

Mutual Funds Converting to ETFs for Tax Efficiency and Convenience

Since the first quarter of 2021, conversions of mutual funds into exchange-traded funds (ETFs) have been a growing trend. Actively managed and higher-fee mutual funds are using this to attract investors by providing a lower-cost, more tax-efficient version of their strategy.

What Is Behind These Conversions?

The U.S. Securities and Exchange Commission (SEC) approved a rule in 2019 that opened the door to allowing such conversions. Rule 6c-11, known as the ETF Rule, allowed fund providers to create and redeem ETF shares with so-called custom baskets. Custom baskets allow authorized participants—typically large trading firms like market makers—to exchange assets with an ETF that do not perfectly match the ETF's portfolio. This is in contrast with a standard basket where authorized participants exchange assets matching an ETF's portfolio.

The exchange of baskets between the authorized participants and the ETF helps to keep the ETF trading at a price equal to or close to the value of its underlying assets. The process also works to create new shares or eliminate shares based on prevailing demand for them.

The advent of the SEC's ETF Rule spurred product development in the ETF industry by allowing for a level of opacity between the fund's manager and the authorized participants. Prior to the rule's passage, active managers had concerns about revealing intended portfolio changes before having the chance to make them.

With the rule, converting a mutual fund into an ETF became comparatively more appealing for active managers and their firms. Investors in various mutual funds expressed their desire to benefit from the greater tax efficiency of ETFs. According to Morningstar Direct, as of September 5, 2024, there are 82 actively managed ETFs that started their lives as mutual funds. These are U.S.-domiciled ETFs converted from open-ended mutual funds. An additional four funds were converted but subsequently shuttered.

How Does a Conversion to ETF Affect Investors?

Mutual fund companies communicate with investors about upcoming plans to convert a mutual fund to an ETF. Shareholders may be asked to vote on approval of the conversion.

Converting a mutual fund to an ETF retains the strategy's track record, which provides meaningful

information for investors. Upon conversion, the ETF also retains the same portfolio and managers as the mutual fund.

One of the big points that investors should think about is tax savings. ETFs typically make smaller capital gains distributions than their mutual fund counterparts. Once a mutual fund converts to an ETF, the ETF creation and redemption process will be used. Unlike mutual funds, ETFs don't have to sell holdings and thus realize taxable capital gains when the portfolio manager desires to make a change or investors sell their shares.

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Additionally, when investors buy or sell shares of an ETF on an exchange, the dollars flow to and from another investor. In contrast, transactions of mutual fund shares result in either inflows (purchases of fund shares) or outflows (sales of fund shares) of cash to the mutual fund.

Regarding taxation of the conversion itself, investors holding their mutual funds in tax-deferred accounts should not owe taxes when a mutual fund they own converts to an ETF. There is a small difference with taxable accounts.

Investors specify a dollar amount they want to invest when buying mutual funds. This results in constant fractional share purchases. Since ETFs are traded like stocks, they are commonly bought and sold on a per-share basis. (Only a small number of brokers facilitate fractional share purchases of ETFs.) Because of this, a conversion could result in a portion of your mutual fund shares being returned to you as cash—a potentially taxable event.

For example, if you have \$1,500 invested in a mutual fund in a taxable account that converts to an ETF selling for \$140.00 per share, you would receive 10 ETF shares (10 × \$140) and \$100 in cash. The distribution of the cash would be treated as a sell transaction and would be subject to the capital gains tax rules.

Characteristics of Converted ETFs

The converted ETFs shown in Table 1 are displayed by category and ranked by total assets within the category. We included categories we believe most investors hold in their portfolios. Alternative asset class ETFs or those that

TABLE 1
Converted ETFs (Ranked by Total Assets Within Category)

