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Are Vanguard's Canadian-listed ETFs at Risk of a Major Capital Gains Distribution?

Raymond Kerzerho MBA, CFA
Director of Research

PWL Capital Inc.
November 2018

ABSTRACT

The Vanguard Group launched its first ETFs back in 2001, and has since shaken up the asset management industry by gathering more new assets in the U.S. than anyone, be it through the mutual fund or the ETF channel. The not-for-profit firm was able to underprice everyone else on day one, levering up its massive assets with its unique multiple-share-class structure. However, some industry participants raised concerns about this structure eventually resulting in large taxable capital gains distributions. This paper reviews the risk of a capital gains distribution specific to Vanguard ETFs, more specifically from the perspective of Canadian taxable investors. We conclude that Vanguard's multiple-share-class structure is very unlikely to trigger large capital gains distributions.

This report was written by Raymond Kerzérho, PWL Capital Inc. The ideas, opinions, and recommendations contained in this document are those of the authors and do not necessarily represent the views of PWL Capital Inc.

Raymond Kerzérho, Director of Research, PWL Capital Inc., “Are Vanguard’s Canadian-listed ETFs at Risk of a Major Capital Gains Distribution?”.

For more information about this or other publications from PWL Capital, contact:

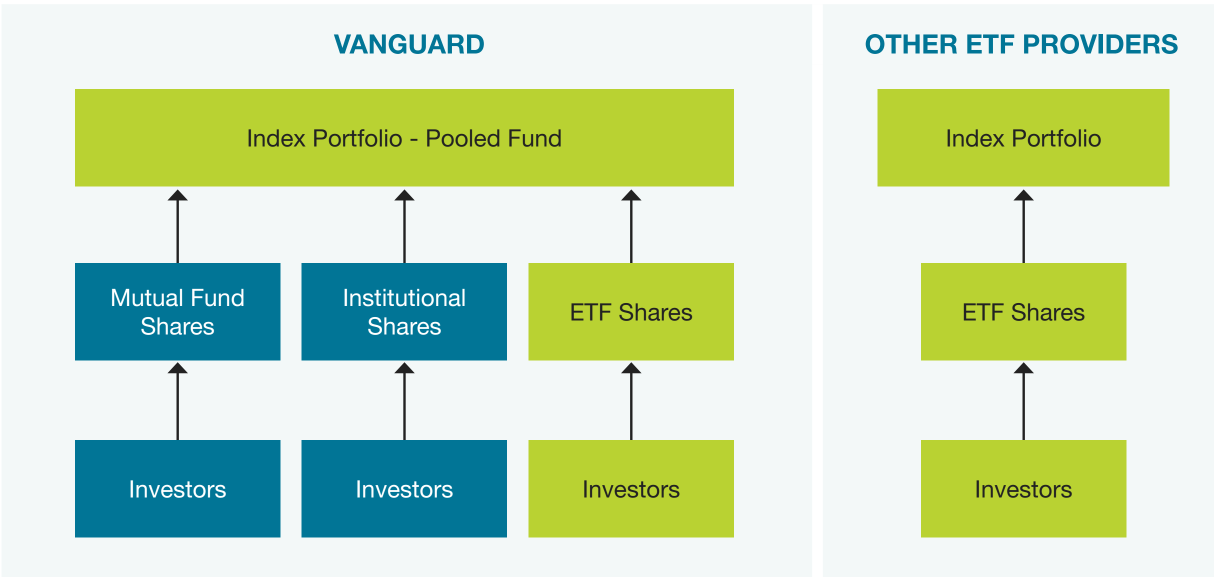
PWL Capital – Montreal, 3400 de Maisonneuve Ouest, Suite 1501, Montreal, Quebec H3Z 3B8
Tel 514-875-7566 • 1-800-875-7566 Fax 514-875-9611
montreal@pwlcapital.com

Content

1 U.S.–listed Vanguard ETFs under the Microscope

Vanguard Group's U.S.–listed ETFs are structured differently than those of other providers. While most other ETFs on the U.S. market are completely self-standing, Vanguard's U.S.–listed ETFs were launched as a new share class of an existing index portfolio. The structure is illustrated in Chart 1 below.

