

Tax-Managed SMAs: Better Than ETFs?

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Exchange-traded funds (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. A tax-managed separately managed account (SMA) may deliver the same diversified, index-like exposure while offering increased after-tax returns for these investors. Parametric research has shown that this return advantage can be as large as 2% annualized on an after-tax, after-fee basis over a 10-year period. This paper offers a description of how ETFs and tax-managed SMAs work, and it demonstrates the advantages of using tax-managed SMAs for tax efficiency and customization. For many high-net-worth investors, these benefits can be substantial—and they reinforce why advisors should consider tax-managed SMAs when selecting a passive market exposure.

Key takeaways

- » A tax-managed SMA can provide many of the same opportunities as ETFs, such as index-based market exposure. But since not all indexes are available as ETFs, an even broader selection of indexes is available for SMAs.
- » SMAs can target customized and/or exclusionary blended benchmarks, and these customizations can be changed as the investor's priorities change.
- » Tax-managed SMAs have the added ability to harvest losses that can be used to offset capital gains, which can reduce an investor's overall tax bill.
- » SMAs can be a vehicle for tax-efficient charitable gifting while potentially reducing current and future tax liability.

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 has nearly \$360 billion in assets under management today. SPY's success paved the way for a multitude of funds to develop for other market segments, such as US small cap, developed international, and emerging markets.

The most popular ETFs track well-known capitalization-weighted indexes published by S&P[®], MSCI, and FTSE Russell. Newer ETFs move beyond these indexes to include strategies such as fundamentally weighted, equal-weighted, and low-volatility indexes. ETFs produce this exposure by replicating the stated index, which means purchasing all securities according to their index weight.

However, the primary use of ETFs continues to be passive exposure to cap-weighted indexes. These funds are naturally tax efficient due to the low turnover associated with broadly diversified indexes and the ability of ETFs to deliver low-basis securities for rebalances and withdrawals. This happens as part of the unique creation and redemption mechanism for ETFs. However, while ETFs may be appropriate for some investors, high-net-worth investors facing high tax rates and holding more complex investment portfolios may be better served through customized tax-managed SMAs.

How tax-managed SMAs work

Like an ETF, a tax-managed SMA can provide investors with index-based market exposure. ETFs include a large range of cap-weighted indexes such as the S&P 500[®], Russell 3000[®], and MSCI EAFE, as well as alternatively weighted indexes such as the Research Affiliates Fundamental Index[™]. However, since not all indexes are available in ETF format (for example, the Russell Defensive Equity indexes), an even broader selection of indexes is available for SMAs. Additionally, SMAs can target blended benchmarks, and these blends can be changed dynamically over time as the investor's view changes.

Unlike ETFs—which are constrained to hold constituents at the index's prevailing weight—SMAs can have flexible holdings while still expressing a low tracking error to the underlying benchmark. This flexibility can result in added tax efficiencies because tax-managed SMAs 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, which can reduce an investor's overall tax bill. This is a prime benefit of the tax-managed SMA, since it passes capital losses to the individual investor—something an ETF can't do.

Consider a tax-managed portfolio benchmarked to the S&P 500[®], for example. The portfolio is initially invested in about 300 to 400 securities selected to mimic the benchmark in terms of sector and industry weights, with low tracking error. The optimization also ensures the portfolio resembles the benchmark in terms of risk factors such as yield, beta, and market capitalization.

After the initial portfolio is invested, portfolio managers monitor for risk and tax-loss harvesting opportunities. In a portfolio of 300 to 400 securities, some equity prices will rise while others fall. Securities with prices below their cost basis present opportunities to harvest losses. When such opportunities arise, the portfolio gets loss harvested. The tax lots exhibiting losses are sold and replaced with newly purchased securities in a manner that's mindful not to violate wash-sale rules. The intended result is a portfolio designed to closely track the benchmark on a pretax 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 generate from the investor's active-manager investments, the sale of real estate, or the sale of concentrated stock positions. The goal is for the portfolio to track its target benchmark 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.

The primary goal of the portfolio is, of course, to capture the benchmark return, not to generate losses. But systematic loss harvesting takes advantage of the loss opportunities as they appear throughout the year. Figure 1 shows the percentage of winners and losers in the S&P 500[®] over the past 33 years. Notice that there are stocks that end with a negative return each year. Additionally, an SMA can capitalize on a lot of security movement that occurs throughout the year. Despite the limited number of securities that finished 2019 at a loss, for example, 23% of constituents had at least a 10% drawdown at some point during the year. By contrast, a slightly negative calendar year for returns resulted in 70% of constituents having a 10% drawdown during 2018.

