NB PRIVATE WEALTH

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The Rise of Active ETFs

Tax-sensitive investors are increasingly turning their attention to active ETFs and the benefits they can provide.

Exchange traded funds (ETFs) have proven to be a versatile tool to achieve diverse investment objectives and often comprise a cornerstone of modern portfolios, offering a blend of tax efficiency, trading flexibility and transparency. While passive strategies have long dominated the ETF landscape, actively managed strategies are now making headway. Below, we explore the growth of active ETFs, their structural advantages, and an innovative method of converting existing assets to ETFs where appropriate.

EMERGENCE OF ACTIVE ETFs

The U.S. active ETF market has experienced remarkable growth in recent years, culminating in a record-breaking 2024. At year-end, active ETFs collectively managed $868 billion in assets and had attracted nearly $287 billion in net flows, representing about 26% of all new net flows into ETFs in 2024. This was despite active ETFs accounting for just 8% of the total ETF market by assets under management, outpacing their passive counterparts by nearly five times with an organic annual growth rate exceeding 51%. Key asset classes and categories driving growth include core U.S. equities, fixed income and derivative income strategies.[1]

This broadening footprint has not gone without acknowledgement in the financial world, as investment gatekeepers such as Morningstar and Envestnet recently announced expanding coverage of the ETF universe.

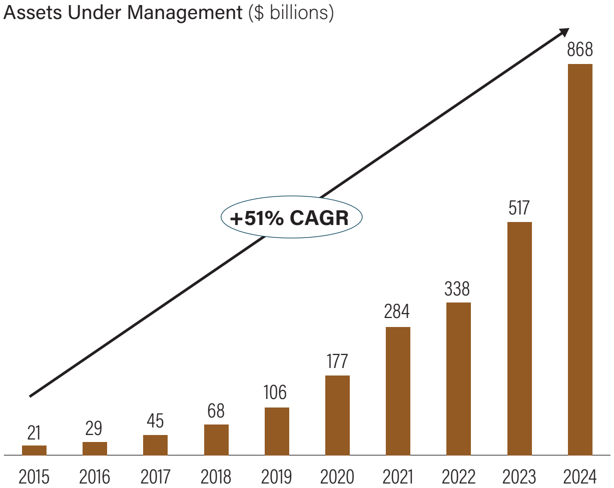
STRUCTURAL ADVANTAGES

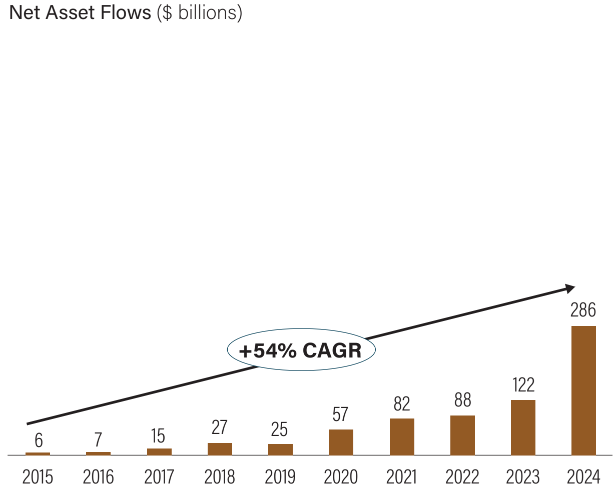
While many of our NB Private Wealth clients garner exposure to core assets like U.S. large-cap equity and core fixed income in separately managed accounts (SMAs), commingled funds are often a common add-on to gain exposure to asset classes or strategies that may be less amenable to an SMA—for example, flexible "go-anywhere" fixed income strategies, emerging markets, international or high yield. As such, we believe it makes sense to understand the differences between mutual funds and ETFs. Indeed, ETFs offer several advantages over mutual funds that have made them an increasingly popular choice for investors, whether used as an add-on or as the core allocation in an overall portfolio.

[1] Source: Morningstar, as of December 31, 2024.

AN EXPANDING MARKET PRESENCE

Growth of U.S. Active ETFs





Source: Morningstar, as of December 31, 2024. CAGR refers to Compound Annual Growth Rate.

1. Tax Efficiency

One of the most significant advantages of ETFs over mutual funds is their tax efficiency.

When investors buy shares of a fund, they inherit the fund's embedded capital gains, which are the unrealized gains from securities the fund has held over time. If the fund sells those securities, all shareholders are taxed on the gains, even if they did not benefit from the fund's earlier performance. Therefore, a fund can increase its tax efficiency by minimizing its volume of taxable sales of securities.

ETFs can be efficient in this respect because shareholders can sell their holdings directly to other investors, and the ETF itself does not have to sell securities to provide liquidity for investors. In contrast, mutual funds must generally sell securities to meet redemptions, which can generate taxable gains that are passed on to all shareholders, even those who did not redeem their shares. This can create unexpected tax liabilities for mutual fund investors.

