taxes on income or capital gains.

But these are pressing concerns for taxable investors, whose non-qualified accounts are potentially subject to dividends, interest and capital gains each year. Indeed, while most investors associate capital gain taxes with the sale of an appreciated security, taxable fund investors often pay capital gain taxes even though they have not sold the position.

These payments add up over time. Consider two separate hypothetical $100,000 investments made at the end of 2009 in the same top-quartile U.S. Large-cap Blend Fund portfolio. One is housed in a taxable account, the other in a qualified account that grows tax free. Fast forward 10 years and the qualified account would have been worth $364,000, while the taxable account would be worth $316,000 — fully 13% less.

Taxation hurts twice as investors pay taxes and benefit less from compounding growth over time. Paying higher taxes means less money remains invested, and missed opportunities for future growth.

**Two hypothetical $100,000 investments made at the end of 2009**




Source: BlackRock analysis of Morningstar data (as of Dec. 31, 2019); Pre-tax annualized rate of return was 13.78%, post-tax rate was 12.21%; Morningstar uses the highest marginal tax bracket rate for each calendar year.

# 2 HOW FUNDS GENERATE CAPITAL GAINS AND WHY ETFS CAN HELP REDUCE THE IMPACT OF TAXES

All funds, including mutual funds and ETFs, are required to distribute realized portfolio gains to shareholders, regardless of performance and fund owners have to pay taxes on these distributions.

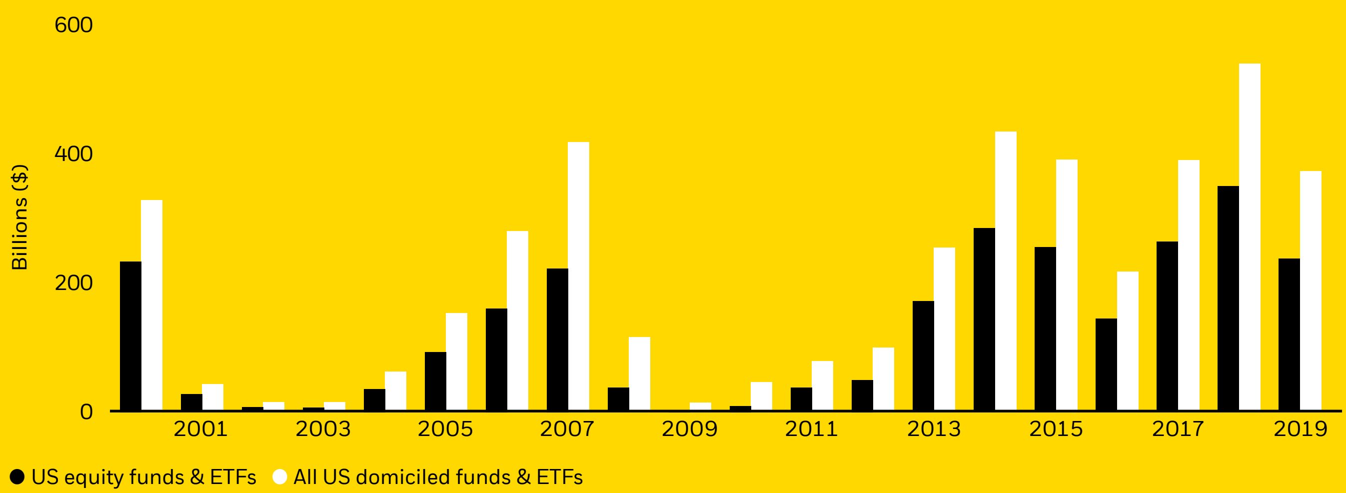
In aggregate, fund capital gain distributions have trended higher for the past 10 years and 2018 saw the largest aggregate annual distribution in at least two decades. The upswing of capital gains distributions is the result of several factors, each of which provides a lesson for advisors when thinking about incorporating tax efficiency into portfolio construction.

First, the longest U.S. equity bull market in history provided the fuel for taxable gains, as the S&P 500 rose 450% from March 2009 through 2019.[3] The average annualized return of alpha-seeking U.S. equity mutual funds tracked by Morningstar was 11.9% in the decade ended 2019. Since many stocks inside fund portfolios accrued significant unrealized gains over the decade, even minor portfolio allocation changes can trigger pent-up capital gains.

