Tax-Smart ETF Strategies

Every advisor has clients who are very concerned with taxes and become especially anxious when rates increase or are rumored to do so. "Now that the American Taxpayer Relief Act has increased the top long-term capital gains tax rate to 20% and the new Medicare tax adds another 3.8% on net investment income, some clients are looking at an 8.8% increase in capital gains rates, from 15% to 23.8%," says Glenn Frank, CFP®, CPA/ PFS, Director of Investment Tax Strategy at Lexington Wealth Management in Lexington, Massachusetts.[1] "Accordingly, clients who focus on taxes have become even more interested in how you can create a tax efficient portfolio and what you can do to lower their tax burden."

This gives tax-aware advisors a chance to add value with ETFs. The unique way ETFs are created and redeemed results in the infrequent distribution of capital gains which gives ETFs an edge over mutual funds in terms of tax efficiency. Additionally, the broad range of ETFs available opens up interesting possibilities for re-allocating client portfolios to create more potential opportunities to harvest losses that help offset taxable gains.

HOW TO BOOST AFTER-TAX RETURNS WITH ETFS

Consider this: If one ETF is tax efficient, it should follow that using multiple ETFs can further enhance tax efficiency. In fact, Frank suggests that advisors looking to boost after-tax returns might consider dividing a portfolio's core large cap asset allocation, traditionally invested in a broad US index fund such as SPY, among the nine sectors.[2] This could be implemented using the nine Select Sector SPDR® ETFs.

Of course, you may wonder just how much more tax efficient you can get than SPY, which has distributed an average capital gain of 0.00% since 2006 (versus 1.00% for the average S&P 500® Index mutual fund) with an expense ratio of just 0.0945%.

However, Frank points out that dividing the domestic core allocation among the nine Select Sector SPDR ETFs increases opportunities to harvest portfolio losses, giving you more control over clients' tax situations.

"Tax-aware advisors, not mutual fund managers, should control clients' tax destiny," he says. "As the economy continues to recover, portfolio gains will gradually erase the capital loss carryovers that likely offset taxable gains for many clients in the years since the market downturn. Therefore, booking losses to offset current portfolio gains becomes increasingly important, especially for clients facing an increase in their capital gains tax rate."

Frank points out, too, that in the years following the 2008 market downturn, just as capital loss carryovers offset portfolio gains for your clients, many mutual funds were able to keep their capital gains distributions relatively low by using their own losses from previous years to offset the current year's gains.

"As these capital loss carryovers are exhausted, funds will have to distribute their gains when they sell profitable positions," he says. "These distributions are taxable to shareholders regardless of how long they have held the fund and can result in capital gains. However, because ETFs trade as baskets of securities, managers don't often have to sell individual securities to meet shareholder redemptions. Therefore, investors' redemptions don't create capital gains to be shared by all investors in the ETF, making them a more tax-efficient choice than mutual funds."

CREATE MORE OPPORTUNITIES TO HARVEST LOSSES

Since investing in multiple sectors using ETFs can help reduce taxes by increasing opportunities to harvest losses, it's worth exploring the strategy to re-construct SPY by buying all nine of the Select Sector SPDR ETFs:

- Financial Select Sector SPDR Fund (XLF)
- Industrial Select Sector SPDR Fund (XLI)
- Technology Select Sector SPDR Fund (XLK)
- Materials Select Sector SPDR Fund (XLB)
- Energy Select Sector SPDR Fund (XLE)
- Health Care Select Sector SPDR Fund (XLV)
- Utilities Select Sector SPDR Fund (XLU)
- Consumer Staples Select Sector SPDR Fund (XLP)
- Consumer Discretionary Select Sector SPDR Fund (XLY)