ETF	Ticker	1-Yr Ann'l Ret (%)	1-Yr Ret Cat Grade	3-Yr Ann'l Ret (%)	3-Yr Ret Cat Grade	5-Yr Ann'l Ret (%)	5-Yr Ret Cat Grade	10-Yr Ann'l Ret (%)	Exp Ratio (%)	Exp Ratio Grade	Total Assets* (\$ Mil)	Date Converted
Large Blend												
Dimensional US Core Equity 2 ETF	DFAC	24.2	D	8.3	C	14.9	C	11.1	0.17	B	29,685	6/11/2021
Dimensional US Equity ETF	DFUS	26.3	C	8.7	B	15.8	B	12.6	0.09	A	10,004	6/11/2021
Fidelity Enhanced Large Cap Core ETF	FELC	28.3	A	10.2	A	16.6	A	12.7	0.18	B	3,499	11/17/2023
Kovitz Core Equity ETF	EQTY	20.2	F	4.8	F	12.5	D	9.7	0.99	F	1,101	12/9/2022
JPMorgan Equity Focus ETF	JPEF	31.3	A	11.3	A	17.8	A	13.6	0.50	C	786	7/28/2023
Harbor Dividend Growth Leaders ETF	GDIV	21.6	D	7.4	D	13.4	D	11.3	0.50	C	280	5/23/2022
EA Bridgeway Blue Chip ETF	BBLU	26.0	C	11.9	A	15.9	A	13.1	0.15	B	200	10/14/2022
Large Growth												
Fidelity Enhanced Large Cap Grth ETF	FELG	32.9	D	8.3	A	19.4	A	15.2	0.18	A	2,708	11/17/2023
TCW Compounders ETF	GRW	34.7	C	8.7	A	15.2	D	—	0.75	D	178	5/3/2024
FundX ETF	XCOR	28.4	A	10.2	D	10.5	F	9.0	1.27	F	158	10/17/2022
Franklin Focused Growth ETF	FFOG	36.5	F	4.8	D	16.8	B	—	0.55	C	117	11/3/2023
Fidelity Disruptors ETF	FDIF	21.3	A	11.3	F	—	—	—	0.50	C	87	6/16/2023
Logan Capital Broad Innova Gr ETF	LCLG	30.7	D	7.4	C	17.3	B	14.5	0.96	F	66	8/5/2022
FundX Aggressive ETF	XNAV	23.7	C	11.9	C	10.3	F	7.9	1.30	F	27	10/17/2022
Large Value												
Dimensional US Mktwide Value ETF	DFUV	20.4	D	6.9	D	11.4	D	8.9	0.21	B	11,066	5/6/2022
Fidelity Enhanced Large Cap Val ETF	FELV	22.0	C	7.8	C	12.2	C	9.5	0.18	B	1,918	11/17/2023
Hartford Quality Value ETF	QUVU	18.8	F	6.8	F	10.7	D	—	0.45	D	180	10/13/2023
BrandywineGLOBAL Dyn US Lg Val ETF	DVAL	18.5	F	5.6	F	12.8	B	9.5	0.49	D	114	11/28/2022
Cambiar Aggressive Value ETF	CAMX	18.4	F	5.2	F	11.6	D	5.3	0.59	D	57	2/13/2023
Mid-Cap Blend and Growth												
Fidelity Enhanced Mid Cap ETF	FMDE	24.2	B	5.6	C	12.5	B	9.6	0.23	B	1,802	11/17/2023
Motley Fool Mid-Cap Growth ETF	TMFM	18.9	C	(1.8)	C	8.7	F	8.5	0.85	F	201	12/13/2021
Small-Cap Blend and Value												
Dimensional US Small Cap ETF	DFAS	17.1	D	4.9	B	12.0	B	8.7	0.26	B	8,516	6/11/2021
JPMorgan Market Expan Enh Eq ETF	JMEE	19.6	B	6.4	A	12.7	A	9.5	0.24	B	1,312	5/6/2022
Fidelity Enhanced Small Cap ETF	FESM	22.7	A	4.4	B	12.3	B	8.7	0.28	C	875	11/17/2023
Dimensional US Targeted Value ETF	DFAT	17.7	C	8.8	A	14.0	B	8.6	0.28	B	10,218	6/11/2021
EA Bridgeway Omni Small-Cap Val ETF	BSVO	19.2	B	7.9	A	14.3	B	7.8	0.47	D	1,385	3/13/2023
Sector												
Fidelity Disruptive Communic ETF	FDCF	31.8	A	(0.1)	B	—	—	—	0.50	C	47	6/9/2023
Fidelity Disruptive Finance ETF	FDFE	24.8	D	(0.8)	F	—	—	—	0.50	C	40	6/9/2023
Vert Global Sustain Real Estate ETF	VGSR	23.3	A	(0.3)	A	3.1	A	—	0.45	C	412	12/4/2023
Neuberger Berman Gbl Real Est ETF	NBGR	16.1	C	(3.0)	C	2.4	A	—	0.75	F	7	10/13/2023
Fidelity Disruptive Medicine ETF	FMED	9.1	D	(6.2)	D	—	—	—	0.50	C	55	6/9/2023
Horizon Kinetics Medical ETF	MEDX	15.9	C	2.9	B	9.8	C	6.6	0.85	F	18	1/27/2023
Horizon Kinetics SPAC Active ETF	SPAQ	3.9	F	—	—	—	—	—	0.85	F	18	1/27/2023
JPMorgan Realty Income ETF	JPRE	21.6	B	1.6	B	5.0	B	6.2	0.50	C	383	5/20/2022
Fidelity Disruptive Technology ETF	FDTX	26.5	C	(4.3)	D	—	—	—	0.50	C	148	6/9/2023
TCW Artificial Intelligence ETF	AIFD	30.8	A	3.0	C	16.6	B	—	0.75	F	53	5/3/2024