The tax efficiency of tax-managed SMAs versus ETFs

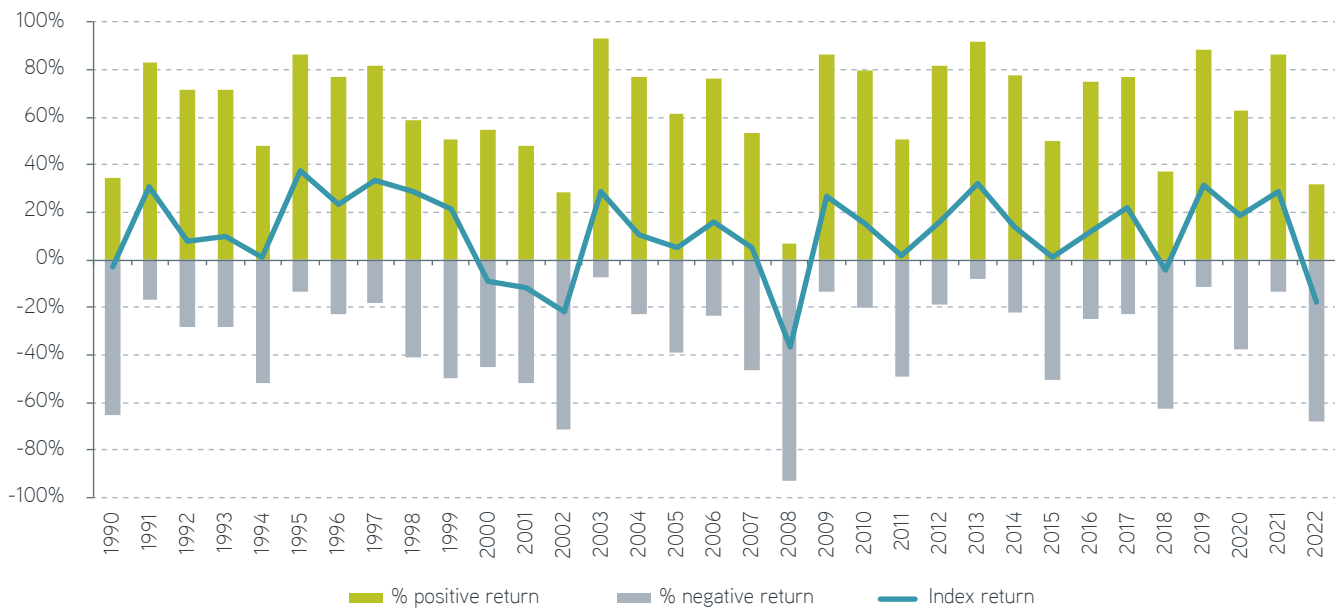
Passive ETFs are known for their tax efficiency due to low turnover and the delivery of low-basis stocks for large redemptions. However, this efficiency is limited to incurring very low taxes for ETF investors. Tax-managed SMAs go further, aiming to generate net capital losses through a combination of gain deferral and tax-loss harvesting. How large is this benefit? To analyze the economic advantages of using a tax-managed SMA, we backtested the comparison of a tax-managed portfolio and a buy-and-hold ETF portfolio.

In the analysis we assume that \$1 million is invested in a tax-managed SMA. We ran three separate backtests for differing time horizons ending on December 31, 2022, to examine the results in varying market environments. Throughout the backtests, the tax-managed portfolio was harvested for losses and the annual tax benefit was assumed to grow at the same rate as the portfolio. At the end of the period, we liquidated the portfolio and subtracted the associated tax costs. For the ETF portfolio we assumed an initial \$1 million investment in SPY (S&P 500® ETF). Dividends were reinvested net of taxes into the ETF, and

the portfolio was liquidated at the end of the period. We assumed a management fee of 35 basis points (bps) for the SMAs. The SPY ETF currently has an expense ratio of 0.09%, but typical expense ratios for US large-cap and developed international equity range from 0.03% to 0.34%. The results of the backtest are shown below.

As shown in figure 2, the ultimate liquidation tax cost of a tax-managed SMA is higher than that of the ETF portfolio. 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 a 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 tax benefit's growth rate and the deferral's length of time. We describe loss harvesting in a passive portfolio as a form of tax deferral because some investors will eventually pay the tax on liquidation of the portfolio. For these reasons it's important to consider the value of tax deferral balanced against the cost of liquidation. Nonetheless, the backtest results show that the tax-managed SMA realized a higher postliquidation annualized growth rate than the ETF portfolio, net of fees.

FIGURE 1: WINNERS AND LOSERS IN THE S&P 500®, 1990–2022



Sources: Parametric, FactSet, 2/28/2023. For illustrative purposes only. It is not possible to invest directly in an index.

Fifteen-year backtests had the strongest relative results from tax management. The results were bolstered by multiple rich periods for tax-loss harvesting, like the global financial crisis at inception and COVID-19, indicating a net-of-fees annualized benefit of 1.8% to 2.1%, depending on whether the assets are liquidated. Similarly, the five-year backtest's inception was in a year with modest volatility and negative return, allowing it to capture a very respectable relative after-tax value-add. Conversely, the 10-year window is most interesting because it began in the midst of a historic bull-market run with very low market volatility and appreciating more than 160% prior to experiencing the volatility of the 2020 COVID-19 pandemic. In spite of the period, the tax-managed SMA still delivered 60 bps of annualized excess net-of-fees performance.