Another challenge for fund managers: outflows. When dealing with redemptions, fund managers need to deliver cash on hand, or else raise cash by liquidating positions. Alpha-seeking U.S. equity funds experienced more than $1.3 trillion in outflows in the 10 years ended 2019, an investor shift that highlights demand for value as higher-cost, alpha-seeking strategies have generally delivered uneven returns.[4]

Portfolio managers often try to minimize the tax effects of meeting redemptions by first liquidating securities held at the highest cost-basis (lowest unrealized gains). In doing so, managers are less likely to recognize large capital gains in the current year; however, remaining portfolio securities generally are left with the lowest cost-basis (highest unrealized gains).

**Figure 3: Aggregate capital gains distributions for U.S. mutual funds and ETFs (2000-2019)**

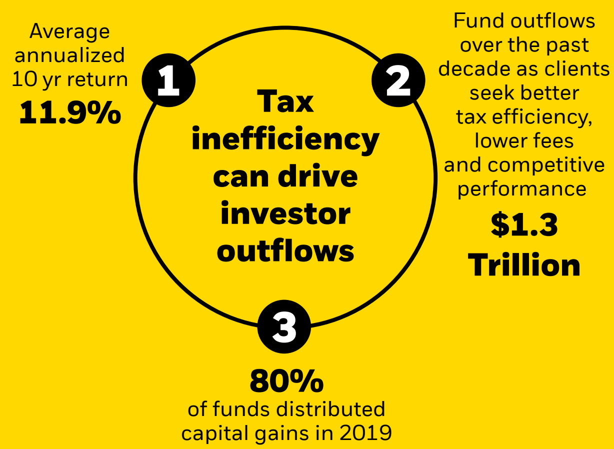



Source: BlackRock analysis of Morningstar data (as of Dec. 31, 2019).

**3** Morningstar (as of Dec. 31, 2019).
**4** Source: S&P Dow Jones Indices, Standard & Poor's S&P Indices Versus Active (SPIVA) research, May 1, 2000 - April 30, 2020.

A decade-long bull market, coupled with increasing redemptions, means that many fund managers have few remaining tools for minimizing distributions. These three forces have contributed to the recent increase in capital gain distributions and demonstrate how taxable investors can be caught in vicious cycles when strong gains in the stock market, paired with redemptions, are compounded when remaining fund investors exit to avoid high unrealized capital gains in the future.

**Figure 4: Vicious cycle: The circular nature of capital gains distributions**




Source: Morningstar Direct, as of 12/31/2019. Calculated using the oldest share class of all Active US Equity Open-End Mutual Funds available in the U.S. Past performance is not indicative of future results

## ETFs can help improve portfolio tax efficiencies

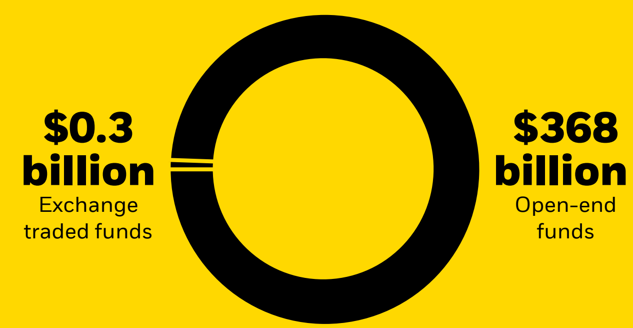
ETFs represent 19% of the $22 trillion in U.S. managed fund assets but distributed less than 1% of 2019's total capital gains distributions (Figure 5).[5] And, despite the recent growth of ETF assets, their low contribution to total capital gains has remained constant. Whereas 80% of alpha-seeking U.S. equity funds made a capital gain distribution in 2019, just 5% of iShares ETFs distributed capital gains.

ETF tax efficiency stems in part from investment strategy. Most U.S. ETF assets under management, some 98%, are within strategies that seek to track the performance of indexes such as the S&P 500 or MSCI ACWI. The most popular market cap-weighted indexes change holdings infrequently and therefore generally have lower portfolio turnover than alpha-seeking managed strategies that opportunistically buy and sell holdings in pursuit of market-beating performance.

Low index turnover generally means fewer sales of appreciated stocks for index funds relative to alpha-seeking strategies. In 2019, the turnover ratio for alpha-seeking managers in the Morningstar U.S. Large-Cap Blend category was 83%.[6] By contrast, the iShares Core S&P 500 ETF (IVV) had 5% turnover.

