NATIXIS INVESTMENT MANAGERS

Choosing the right structure for your index investment needs

This paper is intended to highlight some of the similarities and differences between index mutual funds, index exchange-traded funds ("ETFs"), and index-based separately managed accounts ("SMAs"). Each has its own nuances and characteristics that may suit investors differently based on the size of the investment account, investing behavior, tax bracket, desire for investment advice, and other factors. This paper assumes the reader has a basic knowledge of mutual funds and ETFs.

Invested in an index mutual fund or ETF? You may benefit from a more flexible approach.

References to mutual funds, ETFs, and SMAs will center on index-based, large-cap core equities (e.g., those benchmarked to the S&P 500®), though most of the discussion may apply to other indexed asset classes as well. "Mutual funds" in this paper also refers only to open-end mutual funds.

FIGURE 1: SAMPLE STRATEGY COMPARISON

Strategy	S&P 500® Mutual Fund	S&P 500® ETF	Index-Based SMA
Benchmark example	S&P 500®	S&P 500®	S&P 500®
Typical # holdings	~500 (full replication)	~500 (full replication)	50–300+ (sampled or optimized)
Hold individual stocks directly	No	No	Yes
Purchases/sales at NAV	Yes	No, trades like a stock	No, trades individual stocks
Tracking error to the index	Usually < 0.10%	Usually < 0.10%	Varies, but typically < 2%
May be more suitable for:	Small, frequent contributions	Tactical trading during the day	Taxable investors, and/or those desiring customization or tax management

Source: Active Index Advisors®

Index mutual funds

Index mutual funds are intended to track an index, minus their expense ratio. They primarily achieve this goal by holding substantially all securities at the same weights as the index (also known as full replication). Mutual funds often have low minimum initial and future investment requirements (sometimes less than $1,000 for initial investments). The largest ones often have expense ratios under 0.10% and may track the benchmark within 0.10% per year.

Mutual funds combine the assets of many investors, allowing investors to achieve broader diversification with fewer assets than if they were to buy individual stocks on their own. The downside of this is that investors (in taxable accounts) are potentially subject to income and capital gains distributions, even if they did not sell, and even in a down market.

All purchases and redemptions are only done once a day, at the end of the trading day, at the Net Asset Value. Mutual fund shares are exchanged only with the fund, and not between other investors.

Exchange-traded funds

An exchange-traded fund is a special type of mutual fund that trades like a stock. While mutual funds are bought or sold directly from a mutual fund company at the Net Asset Value, ETFs are primarily bought and sold throughout the day on a stock exchange, at prices based on supply and demand. Trades are also primarily done between individual investors and not with the fund itself (unless you are an institution trading in very large volumes).

As with a mutual fund, ETF investors are pooling their assets together and buying shares in the fund, and it's the fund that owns the securities. ETFs are also available with expense ratios less than 0.10% and may track their benchmarks just as closely as their mutual fund brethren, since these also tend to utilize full replication.

Purchasing an ETF requires a brokerage account, may have a commission cost, and will have a bid-ask spread when traded. You may buy or sell as little as one share of an ETF, but brokerage fees would make this cost prohibitive and you may want to trade only in large amounts to justify the costs.

Separately managed accounts

Separately managed accounts are not pooled vehicles like mutual funds or ETFs. Instead, investors engage the services of an investment manager, who is given discretion to purchase stocks on the investor's behalf. Minimum account sizes are larger (often $100,000 and up) since the investor owns the stocks directly and can't simply buy a single share to properly diversify their portfolio.

Retail index-based SMAs don't typically buy all the securities in an index and may limit their holdings to between 50 and 300 securities. Since they do not use full replication, they may not track the benchmark index as closely as a mutual fund or ETF. However, there are two main reasons why SMAs do not use full replication.

First, fully replicating an index often requires hundreds of millions of dollars to be done properly. Second, holding a subset of the index provides the flexibility to add value on an after-tax basis through tax-loss harvesting. Tax-loss harvesting is the process of selling securities for a loss while retaining gains on paper. Net losses may then be used to offset capital gains in other investments, and thus defer taxes associated with capital gains.

Retail SMAs are only available through a financial advisor, and fees may include compensation for advice, trading, custody, and portfolio management. These fees may vary, but are often in the range of 1%–1.5%.

FIGURE 2: MINIMUMS AND FEES

	S&P 500® Mutual Fund	S&P 500® ETF	Index-Based SMA
Typical minimum investment	$100–$3,000	1 share	$100,000
Typical net expense ratio	0.09% +	0.06% +	~ 1%*
Typical management fee	0.03% +	0.06% +	0.30%
Typical brokerage costs	Generally none	~ $10/trade, but sometimes waived	May often choose either asset-based pricing or brokerage fees*

*SMA fees may include fees for the advisor, trading, custody, platform sponsor, and portfolio manager. Source: Active Index Advisors®

So which one is right for me?

Why would anyone consider using an SMA if they cost more? The crux is in the ownership structure of the investment. Mutual funds and ETFs are pooled investment products, where investors own shares in a fund. Investors do not own any stocks directly. An SMA is not a pooled investment product, but rather an investment service, where the investor is the sole owner and owns stocks directly. SMAs give investors the ability to open accounts with existing stock positions, to restrict individual stocks from being bought or sold, and to benefit from loss harvesting. These features are unavailable to holders of mutual funds and ETFs.