Figure 1: S&P 500 SECTOR PERFORMANCE

INDEX	ASSET CLASS	YTD RETURN	ETF SWAP	TICKER
S&P 500 Financials	US Financials	-25.16%	Financial Select Sector SPDR	XLF
S&P 500 Materials	US Materials	-21.79%	Materials Select Sector SPDR	XLB
S&P 500 Industrials	US Industrials	-14.68%	Industrial Select Sector SPDR	XLI
S&P 500 Energy	US Energy	-11.40%	Energy Select Sector SPDR	XLE
S&P 500 Information Technology	US Information Technology	-5.81%	Technology Select Sector SPDR	XLK

Source: Zephyr StyleADVISOR, SSgA, as of 9/30/2011

Frank explains, "Rather than evaluate whether there are losses in one fund like SPY, there are nine funds that collectively serve as a substitute for SPY to consider. It's likely that there will be losses in a few of the nine sectors that we can harvest to offset gains elsewhere in the portfolio and/or reduce taxes."

Frank says that tax loss harvesting, or the reduction of realized gains by proactively taking losses, is a true source of added value for clients, especially those with the highest capital gains rates or in situations where capital loss carryovers have been exhausted.

Of course, high levels of volatility tend to produce more situations to harvest losses. For example, at the end of September 2011, five of the nine S&P 500 sectors had losses:

If you owned all nine SPDR select sector funds in September of 2011, you could have sold these five funds to reduce other 2011 gains, carrying over any remaining losses to 2012. That would have been especially beneficial as, by the end of 2012, all nine sectors had entered positive territory.

Frank stresses that harvesting losses should occur throughout the year, not only at year-end. "If advisors wait until year-end to harvest portfolio losses, investments that were down in the early spring could bounce back into positive territory," he says.

For example, for the first month of 2013, the S&P 500 Index rose more than 5.31%, in spite of Apple, the S&P's highest-weighted member, which was the index's worst-performer at -14.3%. However, if you held the Technology Select Sector SPDR Fund (XLK) where Apple is weighted more than 14%, you likely could take advantage of a first quarter loss.

Frank says the inspiration for this strategy comes from strategies available in the market that utilize a separately-managed account structure to help manage taxes. Rather than hold every index constituent in the same weight as the S&P 500 Index, these types of strategies utilize a tax-aware optimizer to construct a portfolio benchmarked to the S&P 500 Index. As an optimized portfolio, the account holds 325 to 375 names and is monitored regularly for opportunities to harvest losses that could then be used to offset realized gains.

With the proliferation of ETFs, advisors don't need to use a more expensive, separately-managed account (SMA) strategy to pursue these goals since they can largely replicate such a strategy with ETFs," he says. "Constructing these portfolios with ETFs rather than in an SMA with individual securities can be a better option because it **may** increase diversification to temper overall portfolio risk and **lofty minimums need not be met. There's also much less complexity than with hundreds of individual stocks. Note, however, that the opportunity for loss harvesting will be greater with 300+ positions versus nine."**

As another plus, simulating the S&P with the same relative weights doesn't take a lot of time to implement. "It's a mechanical process," says Frank. "You simply allocate the funds and remain watchful for drops in value. There are plenty of competing ETFs and mutual funds, so when a sector slides you could sell your Select Sector SPDR fund to record the loss. You could then replace it with a similar fund, a tax swap that you hold for a full 30 days per the Wash-Sale Rule, before returning to your original SPDR sector fund."

The Wash-Sale Rule is an Internal Revenue Service (IRS) regulation prohibiting a taxpayer from claiming a loss on the sale of an investment when the same or a substantially identical investment was purchased within 30 days before or after the sale date.[3]

Again, Frank stresses that harvesting losses can't wait until the end of the tax year. "Monitoring these accounts on an ongoing basis ensures you take advantage of periodic market dips," he says. "You know to look when the market takes a hit."

Frank adds that deciding whether to split an allocation to SPY among sector funds also depends on balancing the extra fund expenses and trading costs with the benefits you can reasonably expect to gain by managing the sectors throughout the year. "The strategy could cost 10 to 15 basis points more than investing in one ETF," he concludes. "The assumption here is that you gain more than that through the tax savings of an active tax loss harvesting program."