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use option or trading strategies were excluded.

Converted ETFs have the reputation of being recently launched mutual funds that were then converted to ETFs. In fact, inception dates for the funds shown range from November 1984 to June 2021. Of the 66 funds displayed, 45 have at least a 10-year track record.

Most are small; the largest assets under management (AUM) is just under \$30 billion and the smallest is around

\$7 million. The average expense ratio is 0.59%. Expense ratios tend to be above average (expensive). Only 18 ETFs have **A+** Investor Grades of A or B for their expense ratios; 30 have grades of D or F. All ETFs in the table are actively managed.

Oldest and Newest Converted ETFs

The Eaton Vance Total Return Bond ETF (EVTR) is the

TABLE 1 (CONTINUED)

Converted ETFs (Ranked by Total Assets Within Category)

ETF	Ticker	1-Yr Ann'l Ret (%)	1-Yr Ret Cat Grade	3-Yr Ann'l Ret (%)	3-Yr Ret Cat Grade	5-Yr Ann'l Ret (%)	5-Yr Ret Cat Grade	10-Yr Ann'l Ret (%)	Exp Ratio (%)	Exp Ratio Grade	Total Assets* (\$ Mil)	Date Converted
Foreign Large Blend												
Dimensional Wld ex US Core Eq 2 ETF	DFAX	16.8	F	2.8	D	8.7	B	4.9	0.28	C	7,098	9/10/2021
JPMorgan Int'l Rsrch Enh Eq ETF	JIRE	20.2	B	5.5	A	9.0	B	5.4	0.24	B	6,922	6/10/2022
Fidelity Enhanced International ETF	FENI	22.1	A	5.1	A	9.4	A	5.7	0.28	C	1,688	11/17/2023
AB International Low Volatility Eq ETF	ILOW	25.8	A	4.6	B	7.4	D	—	0.50	D	848	7/12/2024
Touchstone Dynamic Int'l ETF	TDI	20.6	A	2.7	D	6.9	D	4.9	0.65	F	53	12/11/2023
Foreign Other												
Martin Currie Sustainable Intl Eq ETF	MCSE	13.7	F	(6.5)	F	6.9	D	—	0.61	C	32	11/28/2022
Dimensional International Value ETF	DFIV	18.6	C	9.2	A	10.9	A	5.0	0.27	A	7,792	9/10/2021
Conductor Global Equity Value ETF	CGV	7.8	F	1.9	D	4.9	F	5.2	1.25	F	105	7/29/2022
Global Large-Stock Blend and Growth												
SmartETFs Dividend Builder ETF	DIVS	21.3	C	0.1	A	0.1	A	0.1	0.65	D	33	3/26/2021
Motley Fool Global Opportunities ETF	TMFG	21.0	C	(0.0)	A	0.1	A	0.1	0.85	F	434	12/13/2021
Fidelity Disruptive Automation ETF	FBOT	11.4	D	(0.0)	B	—	—	—	0.50	B	96	6/9/2023
Diversified Emerging Markets												
Global X Emerg Mkts Great Cnsmr ETF	EMC	8.8	F	(11.8)	F	(1.0)	F	1.0	0.75	F	138	5/12/2023
Global X Emerg Markets ex-China ETF	EMM	11.7	D	(5.5)	F	4.3	D	3.4	0.75	F	27	5/12/2023
Intermediate Core-Plus Bond												
Eaton Vance Total Return Bond ETF	EVTR	9.8	A	(1.3)	B	0.8	B	3.2	0.32	B	515	3/22/2024
