



Investing for Tax Savings: How to Create a Tax- Efficient ETF Portfolio

ETFs provide enhanced tax benefits versus other asset classes.

Twin Oak Editorial Team

The key to a successful investing strategy isn't merely generating high yield, but also retaining the highest post-tax returns.

This is why tax-efficient ETFs (exchange-traded funds) have for decades been one of the most popular investment vehicles. These funds are designed to help investors build wealth in a way that reduces taxable events, prioritizing cost-control as well as performance.

If structured correctly, tax-efficient ETFs can play a central role in an investor's long-term portfolio strategy.

What Are Tax-Efficient ETFs, and How Do They Minimize Tax Liabilities?

A tax-efficient ETF is a type of exchange-traded fund built to reduce investors' exposure to taxable capital gains. Whereas traditional mutual funds trigger taxable distributions when managers buy or sell holdings, ETFs allow "in-kind" transactions that help reduce—or eliminate—taxable events.

Here's how this works in practice: An ETF issuer wants to adjust the holdings of their ETF. To do so, they exchange shares of their ETF for shares of the underlying securities with a market-maker. When the ETF issuer, or manager, wants to redeem shares, the trade happens in reverse.

Because no shares are being sold for cash, no tax is applied to the transaction. Therefore, investors often pay taxes only when they sell their ETF shares, not when the fund itself trades internally. This allows investors to benefit from enhanced holdings flexibility as well as long-term tax efficiency.

How Do Tax-Efficient ETFs Compare to Traditional ETFs and Mutual Funds?

ETFs and mutual funds are similar in that they allow investors to purchase a single security that provides exposure to several underlying securities. But they differ in important ways. Traditional mutual funds must sell holdings to meet investor redemptions, which can trigger taxable gains distributed to all shareholders—even those who didn't sell.

Traditional ETFs, because of in-kind redemptions, avoid those taxable distributions. But while most ETFs already have tax advantages compared to mutual funds, not all ETFs are equally efficient.

Tax-efficient ETFs go one step further by prioritizing strategies that reduce turnover, manage dividend exposure, and optimize tax treatment within the fund itself. Because ETFs can be customized and actively adjusted, portfolio managers have the ability to design specialized ETFs that balance capital appreciation with tax management, a hybrid model that seeks to capitalize on the full range of benefits found in ETFs.

At Twin Oak, for example, we embed tax-aware portfolio management throughout our investment process.

What Strategies Make an ETF Tax Efficient?

Several structural and managerial decisions can enhance an ETF's tax efficiency. The first is low portfolio turnover, in that the fewer trades a fund makes, the less likely it is to have to realize capital gains. This is why long-term, buy-and-hold strategies are recommended when leveraging ETFs in an equity portfolio.

Beyond in-kind creations and redemptions, which allows fund managers to bypass capital gains taxes by trading shares for underlying securities rather than cash, having a comprehensive investment strategy, centered on disciplined rebalancing, can further reduce potential taxable events.

Other aspects of a tax-efficient ETF strategy could be selecting securities that have qualified dividends, aiming to minimize ordinary income distributions, or leveraging complicated tactics such as tax-loss harvesting, where underperforming assets can be sold to realize a capital loss, thus offsetting taxes owed on realized capital gains.

If implemented correctly, these strategies allow investors to defer taxes while allowing their portfolio to compound over time.

What Are the Key Benefits and Limitations of Tax-Efficient ETFs?

The most obvious benefit is tax savings. For example: If you have two investments of \$1 million each, with one going into a traditional mutual fund with an annual tax drag of 2% and the other into an ETF where taxes are deferred until liquidation, the former would hold \$3.1 million whereas the latter would hold \$4.1 million after 15 years of continuous investing (disclaimer: there are limitations of relying on this or any example and assumptions used to illustrate this point, consult your appropriate professional prior to understanding any investment risks)..

Beyond lower tax drag and increased ability for tax deferral—where investors are able to retain more of their returns since less taxable events occur—tax-efficient ETFs carry additional benefits.

First, they can be actively managed, which increases their ability to outperform a given benchmark while also deferring taxable events. Beyond this key benefit, ETFs publish their holding daily, providing transparency into investments; trade intra-day, allowing real-time buying and selling (unlike mutual funds); and are traditionally a lower-cost investment vehicle than other types of funds.

While these benefits are attractive, they are not guaranteed. A seasoned portfolio manager is required to maximize tax efficiency and investment potential. If left in the wrong hands, an ETF can easily become a tax-inefficient, dividend-heavy, and cost prohibitive.

Who Should Consider Tax-Efficient ETFs, and How Do They Fit Into a Portfolio?

Tax-efficient ETFs can play a role in almost any investor's strategy, but they're especially valuable for high-net-worth investors and family offices who hold assets in taxable brokerage accounts and want to minimize taxable gains. In addition, long-term, set-it-and-forget-it investors—especially the retail class who seek predictability and simplicity—can enjoy the full range of tax-related benefits across a longer investment horizon. And even those with short timelines, like retirees, can manage withdrawals strategically to maximize tax efficiency.

Tax-efficient ETFs can act as a foundational strategy for all investors, many of whom will also benefit from specialized holdings in tax-advantage retirement accounts, like IRAs and 401(k)s.

By any measure, tax-efficient ETFs are powerful tools for maximizing after-tax returns. By leveraging low turnover, in-kind transactions, and disciplined portfolio management, they minimize the tax drag that erodes long-term gains.

A well-constructed mix of tax-efficient ETFs across sectors and regions can help investors pursue growth—and keep more of it—year after year.

Definitions (as used by Twin Oak):

- 1. Cost-effective ETFs:** As defined compared to hedge funds, which commonly charge a 2% management fee as well as 20% of the profits.
- 2. Institutional Grade:** Investment strategies generally only accessible in private fund formats to accredited investors.
- 3. Tax Alpha:** The amount of a gross return lost to the tax drag of an investment vehicle through realized taxable events.
- 4. Low Cost:** Defined on a case-by-case basis but generally refers to solutions that are cheaper than private funds (2% management fees and 20% carry).

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