EXPAND YOUR TAX-AWARE PORTFOLIO RE-CONSTRUCTION

Given the increasing range and product depth of ETFs, Dave Mazza, Head of ETF Investment Strategy for SSgA, notes that the approach of dividing a large-cap domestic core allocation among multiple ETFs to construct a more diversified portfolio that offers more opportunities for harvesting losses could be employed for international or emerging markets allocations as well.

For example, you can enhance the diversification of your international developed allocation by dividing your exposure among 10 SPDR international sector ETFs such as the SPDR S&P® International Financial Sector (IPF) and the SPDR S&P International Health Care Sector (IRY). (For the full listing of SPDR international sector ETFs available, visit spdrs.com.)

Similarly, you could diversify your emerging markets allocation by dividing your allocation among our regional emerging market ETFs, including the SPDR S&P Emerging Asia Pacific ETF (GMF), SPDR S&P Emerging Latin America ETF (GML), SPDR S&P Emerging Europe ETF (GUR), and the SPDR S&P Emerging Middle East & Africa ETF (GAF).

TACTICALLY MANAGE TAX-EFFICIENT ETF PORTFOLIOS

In addition to increasing opportunities for tax loss harvesting, reconstructing specific portfolio allocations with multiple ETFs gives you the ability to express your views on the market. In fact, Mazza finds advisors are increasingly interested in implementing tactical investing strategies to increase a portfolio's after-tax returns.

Therefore, he suggests that once you divide a core ETF allocation among various sectors, employing strategic or tactical overlays can provide more potential value.

"You can reduce risk and add to after-tax returns by customizing the core comprised of sector ETFs based on your market outlook," he explains. "Here, you'd seek to add alpha either by weighting (under or overweighting) various sectors, or omitting sectors all together. What's interesting about sectors is that they can behave extremely differently depending on the economic environment. For example, the difference between the best performing sector (financials) and the worst (utilities) is 29% over the trailing one-year as of June 30, 2013."[4]

If your evaluations are valuation-driven, the goal, of course, is to buy low and sell high. "To determine what sectors are most attractively priced and which are the least attractive, you'll want to review metrics, such as the relative P/Es, forward and trailing, of the US sectors relative to their historic averages," says Mazza. "However, everyone has their own favorite valuation metric, so what's interesting is looking not just at relative valuations, but historical as well."

Further, if your valuation analysis identifies a sub-sector where you see opportunity, Mazza says ETFs offer the precision that's necessary to implement an overweight to more precise exposures and hard to reach markets.

"The broad range of ETFs means you can always refine your investments and get a little more focused," he says. "For instance in the financial sector, instead of a broad domestic fund like the Financial Select Sector SPDR Fund (XLF) you might focus on the international market with SPDR S&P International Financial Sector ETF (IPF) or a more targeted part of the domestic financials market with the SPDR S&P Regional Banking ETF (KRE)."

This tactical strategy also affords you the ability to customize sector holdings based on clients' risk tolerance as well, to avoid sectors or industries to which they may be over-exposed as a result of their employment or legacy stock holdings. "An advisor could avoid exposure to a certain company that may be included in a sector ETF, but not an industry ETF that may have a high correlation over the long-run," notes Mazza.

A WORD OF CAUTION

Of course, if you implement tactical strategies, you need to be mindful of creating short-term capital gains (federal and state) that are taxed at ordinary income rates—rates that for most investors are higher than the new maximum 20% on long-term gains.

For every $100 in net short-term gains realized, taxable investors in the 35% tax bracket add $35 to their tax liability, more if the Medicare surcharge of 3.8% applies. Likewise, for every $100 in net short-term losses realized, taxable investors in the same tax bracket reduce their tax liability by $35," Frank notes.

QUANTIFYING THE BENEFITS OF A TAX-AWARE APPROACH

How much can tax-aware investing save your clients in taxes? It depends on how much the market moves and to what degree portfolio losses can offset gains. "You see studies quantifying the benefits of an active tax loss harvesting program, or of proper asset location where investments are placed in taxable or non-taxable accounts based on their taxability," Frank says. "Practicing tax-aware portfolio construction along with these other tax-smart strategies has the potential to dramatically improve after-tax returns, perhaps even saving the equivalent of the client's annual fee."

