

The hidden mechanics of tax-efficient investing

ETFs enjoy a potential structural tax advantage over mutual funds, independent of whether they're actively or passively managed.

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Key takeaways:

- Active managers can trade frequently in pursuit of outperformance. When gains are realised, these can be passed directly through to shareholders as capital gains distributions.
- Passive strategies mitigate some of this simply by trading less. But the structure of the investment vehicle matters as much as the strategy itself – and even index mutual funds can be forced to distribute capital gains during periods of heavy redemptions.
- For investors with taxable assets, choosing the right investment vehicle and account can be worth a persistent advantage that compounds quietly, requires no forecasting skill, and does not depend on market timing.

Improving investment returns is not always about picking the right stocks or timing the market. It's also about what you keep — and how much quietly leaks away to taxes each year.

The impact of taxes on total return is easy to ignore. It rarely shows up on performance charts, and is often treated as a secondary concern, as many investors participate in markets through tax-sheltered retirement vehicles. But over time, like much of investing, the tax effect compounds. And for investors holding assets in taxable accounts, it can make a material difference to long term outcomes.

We see three broad ways investors can potentially reduce the effect of taxes: thoughtful asset location, understanding the tax costs embedded in active management and — often overlooked — choosing investment vehicles with structural tax advantages. These decisions are closely linked, and taken together they have the potential to meaningfully improve after tax returns potentially without any additional market risk.

Asset location: not what you own, but where you hold it

Asset location is a simple idea with powerful implications. It focuses not on what assets you hold, but on where you hold them — placing different investments into the account types best suited to help shelter them from tax.

In the US, the main account types carry very different tax treatments. Traditional 401(k)s and IRAs defer tax until withdrawal. Roth account contributions are made after taxes have been paid, but allow investments to grow and be withdrawn tax free. Taxable brokerage accounts, by contrast, can expose investors to annual taxes on dividends, interest and realized capital gains.

Because different assets possess very different tax profiles, this matters. Corporate bonds and real estate investment trusts (REITs), for example, can distribute regular income taxed at ordinary rates. Broad equity index funds and some growth stocks, by contrast, tend to generate most of their return through unrealised gains — which are not taxed until an investor chooses to sell.

The logic of asset location follows naturally. Tax inefficient assets belong in tax advantaged accounts. More tax efficient holdings can sit in taxable accounts, where lower long term capital gains rates apply.

The underappreciated tax implications of active mutual funds

Active mutual funds can be significantly less tax-efficient than passive funds which tend to have lower portfolio turnover. The effect of this can be underappreciated.

Active managers can trade frequently in pursuit of outperformance. When gains are realised, these can be passed directly through to shareholders as capital gains distributions. Capital gains distributions are taxable events, even if the investor has not sold a share of the fund. In some cases, this may result in a mutual fund distributing gains in the same year it delivers a negative return.

Frequent trading increases the likelihood of short term gains, which are taxed at ordinary income rates and can be higher than capital gains tax rates. And because the fund manager — not the investor — decides when gains are realised, shareholders can lose control over the timing of their tax bills.

Passive strategies can mitigate some of this simply by trading less. But the structure of the investment vehicle may matter as much as the strategy itself — and even index mutual funds can be forced to distribute capital gains during periods of heavy redemptions.

The practical conclusion is straightforward. Active mutual funds may be best held inside tax advantaged accounts such as IRAs or 401(k)s, where distributions do not trigger an immediate tax bill. Holding them in taxable accounts may be like handing control of much of your tax outcome to someone else.

ETFs: a potential structural advantage, not a cyclical one

But ETFs can have a further tax-benefit trick up their sleeve and the reason lies in how they handle investor flows. When investors exit an ETF, shares are typically redeemed in-kind for a basket of underlying securities rather than cash. This allows the fund to meet redemptions without selling assets — the primary mechanism through which mutual funds generate taxable capital gains. Redemptions are taxable events, though, and investors are responsible for paying taxes on any gain (or taking a tax-loss) realized in the sale of the ETF.