Chart 1: Structure of a U.S.–listed Vanguard ETF vs. Other ETF Providers

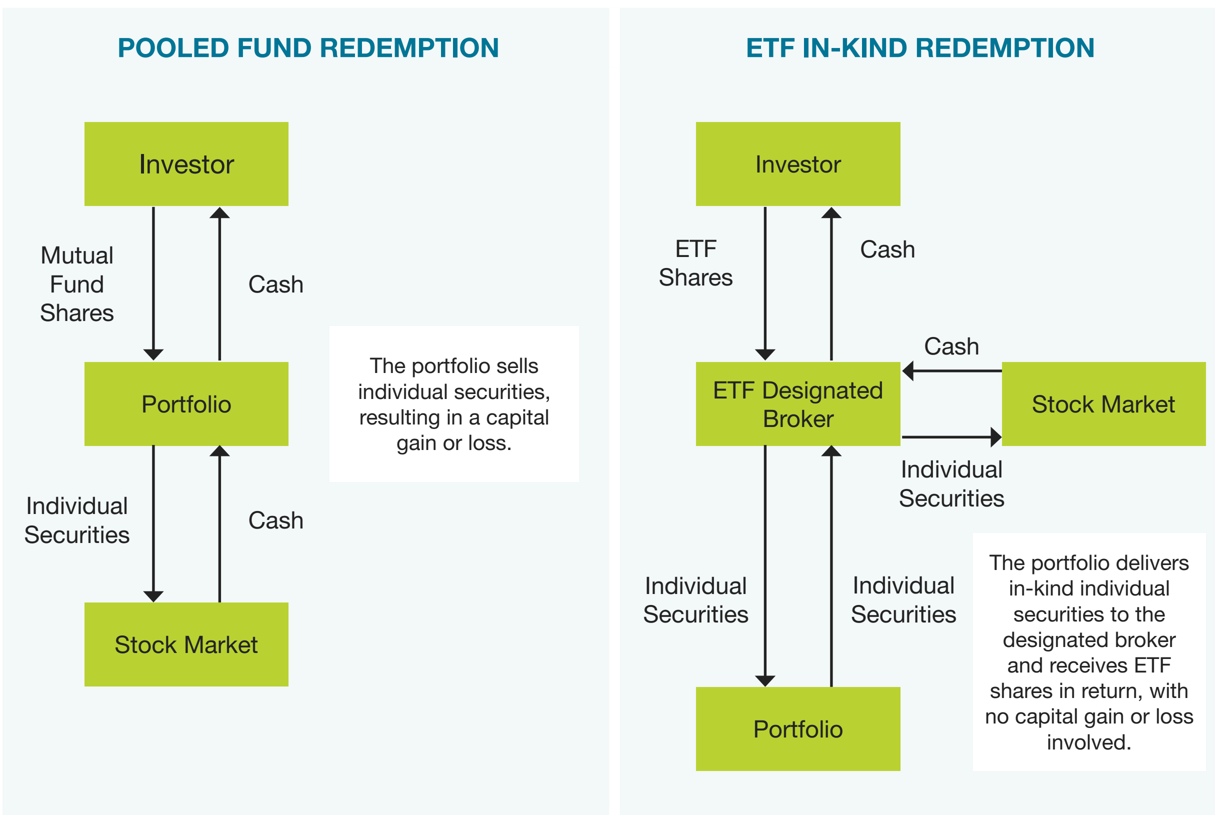


Source : The Vanguard Group

The most obvious advantage of the Vanguard structure is that it allowed its ETFs to start on day one with a huge base of assets under management and, consequently, to launch ETFs with economies of scale and the lowest possible expense ratio. For example, the Vanguard Total Stock Market ETF allows investors to participate in a $700 billion portfolio—more than twice the amount of assets under management of the massive Canada Pension Plan.