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

Additional benefits of tax-managed SMAs

In addition to passing through losses, SMAs offer a number of 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, the investor can more smoothly transition the holdings in existing accounts to the new investment mandate with a tax-managed SMA. 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.

FIGURE 2: COMPARING A TAX-MANAGED SMA TO AN ETF PORTFOLIO (SPY) OVER 5, 10, AND 15 YEARS, ENDING 12/31/2022 (NET OF FEES) (BACKTESTED)

	5 years		10 years		15 years	
	SMA (Net of fees)	SPY	SMA (Net of fees)	SPY	SMA (Net of fees)	SPY
Starting market value	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Ending market value	\$1,533,665	\$1,527,221	\$3,175,414	\$3,091,480	\$3,439,652	\$3,266,675
Cost basis	\$879,135	\$1,082,723	\$1,235,763	\$1,281,057	\$1,097,005	\$1,365,380
Added value of loss harvesting	\$116,552	\$0	\$104,955	\$0	\$928,729	\$0
Liquidation taxes (portfolio and value add of loss harvesting)	\$162,419	\$105,791	\$469,568	\$430,881	\$733,424	\$452,508
Total value (preliquidation)	\$1,650,217	\$1,527,221	\$3,280,369	\$3,091,480	\$4,368,381	\$3,266,675
Total value (postliquidation)	\$1,487,797	\$1,421,431	\$2,810,801	\$2,660,599	\$3,634,957	\$2,814,167
Annualized return (preliquidation)	10.5%	8.8%	12.6%	11.9%	10.3%	8.2%
Annualized return (postliquidation)	8.3%	7.3%	10.9%	10.3%	9.0%	7.1%
Annualized SMA benefit over ETF						
Preliquidation	1.7%	-	0.67%	-	2.1%	-
Postliquidation	1.0%	-	0.61%	-	1.8%	-

Source: Parametric, 12/31/2022. Hypothetical performance is for illustrative purposes only, does not represent actual returns of any investor, and may not be relied on for investment decisions. Returns reflect the deduction of advisory fees (0.35%) and transaction costs (0.10%). Hypothetical returns reflect the reinvestment of dividends and other earnings. Past performance is not indicative of future results. All investments are subject to the risk of loss. Actual client returns will vary. All investments are subject to loss. Refer to the disclosures for important information. Assumes highest marginal federal tax rates. For short-term gains, the highest US federal marginal income tax rate is 37% plus the 3.8% net investment income tax, for a combined rate of 40.8%. 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%. All SMA figures reflect the deduction of a 0.35% management fee and 0.10% trading costs. SMA figures reflect hypothetical backtests over the time period indicated. Backtests are conducted with historical S&P 500 constituents and optimizing a hypothetical portfolio on a monthly basis using an optimizer and settings similar to that used by PPA PMs. State Street's SPDR S&P 500® Fund (SPY).

Asset-class rebalancing

The access to individual positions and tax lots 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 lots to sell that will help minimize the tax impact of the changes. An ETF investor may also choose specific tax lots, but at the ETF level only and not at the individual company level. Access to individual securities and tax lots in 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. Investors have a greater amount of control for a completely personalized experience.

Control over the underlying exposure

The underlying index exposure of an ETF is typically decided by an ETF sponsor. If an investor disagrees with changes in the underlying exposure, they may face a large tax hit for selling out of highly appreciated ETF shares. In the past few years, for example, popular ETF and index providers have added China A-shares to their emerging markets products—a decision unpopular among some investors. Investors are then forced into a dilemma in which they must choose between liquidating the whole fund and incurring taxable gains or holding an exposure they don't condone. With a tax-managed SMA, that exposure decision lies entirely with the owner of the account. Such dramatic shifts in exposure require 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. Alternatively, the investor can design a custom tax-managed SMA 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. The tax-managed SMA can also use harvested losses to offset the gains that accompany the sale of concentrated stock positions.

Responsible investing

Tax-managed SMAs allow investors to customize their passive exposure to align their investments with their ESG principles and exclude securities issued by companies whose business practices conflict with those principles. For example, certain Catholic investors may choose to exclude companies involved in adult entertainment or that support abortion providers. Other investors may choose to divest from companies involved in fossil fuels. Tax-managed SMAs let investors design their exposure to exclude selected companies while relying on SMA managers to optimize their portfolios to capture the benchmark return as closely as possible.

Conclusion

Although ETFs and tax-managed SMAs provide transparent passive equity exposure, the structure of separate accounts offers certain advantages over ETFs from both tax-efficiency and flexibility perspectives. Loss harvesting in an SMA potentially increases annualized after-tax returns by up to 2% over a 10-year period. 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 through screens and optimization. While smaller accounts are served well by a simple ETF solution, investors with larger accounts should consider the additional benefits of a tax-managed SMA.

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