Frank notes that there's not a lot of time involved in managing the divided tax-aware portfolios which is a plus in terms of practice management. He explains, "Setting up the nine sector funds is mechanical and the sectors you choose to emphasize can be appropriate for all the portfolios you manage in this fashion."

Tax-aware portfolio construction is also a relatively easy concept for clients to understand and can be integrated easily into the annual tax review meeting. Notes Frank, "Clients readily grasp that building and maintaining portfolios of ETFs is a tax-efficient way to add to their after-tax returns at a low cost—and they view your emphasis on tax-aware investing as a definite value add. They appreciate that you're mindful of the increase in capital gains taxes and are being proactive in efforts to increase their after-tax returns."

"Using this approach combines some of the classic individual security techniques with a relatively tax efficient asset, an ETF," concludes Mazza. Therefore, tax-aware portfolio construction can be a win/win. These strategies add to clients' after-tax returns and, by potentially adding alpha in excess of your cost, provide a way for you to distinguish yourself from the competition and grow your practice.

ETF RESOURCES AT STATE STREET GLOBAL ADVISORS

ABOUT SPDR® ETFS & SPDRS.COM

SPDR ETFs are a comprehensive fund family of over 100 international and domestic ETFs. Offered by State Street Global Advisors, SPDR ETFs provide investors with the flexibility to select investments that are precisely aligned to their investment strategy. Recognized as the industry pioneer, State Street created the first ETF in 1993 (SPDR S&P 500®—Ticker SPY). Since then, we've sustained our place as an industry innovator through the introduction of many ground-breaking products, including first-to-market launches with gold, international real estate, international fixed income and sector ETFs.

SPDRS.COM

For rich ETF content, tools and comprehensive information on our ETFs, visit us at spdrs.com. While you're there, don't forget to check out our portfolio tools:

- **PORTFOLIO ANALYZER** - a web-based portfolio analysis and proposal tool for quick portfolio evaluation and assessment.
- **PORTFOLIO CONSTRUCTOR** - a comprehensive web-based portfolio design and proposal tool that enables you to model, analyze and construct portfolios utilizing a variety of investment products and investor profiles.
- **CORRELATION TRACKER** - allows you to run correlations among ETFs, mutual funds, individual stocks and even portfolios using total returns.
- **ETF SCREENER** - a comprehensive search and filter system covering all US listed exchange traded products.

SALES AND MARKETING

For more information about our ETFs or how to invest, please call 866.787.2257.

SPDR ETF SALES STRATEGY GROUP

The SPDR ETF Sales Strategy Group is responsible for the development of world class investment content and client-focused consulting services for the ETF marketplace. Leveraging SSgA's global investment expertise across asset classes, the group works to develop and implement investment themes and product ideas while also providing investment professionals with the insights, tools and overall support services required in the ever-changing global investment landscape. To contact SPDR ETF Sales Strategy, email ETFSalesStrategy@ssga.com.

SPDR CAPITAL MARKETS GROUP

The globally integrated SPDR Capital Markets Group delivers investment management expertise, detailed product analysis, and ETF trade implementation to investors, with the goal of educating clients on the structure and application of SPDR ETFs. Leveraging SSgA's global investment presence, the group provides industry insight, thematic market trends, and world class support to institutional investment management firms and primary and secondary market participants. To contact SPDR Global Capital Markets Group, email ETF_Global_Capital_Markets@ssga.com.

BLOOMBERG PAGE

Enter SPDR to find us on Bloomberg.

SPDR UNIVERSITY (SPDRU.COM)

Brought to you by State Street's family of SPDR ETFs, SPDR University (SPDR U) is an online education source built exclusively for investment professionals to meet the growing demand for quick access to high-quality educational content. With tools and information you can put into practice, SPDR U offers a variety of topics, including: ETF education; portfolio strategies; up-to-date market analysis; actionable investment ideas; and best practices for managing your business. Learn more and go to spdru.com today.