At the same time, one might ask whether this multi-share-class structure poses a risk of large capital gains distributions. The classic ETF structure has a key advantage over the pooled fund structure: ETF holders are insulated from the tax consequences resulting from other shareholders' transactions. One shareholder selling ETF shares at a big profit cannot "socialize" their taxable gain to the remaining shareholders, as the ETF shares will either be sold to another investor on the open market or be redeemed in kind by the ETF provider: these transactions do not trigger capital gains into the ETF portfolio. By contrast, investors in Vanguard ETFs indirectly hold securities in a common portfolio, along with holders of mutual funds and institutional shares. If a mutual fund or an institutional shareholder of a Vanguard portfolio disposes of their shares, this could trigger a cash redemption. In contrast to in-kind redemptions, cash redemptions are financed by selling securities directly from within the portfolio. Thus, it is theoretically possible that a big taxable capital gain triggered by one of the latter groups could in part be funnelled to ETF shareholders. The difference between pooled fund cash redemptions and ETF in-kind redemptions is illustrated in Chart 2.

Chart 2: Impact of Net Redemptions: Mutual Funds vs. ETFs



Source: PWL Capital

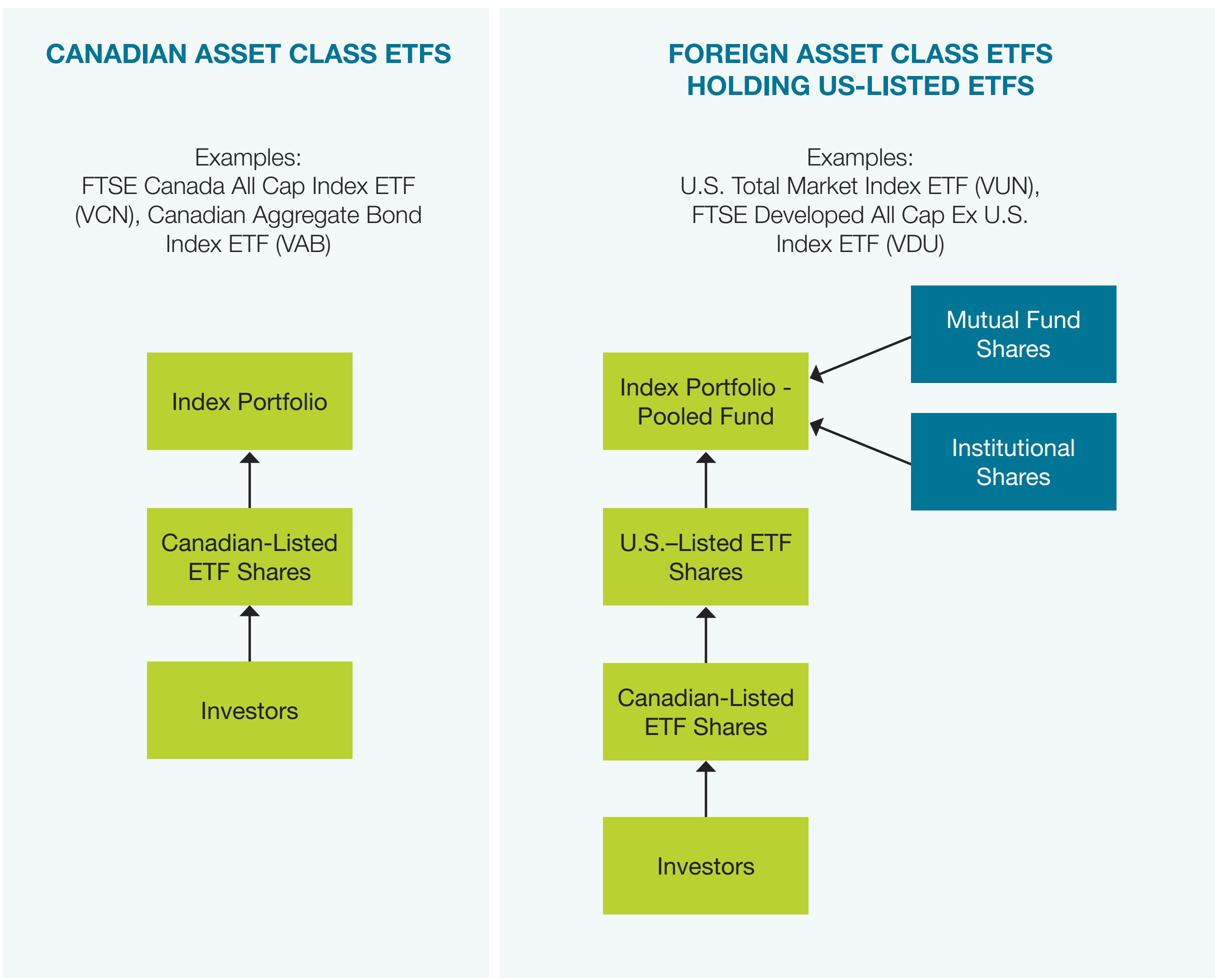
Understanding this risk is particularly important for **Canadian investors holding U.S.–listed Vanguard ETFs** in a taxable portfolio. This is because, under Canadian tax law, capital gain distributions from a foreign ETF are taxable at the full, ordinary income-tax rate.