Angel Oak Mortgage-Backed Securities	MBS	10.3	A	(2.2)	D	—	—	—	0.50	D	72	2/16/2024
Short-Term Bond												
JPMorgan Limited Duration Bond ETF	JPLD	8.0	B	2.6	A	2.2	B	2.0	0.24	C	757	7/28/2023
Eaton Vance Short Duration Inc ETF	EVSD	8.0	A	2.0	A	2.1	B	2.6	0.24	C	176	6/14/2024
Nbg Bm Short Duration Income ETF	NBSD	7.8	C	1.8	B	2.3	A	1.9	0.35	D	153	6/21/2024
AB Short Duration Income ETF	SDFI	7.7	C	1.0	D	1.7	D	—	0.30	C	91	6/7/2024
Multisector Bond												
AB Short Duration High Yield ETF	SYFI	10.5	B	2.5	A	3.5	A	3.6	0.40	A	632	6/7/2024
TCW Flexible Income ETF	FLXR	10.5	B	1.6	A	4.2	A	—	0.40	A	356	6/21/2024
FundX Flexible ETF	XFLX	7.2	F	(1.0)	D	0.7	F	1.7	1.17	F	63	10/6/2023
Municipal Bond												
JPMorgan Sustainable Muni Inc ETF	JMSI	6.5	B	(0.5)	D	0.9	F	1.9	0.18	B	218	7/14/2023
Eaton Vance Short Dur Muni Inc ETF	EVSM	5.0	A	2.8	A	1.9	A	—	0.19	C	130	3/22/2024
Derivative Income												
Main BuyWrite ETF	BUYW	9.5	F	7.6	B	7.6	C	—	1.14	F	497	9/9/2022
Dividend Performers ETF	IPDP	26.3	A	8.6	A	17.2	A	—	1.52	F	21	3/7/2022
Tactical Allocation												
Adaptive Alpha Opportunities ETF	AGOX	18.2	B	3.9	B	13.4	A	10.2	1.39	D	298	5/10/2021
FundX Conservative ETF	XRLX	18.2	A	2.7	C	6.5	C	6.1	1.63	F	56	10/6/2023
RH Tactical Rotation ETF	RHRX	21.8	A	3.3	B	6.5	B	5.0	1.36	D	16	11/8/2021
RH Tactical Outlook ETF	RHTX	16.4	B	1.2	D	5.2	F	5.1	1.38	D	9	11/8/2021

*As of 9/4/2024.

Source: AAIL/Morningstar Direct. Data as of 8/31/2024.

oldest fund in Table 1. It was inceptioned as a mutual fund on November 14, 1984. The Eaton Vance Total Return Bond provides exposure to a diversified mix of investment-grade bonds. It is classified as an intermediate core-plus bond fund because of its 7.6% allocation to high-yield debt.

The newest fund is the Angel Oak Mortgage-Backed Securities ETF (MBS), which was launched as a mutual fund on June 4, 2021. It includes exposure to residential

mortgage-backed securities, which is why it is classified as an intermediate core-plus bond ETF instead of as an intermediate core bond ETF.

Most and Least Expensive Converted ETFs

FundX's family of four ETFs hold other ETFs. Strategies include growth, multisector bond and tactical. The four funds alter their allocations based on FundX's proprietary trend strategy. Asset allocations are shifted in

response to market conditions with the goal of improving returns, diversifying the portfolio and adapting to market conditions. Sector rotation strategies strive to profit from business cycle changes.