Structural differences matter, too, and help explain why index ETFs have historically distributed fewer capital gains than index mutual funds. As mutual fund managers satisfy redemption requests from investors by selling securities to raise cash, the realized capital gains are passed on to remaining fund investors as distributions.

**Figure 5: ETFs contributed less than 1% of 2019's total capital gains distributions**



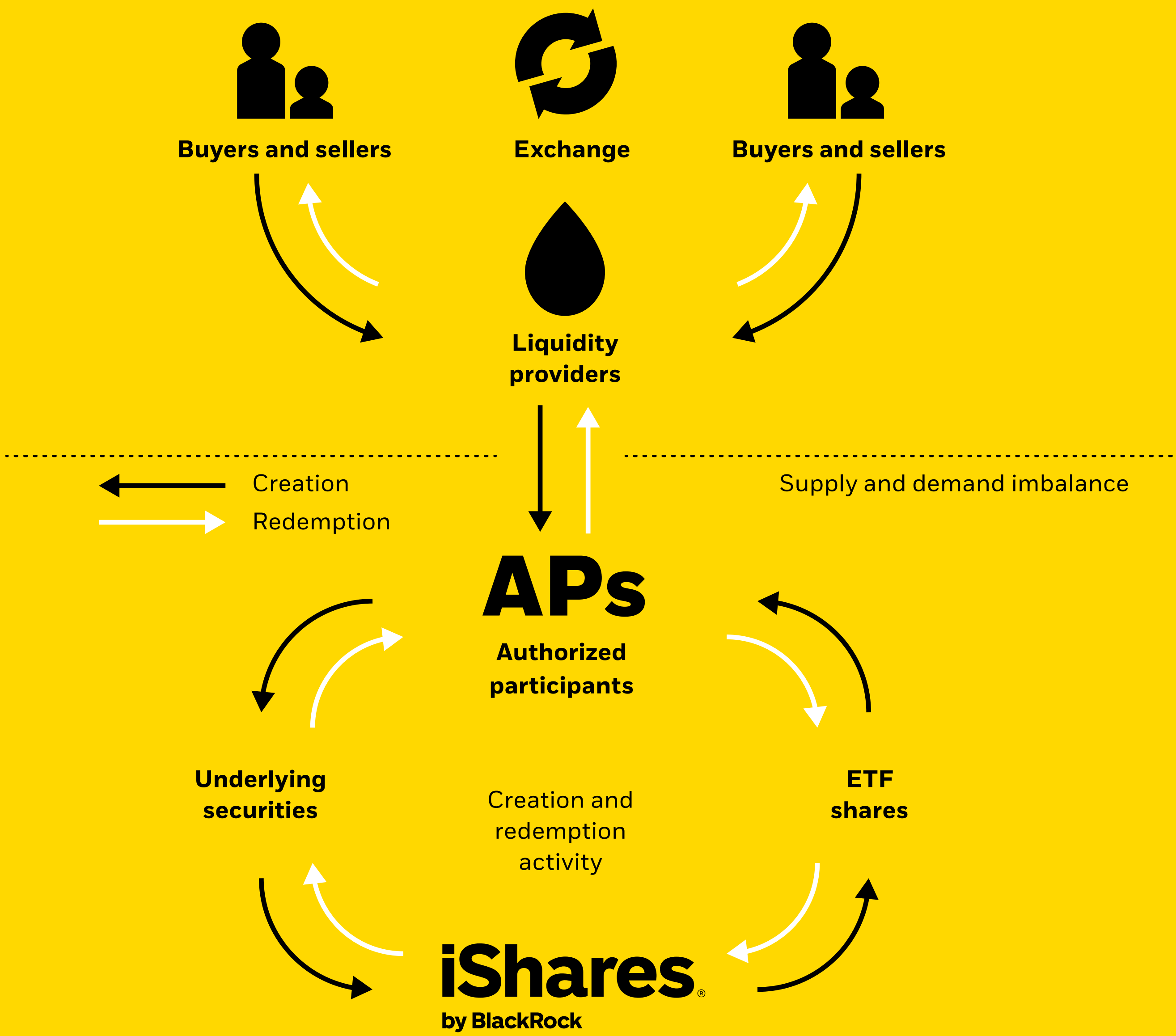

Source: Morningstar 2019. Past distributions not indicative of future distributions

**5** BlackRock analysis of Morningstar data (as of Dec. 31, 2019).
**6** BlackRock analysis of Morningstar data (as of Dec. 31, 2019).