The result is a difference in tax realization. Passive ETFs sit at the top of the ranking: low turnover combined with in-kind redemptions means capital gains distributions are rare, but taxes are paid on dividend distributions and any share sales. Active ETFs, while trading more, can benefit from the same structure by not generating capital gains (or losses) each time a portfolio manager trades. But like passive funds, taxes are paid on dividend distributions and any capital gain resulting from share sales. Active ETFs can, therefore, be more tax efficient than active mutual funds.

Passive mutual funds sit somewhere in between. They are generally efficient, but still vulnerable to forced sales during periods of outflows or index turnover. Again, taxes are paid on dividend distributions and any share sale. Active mutual funds, as a group, appear to be the least efficient combination — potentially high turnover paired with cash redemptions can result in taxable distributions.

The data reflects this. In a typical year, a large share of mutual funds distribute capital gains, while only a small fraction of ETFs do. In taxable accounts, that gap can translate into an annual tax drag. Our analysis showed that active ETFs exhibited an average annual tax burden 1.26% lower than active mutual funds for the 5-year period ending 4/30/26, and 1.48% lower for the 3-year period ending 4/30/26.¹

¹ Federated Hermes analysis/Morningstar Inc., as of April 30, 2026. The analysis covers 2,518 U.S. equity mutual funds and ETFs across nine Morningstar categories. “Tax burden” (tax drag) is defined as the difference between total return and Morningstar’s pre-liquidation after-tax return, which reflects taxes paid on income and capital gain distributions but excludes taxes that would be incurred upon liquidation of fund shares. Results represent averages of fund-level tax drag for the specified periods. Comparisons are based on actively managed ETFs versus actively managed open-end mutual funds. All returns are net of expenses and calculated using Morningstar’s standardized methodology, which assumes the highest applicable US federal marginal tax rates and reinvestment of after-tax distributions. The analysis does not account for state or local taxes, investor-specific tax circumstances, transaction timing, or holding period differences, and actual investor outcomes may vary.

² The Role of Taxes in the Rise of ETFs by Rabih Moussawi, Ke Shen, Raisa Velthuis. Past performance is no guarantee of future results. The estimated tax benefits do not take into account the tax at liquidation, which can vary across investors due to the timing of liquidation, tax-loss harvesting, and the step-up in cost basis if investors hold their positions until death.

³ For illustrative purposes only. This example is representative of a mathematical principle and is not based on the returns or taxes for any specific investment. Actual investment results will vary.

An investment in an exchange-traded fund (“ETF”) generally presents the same primary risks as an investment in a fund that is not exchange traded and may also be subject to other risks, such as: (i) ETF shares may trade above or below their net asset value; (ii) an active trading market for an ETF’s shares may not develop or be maintained and (iii) trading of an ETF’s shares may be halted by the listing exchange’s officials.

ETFs and mutual funds are subject to risks and fluctuate in value.

Note that ETFs are not immune to capital gains and many equity ETFs do pay dividends on which taxes are owed.

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Why small differences can compound into large outcomes

Tax drag is not a fixed number. It depends on marginal tax rates, portfolio turnover, market conditions and holding periods. In a strong market with limited redemptions, the gap may narrow. In a down year, with high investor redemptions forcing funds to sell, it can widen sharply.

A study of US fund distributions from 2012-2023 estimated an average tax savings of approximately 1% for ETFs vs. active mutual funds.² However modest, any tax savings can compound meaningfully in a portfolio over time.

This variability is precisely what may make structure so important. A 1% annual tax drag may sound modest. Over 25 years, however, it can reduce the end value of a \$100,000 investment compounding at 8% per year from roughly \$685,000 to \$543,000 — a difference of around \$142,000.³

For investors with taxable assets, that’s not a marginal consideration. Choosing the right vehicle and placing it in the right account can be a persistent advantage that compounds quietly, requires no forecasting skill, and does not depend on market timing.

In investing, structure matters. And when it comes to tax efficiency, ETFs are designed with that in mind.