This “fund of funds” approach results in comparatively higher expense ratios versus tracking an index with individual stocks. The FundX Conservative ETF (XRLX) has the highest expense ratio at 1.63%. It holds core equity ETFs and bond ETFs.

The Dimensional U.S. Equity ETF (DFUS) has the lowest expense ratio at 0.09%. It intends to provide broad exposure, with a portfolio of nearly 2,500 U.S. stocks. The Dimensional U.S. Equity may also buy or sell futures contracts and options on futures contracts to increase or decrease equity market exposure based on actual or expected cash inflows to or outflows from the portfolio.

Mixed Performance and Expenses

Despite the potential tax benefits, converted ETFs—as a group—don’t show superior returns. Only six have A+ Investor Grades of A for one-, three- and five-year returns. Such grades are awarded when an ETF’s return ranks in the top 20% of its category.

Those six are the Dividend Performers ETF (IPDP), Eaton Vance Short Duration Municipal Income ETF (EVSM), Fidelity Enhanced International ETF (FENI), Fidelity Enhanced Large Cap Core ETF (FELC), JPMorgan Equity Focus ETF (JPEF) and Vert Global Sustainable Real Estate ETF (VGSR). Most of these have average expense ratios for their respective categories. The Fidelity Enhanced Large Cap Core is the cheapest with an expense ratio of 0.18%, while the Dividend Performers is the most expensive of this group with an expense ratio of 1.52%.

The Dividend Performers is categorized as a derivative income fund. It invests in dividend-paying U.S. stocks as well as in credit spread options on an S&P 500 ETF or the S&P 500 index. It may also invest in equity real estate investment trusts (REITs). A credit spread is an options strategy that involves the purchase of one option and the sale of another option in the same class and with the same expiration but different strike prices.

There are 10 ETFs in the table that have below-average one-, three- and five-year returns, as evidenced by their A+ Investor Grades of D and F for all three periods.

Conventional Strategies With a Twist

The active bent of these ETFs permits following a general theme, but often with a twist. The large blend and

large growth categories contain the largest number of converted mutual funds. Both the Dimensional U.S. Core Equity 2 ETF (DFAC) and the Dimensional U.S. Equity invest in large-cap stocks but also use futures contracts and options on futures contracts for U.S. equity securities and indexes.

The two ETFs are similar, with familiar top holdings including Apple Inc. (AAPL), Microsoft Corp. (MSFT) and Nvidia Corp. (NVDA). More specifically, part of the Dimensional U.S. Equity’s objective is to minimize taxes. It has also realized better returns than the Dimensional U.S. Core Equity 2. The latter’s objective simply says it considers the “federal income tax implications of investment decisions.” Notably, both ETFs have three-year tax-cost ratios of 0.5%.

The Fidelity Enhanced Large Cap Core also has familiar stocks in its top holdings. It invests in S&P 500 constituents but utilizes a quantitative analysis of historical valuation, growth, profitability and other factors. The intention is to select a broadly diversified group of stocks with the potential to outperform the S&P 500. The Fidelity Enhanced Large Cap Core’s objective also allows its managers to venture outside the U.S. borders to invest a small portion in foreign issuers.

Using ETF Conversion to Rebrand a Fund

Some mutual funds have taken the opportunity to rebrand when converting to an ETF. We observed this more frequently among smaller funds than larger ones. The Kovitz Core Equity ETF (EQTY), for example, was converted from the Marathon Value Portfolio. The Kovitz Core Equity seeks long-term capital appreciation through fundamental research while also aiming to minimize the odds of capital loss. Its category risk index of 1.05 is low enough to earn it a grade of B.

Kovitz is a registered investment adviser (RIA). We point this out because pressure from clients of wealth managers can help push a mutual fund manager to consider an ETF conversion.

What Makes a Fund Ripe for Conversion?

While there are no specific factors we can point to, we do observe that the ETFs currently converted from mutual funds are mostly actively managed and more likely to be the types held in taxable accounts. There is less benefit for low-cost mutual funds to convert. Target-date funds’ primary role in retirement accounts also makes them less likely to be converted to ETFs. ■

—*Cynthia McLaughlin, AII investment editor*