Index mutual funds, ETFs and SMAs might all have the same benchmark. In the absence of taxes, mutual funds and ETFs may be the better option since their fees are lower and they may have lower tracking error. However, they are also inflexible. In contrast, an SMA may be customized to include or exclude specific stocks based on an individual's wishes. For example, an investor with substantial holdings in technology may not want to acquire additional stocks in that sector. Investors may also wish to restrict purchases of stock in other sectors such as tobacco or oil companies.

Index mutual funds and ETFs tend to be relatively tax-efficient, with few to no capital gain distributions. They may still distribute dividends, so their returns after taxes may be lower than their returns before taxes are considered. Any net losses in a mutual fund or ETF may not be distributed for the benefit of shareholders and must remain inside the fund.

If an SMA utilizes loss harvesting and realizes capital losses in excess of capital gains, these losses may be used to offset capital gains from other investments. This is allowed because the individual owns the stocks directly. The savings from both the tax deferral and subsequent compounding may exceed the additional costs associated with owning an SMA.

For investors who are highly sensitive to taxes, fees from an SMA are eligible as an itemized deduction. This isn't the case with mutual funds or ETFs since the expense ratios are netted against income in the fund. Furthermore, short-term capital gains in mutual funds and ETFs are combined and distributed as ordinary income, not as a separate short-term capital gain distribution. While tax rates on short-term capital gains and ordinary income are often the same, combining them can be disadvantageous. For example, if the investor has short-term capital losses elsewhere, those losses would not be allowed to net against the short-term capital gains distributed in a mutual fund or ETF. An SMA doesn't have these limitations.

Entering the mainstream

In recent years, ESG analysis has played a bigger role across investment styles, moving from strictly exclusionary practices to a greater emphasis on positive company selection. Changes related to corporate transparency and reporting, along with growing awareness of the business risks associated with governance, environmental, and social issues, have also highlighted some of the potential benefits of considering ESG criteria in an investment approach.

Conclusion

There is no one right answer for everyone. Index mutual funds are generally tax-efficient, so they often make sense in a taxable account. But an SMA may provide further tax benefits if used instead.

The higher your tax bracket or the more sensitive you are to taxes, the greater the value you may receive from an SMA, particularly if you are already using a financial advisor for other services. Mutual funds and ETFs cannot incorporate existing stock positions, cannot be customized for individuals, and cannot distribute net losses. For investors in these situations or those who need enhanced tax management capabilities, SMAs may be the better option (see Figure 4).

For investors who do not have extensive assets, or will be investing or divesting small increments over time, or do not require any customization, a mutual fund or ETF may be a better choice.

FIGURE 3: DISTRIBUTIONS AND TAXES

	S&P 500® Mutual Fund	S&P 500® ETF	Index-Based SMA
Dividends distributed	Yes	Yes	Received as paid
Long-term capital gains distributed	Yes	Yes	Only realized when stocks sold
Short-term capital gains distributed	Yes, but as ordinary income	Yes, but as ordinary income	Only realized when stocks sold
May have capital gain distributions, even if you don't sell	Yes, but not very common	Yes, but not very common	No
Direct benefit from loss harvesting	No, net losses stay in fund	No, net losses stay in ETF	Yes

Source: Active Index Advisors®

FIGURE 4: CUSTOMIZATION FEATURES

	S&P 500® Mutual Fund	S&P 500® ETF	Index-Based SMA
Able to restrict individual stocks	No	No	Yes
Able to fund with cash	Yes	Yes	Yes
Able to fund with stock	Not for retail investors	Limited to Authorized Participants	Yes
Able to constrain net cap gains	No	No	Yes
Able to transition portfolios	No	No	Yes
Able to transition concentrated stock	No	No	Yes
May add value on an after-tax basis	No	No	Yes

Source: Active Index Advisors®

NATIXIS INVESTMENT MANAGERS

Investing involves risk, including the risk of loss. Investment risk exists with mutual funds, ETFs and SMAs. There is no assurance that any investment will meet its performance objectives or that losses will be avoided.The comparisons shown are not comprehensive and may not apply to all mutual funds, ETFs, and SMAs. Investors should not make choices solely on the content contained herein, nor should they rely on this information to apply to their specific situation or any specific investments under consideration. This is not a solicitation to buy or sell any specific security.

Future tax liabilities may be higher in an SMA that uses loss harvesting because it may have larger unrealized capital gains. Tax law and tax rate changes may also impact the relative value of index mutual funds, ETFs, and SMAs.

Natixis Advisors, L.P. does not provide tax advice. Please consult with your financial advisor or tax professional.

This material is provided for informational purposes only and should not be construed as investment advice.

S&P 500® Index is a widely recognized measure of U.S. stock market performance. It is an unmanaged index of 500 common stocks chosen for market size, liquidity, and industry group representation, among other factors. It also measures the performance of the large-cap segment of the U.S. equities market. You may not invest directly in an index.

Natixis Advisors, L.P. provides advisory services through its divisions Active Index Advisors® and Managed Portfolio Advisors®. Advisory services are generally provided with the assistance of model portfolio providers, some of which are affiliates of Natixis Investment Managers, L.P.

Natixis Distribution, L.P. is a limited purpose broker-dealer and the distributor of various registered investment companies for which advisory services are provided by affiliates of Natixis Investment Managers.

Natixis Advisors, L.P. and Natixis Distribution, L.P. are located at 888 Boylston Street, Boston, MA 02199. • 800-862-4863

im.natixis.com

1501531.3.2
Exp. 5/31/2019
WP109-0518