STATE STREET GLOBAL ADVISORS
State Street Financial Center
One Lincoln Street
Boston, MA 02111

866.787.2257

[1] Individuals with taxable incomes above $400,000 or families with taxable incomes above $450,000, saw their tax rate of 35% on ordinary income increase to 39.6% in 2013. Also, their tax rates on capital gains and qualified dividends, previously 15%, jumped to 20%. The Affordable Care Act subjects individuals with incomes above $200,000 or families with income above $250,000 to a 3.8% surtax on net investment income such as interest, dividends, annuity payments, rents, royalties, and capital gains.

[2] The two main classification schemes are the Global Industry Classification Standard (GICS), and the Industry Classification Benchmark (ICB). The GICS was developed by Morgan Stanley Capital International (MSCI) and Standard & Poor's. The GICS hierarchy begins with 10 sectors and is followed by 24 industry groups, 67 industries and 147 sub-industries. The other classification, the ICB, was jointly developed by Dow Jones and FTSE. The ICB hierarchy has 10 industries, 18 super sectors, 39 sectors and 104 subsectors.

[3] http://www.irs.gov/publications/p550/ch04.html#en_US_2012_publink100010601

[4] FactSet, SSgA, as of June 30, 2013.

FOR INVESTMENT PROFESSIONAL USE ONLY. NOT FOR PUBLIC USE.

IMPORTANT RISK INFORMATION

ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETFs' net asset value. Brokerage commissions and ETF expenses will reduce returns.

This material is for informational purposes only and does not constitute investment or tax advice and it should not be relied on as such. It does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. There is no representation or warranty as to the current accuracy of, nor liability for, decisions based on such information.

Circular 230 Disclosure: This communication is not a covered opinion as defined by Circular 230 and is not intended or written to be used, and cannot be used, or relied on, by the taxpayer, for the purpose of avoiding federal tax. This communication was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the written communication; and the taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

The municipal market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a debt security to decrease. A portion of the dividends you receive may be subject to federal, state, or local income tax or may be subject to the federal alternative minimum tax.

While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

Select Sector SPDR Funds bear a higher level of risk than more broadly diversified funds. All ETFs are subject to risk, including the possible loss of principal. Sector ETFs products are also subject to sector risk and non-diversification risk, which generally results in greater price fluctuations than the overall market.

"SPDR" is a registered trademark of Standard & Poor's Financial Services LLC ("S&P") and has been licensed for use by State Street Corporation. STANDARD & POOR'S, S&P and S&P 500 are registered trademarks of Standard & Poor's Financial Services LLC. No financial product offered by State Street Corporation or its affiliates is sponsored, endorsed, sold or promoted by S&P or its affiliates, and S&P and its affiliates make no representation, warranty or condition regarding the advisability of buying, selling or holding units/shares in such products. Further limitations and important information that could affect investors' rights are described in the prospectus for the applicable product.

Distributor: State Street Global Markets, LLC, member FINRA, SIPC, a wholly owned subsidiary of State Street Corporation. References to State Street may include State Street Corporation and its affiliates. Certain State Street affiliates provide services and receive fees from the SPDR ETFs. ALPS Distributors, Inc., a registered broker-dealer, is distributor for SPDR® S&P 500®, SPDR® S&P MidCap 400® and SPDR® Dow Jones Industrial Average, all unit investment trusts, and Select Sector SPDRs. ALPS Distributors, Inc. is not affiliated with State Street Global Markets, LLC.

Before investing, consider the funds' investment objectives, risks, charges and expenses. To obtain a prospectus or summary prospectus which contains this and other information, call 866.787.2257 or visit www.spdrs.com. Read it carefully.

© 2013 State Street Corporation. All Rights Reserved. ID3198-IBG-9499 Exp. Date: 8/31/2014 IBG.EDU.TSETFS.0813 SPD000658