Unlike with mutual funds, ETF investors don't interact directly with fund providers when buying or selling fund shares. Relatedly, ETFs generally don't sell securities to raise cash to meet redemptions. Rather, ETFs employ an "in-kind" mechanism that allows them to meet redemptions without selling securities and realizing gains. The process works when large institutions (authorized participants, or APs) engage with ETF issuers in the "primary market" to redeem (or create) ETF shares based on market demand (Figure 6).

An in-kind ETF redemption might take place when more investors are selling ETF shares than buying in the "secondary market." If there are too many ETF shares outstanding, an AP may buy ETF shares and transfer them to the ETF issuer. Once ETF shares are delivered, the ETF issuer gives the AP a basket of underlying securities. Critically, these in-kind transfers between APs and ETF issuers are not taxable events for fund owners.

**Figure 6: The ETF creation/redemption process**

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## Redemptions to the rescue: Two-way ETF flows help improve tax efficiency

It may seem counterintuitive, but redemption activity can reduce the likelihood that an ETF will distribute gains. So-called two-way creation and redemption activity in an ETF can help minimize the number of stocks with significant unrealized gains.

Consider a mutual fund that bought 100 shares of Stock A on two separate dates for $100 and $150. Subsequently, the fund chooses to sell 100 shares at $180. If the fund manager intends to minimize realized capital gains, they would sell 100 shares with a cost-basis of $150. However, the action leaves a larger unrealized gain for that stock within the fund.

When faced with a redemption, an ETF can do the opposite of a mutual fund. Suppose an ETF received 100 shares of stock on two different dates at $100 and $150. The stock is now at $180. If faced with a redemption, the ETF can in-kind the shares purchased at $100 to an AP. The exchange will lower the unrealized gains for that stock within the ETF (Figure 7). The result: the remaining portfolio would recognize a smaller gain should the fund have to liquidate the position (for example, through an index rebalance).

**Figure 7: Under the hood with mutual fund and ETF redemptions**

### Mutual fund example

**XYZ purchase history**
**Buy 100 shares at $100**
**Buy 100 shares at $150**

↓

**Sells 100 shares at $180, selects $150 tax lot.**

**Result:**
**Realized gains = $30**
**Unrealized gains = $80**

### ETF example

**XYZ purchase history**
**Received 100 shares at $100**
**Received 100 shares at $150**

↓

**Redeem in-kind 100 shares at $180, selects $100 tax lot.**

**Result:**
**Realized gains = $0**
**Unrealized gains = $30**

Example is for illustrative purposes only and not indicative of any future results or experience.


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# 3 STRATEGIES TO HELP ADVISORS REDUCE THE IMPACT OF TAXES

## Tax-loss harvesting

Many tax-conscious investors seek to systematically mitigate gains and/or regular income by tax-loss harvesting.