2 Are There Any Issues with Vanguard's Canadian-listed ETFs?

Vanguard's Canadian-listed ETFs of Canadian securities utilize the classic ETF structure: they hold sole ownership of a portfolio of securities. Therefore, they are not subject to the issues involved with multiple share-classes.

By contrast, **several of Vanguard's Canadian-listed ETFs of foreign securities hold U.S.–listed ETFs.** As a result, a large capital gains distribution in a U.S.–listed ETF that underlies a Canadian-listed ETF could be funneled from the former to the latter. In a sense, these ETFs are akin to Russian nesting dolls: the Canadian ETF owns shares of the U.S. ETF, which, in turn, holds shares of the index portfolio. Chart 3 compares the structure of Vanguard's Canadian-listed ETFs of Canadian and foreign assets.

Chart 3: Ownership Structure of Vanguard's Canadian-listed ETFs



Source: PWL Capital, Vanguard Group

3 The Risk Specific to Vanguard ETFs Is Extremely Remote

We reviewed the evidence provided by Vanguard itself but also from independent sources like Morningstar and ETF.com, and conclude that the risk posed by Vanguard's multiple-share-class structure is extremely limited. Here are our findings:

1. A research paper by Morningstar has demonstrated that the bulk of the reduction of capital gains distributions is obtained by moving from actively to passively managed (index) mutual funds. Passive funds distribute at least 90% less capital gain than do active funds, due to their relatively low turnover. In general, broad-market and large-cap ETFs tend to distribute less capital gain than do sector, speciality and mid- and small-cap ETFs. However, the additional reduction in capital gains distributions obtained by moving from passive mutual funds to passive ETFs is marginal. Therefore, it is difficult to see how integrating a passive mutual fund and a passive ETF under the same structure can result in much larger capital gains distributions.

2. Vanguard suggests that its multiple-share-class structure is actually more, not less, tax-efficient than the traditional ETF structure. Unlike in Canada, the U.S. regulation allows fund companies to select specific securities lots when shares are redeemed by investors. By selectively redeeming high-cost shares to mutual fund investors in cash, and redeeming low-cost shares in-kind to ETF investors, the multiple-share-class structure theoretically allows Vanguard ETFs to beat their competitors' tax efficiency.