In addition, ETFs use an "in-kind" creation and redemption process, which potentially allows them to reduce capital gains when their portfolios are adjusted. This is because securities are exchanged directly with authorized participants instead of being sold on the open market. These exchanges can often be structured in ways that can defer recognition of capital gains.

As a result, ETFs typically distribute fewer taxable capital gains to investors than mutual funds, and typically have much lower embedded capital gains, making them an inherently more tax-efficient investment vehicle.

2. Intraday Liquidity and Trading Flexibility

Unlike mutual funds, which are priced once per day at their net asset value (NAV) after the market closes, ETFs trade on exchanges throughout the trading day. This means investors can buy or sell ETF shares at market prices whenever the stock market is open.

ETFs also offer a variety of trading options that mutual funds do not. Investors can use limit orders, stop orders and margin trading with ETFs, providing more control over how and when they execute trades. Additionally, ETFs can be shorted, allowing investors to profit from declines in the value of the ETF, which is not possible with mutual funds.

Creating Active ETFs With Purpose

Neuberger Berman's Product Strategy and Development team is continually assessing the potential benefits for clients of various investment strategies. When it comes to ETFs, we believe that any new portfolio should represent an asset class or strategy that fulfills an important purpose for investors, whether to provide diversification, exposure to key investment trends or enhanced income opportunities. Overall, we look to introduce viable long-term investment strategies that can attract new investors, supported by healthy liquidity and market-making activity. Only with all those factors in place can an active ETF provide the full advantages described in this article.

3. Transparency

ETFs typically disclose their holdings on a daily basis, providing investors with full visibility into the securities they own. This level of transparency is particularly valuable for those who want to ensure their portfolios align with their investment objectives or avoid specific exposures. Mutual funds, in contrast, disclose holdings much less frequently (often quarterly, with a delay).

USING ETFs WITH SEPARATELY MANAGED ACCOUNTS

For our clients, we increasingly view active ETFs as a way to augment existing SMAs to broaden diversification to less-traveled areas of the market on a tax-efficient basis. For example, someone with exposure to U.S. large-cap stocks in separate accounts could add an active ETF specializing in commodities; or someone with a large municipal bond portfolio might purchase an active ETF pursuing a flexible fixed income strategy to capture yield opportunities in other attractive sectors or geographies. Like SMAs, active ETFs can work effectively as part of a tax-efficient strategy to regularly engage in tax-loss harvesting to capitalize on volatility across market environments.

Given the inherent advantages of the active ETF structure, we believe that, in some cases, it can make sense to transfer SMA assets into an ETF to diversify concentrated positions (assuming contributions meet diversification rules), streamline ownership for future flexibility, or open up opportunities for strategic estate planning.

UNLOCKING TAX EFFICIENCY WITH 351 CONVERSIONS

For those with significant assets in SMAs, "Section 351 conversions"[2] can potentially present a unique opportunity to transition to an ETF structure while maintaining your original cost basis. Named after Section 351 of the Internal Revenue Code, this process enables investors to contribute assets to a newly formed ETF in exchange for shares without triggering capital gains taxes.

The key to a Section 351 conversion is its tax-deferred nature. When a diversified portfolio of assets is transferred from an SMA to an ETF in a manner that meets the requirements under Section 351, no immediate capital gains taxes are incurred; the ETF inherits the original cost basis and holding period of the transferred assets, and taxes are generally deferred until the ETF shares are eventually sold. This allows investors to potentially restructure portfolios efficiently, mitigating the "tax drag" that often accompanies reallocation in traditional accounts. The ETF structure's in-kind redemption provides additional opportunities to further minimize taxable events after conversion.

[2] "Section" references are to the Internal Revenue Code of 1986, as amended.

351 Conversions: Key Considerations

While 351 conversions offer significant benefits, they require careful planning and adherence to IRS rules:

- **Diversification:** The transferred portfolio must meet diversification requirements, including limits on single holdings and aggregate concentrations.
- **Control:** Transferring investors must maintain at least 80% ownership of the ETF immediately post-conversion.
- **Complexity:** The process involves coordination among advisors, custodians and fund administrators, making it essential to work with experienced professionals.

All this said, we believe you should make a thoughtful assessment of whether a transition to an ETF structure in your particular situation could qualify for tax-deferred treatment under Section 351, and whether a Section 351 conversion makes sense for you, before taking any action.

ALIGNING WITH LONG-TERM GOALS

The growing popularity of ETFs underscores their appeal as a modern, efficient and versatile investment vehicle. The ETF structure offers a range of benefits over mutual funds, including tax efficiency, intraday liquidity and greater transparency. For those looking to optimize their portfolios, we believe use of active ETFs and, where appropriate, Section 351 conversions provide compelling advantages that can translate into better alignment with your long-term financial goals.

As always, be sure to consult with your NB Private Wealth team to tailor your approach to your unique goals and circumstances.

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