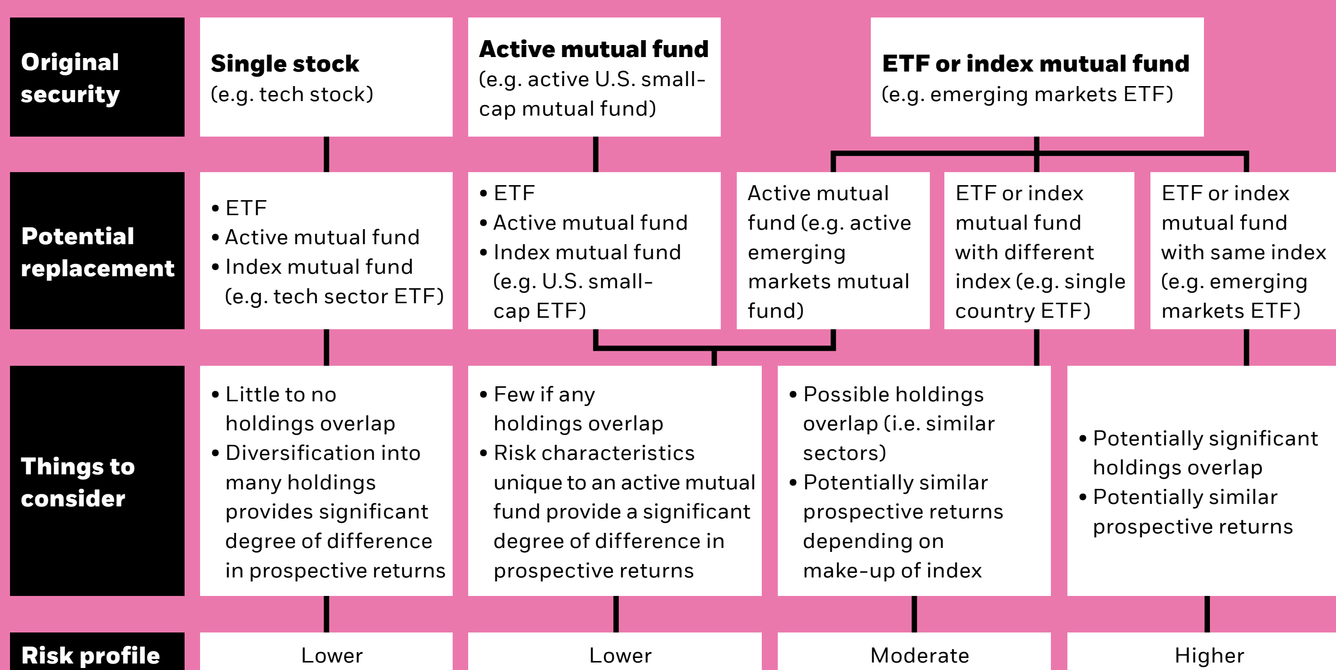
Tax-loss harvesting is the act of selling investments that are down to realize a loss. Some investors may use sales proceeds to purchase a comparable investment, and in doing so, can maintain a similar asset allocation.

Harvested losses can be used, dollar for dollar, to offset capital gains, thereby eliminating potential tax liabilities. In addition, investors can offset up to $3,000 per year of regular income with realized losses. If an investor recognizes more losses than gains, or has already offset the $3,000 income cap, current rules allow for losses to be carried forward indefinitely.

Rules preclude investors from recognizing losses and then quickly buying back their original investment. Such "wash sale" restrictions mandate that an investor cannot realize a loss on the sale of an investment and then buy a "substantially identical" security. Wash sale rules are in effect beginning 30 days before and ending 30 days after a security sale.

The Internal Revenue Service has not defined what constitutes "substantially identical" securities, leaving it up to investors to interpret the rule. Tax practitioners generally agree that investors should consider the degree to which holdings may overlap and the degree of difference in prospective returns (Figure 8).

**Figure 8: Tax-loss harvesting framework**




BlackRock does not provide tax advice. Consult a tax professional regarding any of the information contained in this document.

## Overlooked opportunities to harvest losses

Sometimes investors can harvest losses even when a fund has a positive total return. Opportunities to harvest a loss on a fund that has appreciated in value can arise when a fund has previously distributed capital gains that investors have already paid taxes on.