3. Vanguard has a stellar historical record when it comes to capital gains distributions. Some U.S.–listed Vanguard ETFs have a track record that dates back to 2001. Key Vanguard ETFs listed in the U.S. have shown capital gains distributions that are close to zero. If their structure was flawed, some major distributions would likely have appeared by now. Furthermore, the capital gains distribution record of Canadian-listed ETFs is also very low, as demonstrated in Table 1 on the following page. Any significant capital gains distributions have resulted from currency-hedging transactions rather than the multiple-class-share structure.

4. In the event of a large redemption (more than 1% of the portfolio or $250,000) by a mutual fund or institutional shareholder, Vanguard has the right to redeem shares in-kind, in order to prevent a capital gains distribution that would be detrimental to the remaining shareholders.

Table 1: Key Vanguard ETF Capital Gains Distributions since Inception

Canadian ETF	Ticker	Year of Launch	Capital Gains Dist.	Underlying U.S. ETF Ticker	Year of Launch	Capital Gains Dist.
FTSE Developed All Cap ex U.S. Index	VDU	2013	Zero	VEA	2007	Zero
FTSE Developed All Cap ex U.S. Index (CAD-hedged)	VEF	2011	Minimal*	VEA	2007	Zero
FTSE Emerging Markets All Cap Index	VEE	2011	Minimal*	VWO	2005	Zero
S&P 500 Index	VFV	2012	Minimal*	VOO	2010	Zero
S&P 500 Index (CAD-hedged)	VSP	2012	1.5% in 2017 0% otherwise	VOO	2010	Zero
U.S. Dividend Appreciation Index	VGG	2013	Zero	VIG	2006	Zero
U.S. Dividend Appreciation Index (CAD-hedged)	VGH	2013	0.50% in 2017 0% otherwise	VIG	2006	Zero
U.S. Total Market Index	VUN	2013	Minimal	VTI	2001	Zero
U.S. Total Market Index (CAD-hedged)	VUS	2011	3% in 2017 0.7% in 2012 0% otherwise	VTI	2001	Zero
U.S. Aggregate Bond Index (CAD-hedged)	VBU	2014	Not material	BND	2007	Zero
Global ex-U.S. Aggregate Bond Index (CAD-hedged)	VBG	2014	2.1% in 2017 0% otherwise	BNDX	2013	0.24% to 0.60% in 2010- 2014, 0% otherwise

* "Minimal" = less than 0.10% in any given year

Source: The Vanguard Group, Bloomberg

4 Conclusion

This paper recapitulates our understanding of the Vanguard ETF multiple-share-class structure and the tax concerns it entails. In light of Vanguard's history of limited capital gains distributions and the other alleviating factors at play,we believe Vanguard ETFs will likely be as tax-efficient in the future as those with a classic structure.

We also believe investors wanting to optimize after-tax returns should primarily favour ETFs with a broad market-index exposure, low fees and a low tracking error, and ETFs that hold discount bonds.

5 References

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The Author

Raymond Kerzérho MBA, CFA
Director of Research

PWL Capital Inc.
www.pwlcapital.com/authors/raymond-kerzerho
raymondk@pwlcapital.com

PWL

www.pwlcapital.com

PWL Montreal
3400 de Maisonneuve O.
Suite 1501
Montreal, Quebec
H3Z 3B8

T 514.875.7566
1-800.875.7566
F 514.875.9611
montreal@pwlcapital.com
www.pwlcapital.com/montreal

PWL Ottawa
265 Carling Avenue,
8th Floor,
Ottawa, Ontario
K1S 2E1

T 613.237.5544
1-800.230.5544
F 613.237.5949
ottawa@pwlcapital.com
www.pwlcapital.com/ottawa

PWL Toronto
8 Wellington Street East
3rd Floor
Toronto, Ontario
M5E 1C5

T 416.203.0067
1-866.242.0203
F 416.203.0544
toronto@pwlcapital.com
www.pwlcapital.com/toronto

PWL Waterloo
20 Erb St. West
Suite 506
Waterloo, Ontario
N2L 1T2

T 519.880.0888
1-877.517.0888
F 519.880.9997
waterloo@pwlcapital.com
www.pwlcapital.com/waterloo