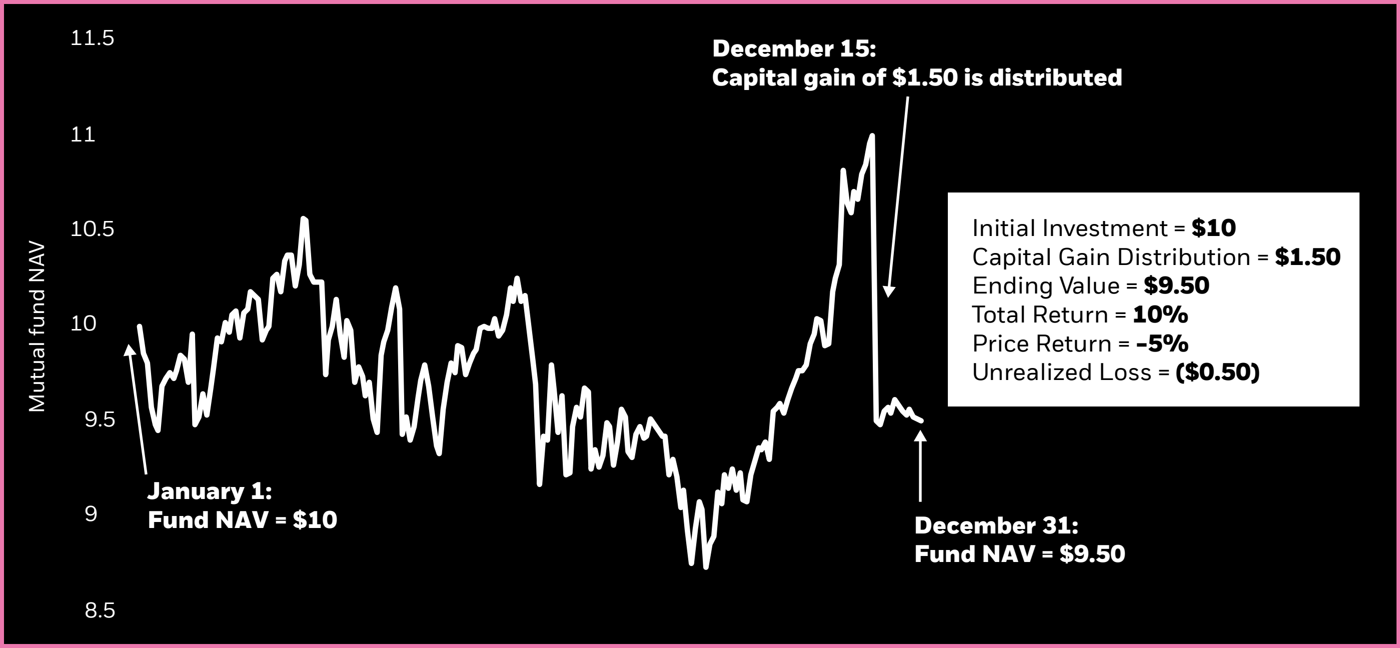
Consider the following hypothetical example of an investor who purchased a mutual fund in January when the price (NAV) was $10. By December, the price rose to $11; however, the fund distributed a capital gain of $1.50 at year-end, which reduces the NAV of the fund on the ex-date. The investor has made $1 on his initial investment, has not yet sold the fund, but will have to pay capital gain tax on the $1.50 distribution. Since the fund's NAV after distribution is $9.50, the investor could realize a loss of $0.50.

It's sometimes difficult to parse out a fund's negative price return (and potential harvesting opportunities) because mutual fund investors often have accounts configured to automatically reinvest distributions, and the account's value often reflects the fund's total return. Fully 78% of alpha-seeking U.S. equity mutual funds had a positive three-year total return (through June 2020), but 60% had a negative price return. On average, that negative price return was -20%.[7]

## Seasonal approach to sidestepping unwanted capital gain distributions

Although tax efficiency should be a year-round consideration, tax management can prove especially useful in the fourth quarter of each year when many open-end mutual funds and ETFs announce estimates for capital gain distributions. These estimates give an investor a window of opportunity, and to the extent that they do not wish to receive the distribution, they can sell out of the fund in advance, being mindful that doing so might have its own tax implications. The proceeds could then be used to purchase a fund providing similar exposure. By doing so, the investor can continue to pursue their strategic asset allocation and will not have received the distribution from the fund.

**Hypothetical yearly performance of a mutual fund**




For illustrative purposes only.

**7** Source: BlackRock analysis of Morningstar Data (as of 6/30/2020).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# LONG-TERM STRATEGIES TO REDUCE THE BITE OF TAXES

Account type, asset class and investment vehicle can have implications for taxable fund investors. For advisors, consideration of tax implications can help clients achieve their financial goals and expand their value proposition. Tax strategies matter for client outcomes because after-tax returns of asset allocations can differ from pre-tax returns. In other words, an asset allocation built using a certain set of funds may work well for a client in a qualified account but deliver a vastly different outcome in a taxable one.

## Consider asset class

Asset class selection is the first step when building portfolios — do I want to own stocks or bonds, U.S. or international? Different asset classes have different tax profiles. For example, most income-generating asset classes will be subject to income taxes for taxable investors.

Not all equity income is created equal, however. The more favorable type of equity income is Qualified Dividend Income (QDI). QDI is taxed at an investor's long-term capital gains rate (highest marginal = 20%), where non-qualified income is taxed at the income tax rate (highest marginal = 37%). Whether a dividend is qualified or not depends on a few considerations:

- **Is the security type eligible for QDI treatment?**
- **Has the investor met the holding requirements for QDI eligibility?**
- **Has the fund making the distribution met the same holding requirement for the underlying position?**

For example, income distributed from most real estate investment trusts (REITs), regardless of holding period, will be taxed as ordinary income. Equity dividends, however, are QDI-eligible. The difference matters at the asset-selection level because a stock with a lower yield than a REIT may provide a better after-tax experience.

In a similar vein, different bonds have different potential tax implications. Municipal bonds are particularly in focus for tax-conscious investors. Interest income on most municipal bonds is generally exempt from federal and often state and local income taxes (where eligible). Investment grade munis, however, will typically yield less than a similar rated corporate bond. Rather than simply evaluate yield on a pre-tax basis, an investor should consider the tax-equivalent yield of the municipal bond before deciding what security will generate more after-tax income.

## Consider investment vehicle in tandem with asset class

A key consideration for advisors making strategic asset allocation decisions: Ought the advisor select a mutual fund, separately managed account or an ETF? The possibility for taxable distributions implications should help determine the vehicle of choice. For example, small-cap growth stocks historically have not paid out much in dividends, so an investor might consider the segment to carry a low potential to generate tax liabilities. But they may fail to consider that higher turnover strategies, in even tax-efficient asset classes, may lead to taxable capital gain distributions. Indeed, the average capital gain distribution from alpha-seeking Small Cap Growth Managers in 2019 was over 5%.[8]

The takeaway: When an investor considers a higher-turnover strategy in a tax-efficient asset class, they should consider whether the vehicle can preserve the efficiencies.

**8** Source: BlackRock analysis of Morningstar Data (as of 12/31/2019). Capital Gain Distribution as percentage of NAV for Active Small Growth funds in 2019 was 5.23%.

## Consider account type

Some popular account types will insulate investors from the year-over-year impact of taxation, such as a 401(k) or an IRA. Most investors should aim to maximize contributions and placements within qualified accounts, but given limitations on contributions, some higher-earning investors may wind up with significant portions of invested assets in non-qualified or taxable accounts.

**Qualified account/
Less tax efficient asset classes**

- High Yield Bonds (HYG – **2.34%**)
- Preferreds (PFF – **1.77%**)
- REITs (IYR – **1.46%**)
- IG Corporate Bonds (LQD – **1.45%**)
- Broad IG Bonds (AGG – **1.06%**)
- Dividend Stocks (DVY – **0.81%**)
- Large Cap US Stocks (IVV – **0.48%**)
- Municipal Bonds (MUB – **0.00%**)

**Taxable account/
More tax efficient asset classes**

Annualized 10-year tax cost in parentheses.

Source: Morningstar as of 8/31/2020. The Morningstar Tax Cost Ratio measures how much a fund's annualized return is reduced by the taxes investors pay on distributions.

# CONCLUSION

Help your clients keep more of what they earn. Putting cost- and tax-efficient iShares ETFs at the core of portfolios can help improve long-term investment returns and help advisors demonstrate value to their clients.

Financial advisors and tax advisors have historically played distinct roles. Increasingly however, clients are demanding more integrated services. They are also looking for a more holistic approach to financial services and are increasingly sensitive about how much they pay. Advisors who include tax efficiency into their due diligence can help align practices with client objectives. Re-upping the focus on client goals can help offset falling fees in both the wealth management and asset management industries.

BlackRock believes tax implications should feature more prominently into portfolio construction and fund due diligence — and we have tools that can help.

## BlackRock tax evaluator

BlackRock can help advisors meet the tax-efficiency challenge. Our tax evaluator can help monitor portfolios to help create a better after-tax experience for clients.

- Users can easily monitor fund capital gain distribution estimates to help better understand the impact of taxes.
- For investors looking to avoid capital gains from a specific fund in the current year, the tool will suggest a low-cost ETF with similar exposure, helping users stay invested while sidestepping an unwanted distribution.
- Find opportunities to harvest losses by examining price return of mutual funds and ETFs.

# AUTHORS

**Sean Murphy, CFA**
iShares product consultant for BlackRock's U.S. Wealth Advisory Business

**Daniel Prince, CFA**
Head of iShares product consulting for BlackRock's U.S. Wealth Advisory Business

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Transactions in shares of ETFs will result in brokerage commissions and will generate tax consequences. All regulated investment companies are obliged to distribute portfolio gains to shareholders. Certain traditional mutual funds can also be tax efficient. Diversification and asset allocation may not protect against market risk or loss of principal.

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