

## **CONFIDENT CONVERSATIONS® on Retirement: How ETFs Help You Defer Taxes—and Boost Long-Term Growth Potential**

**Jessica Sclafani:** Welcome to T. Rowe Price's CONFIDENT CONVERSATIONS® on Retirement. I'm Jessica Sclafani and I'm excited to be your host this season. As a retirement strategist, I've spent years helping people make sense of retirement, both the numbers and the emotions behind them. Together with my colleagues, we'll explore practical insights to help you retire confidently.

Today we're here to talk about ETFs. And I'm going to be brave and start us off with an admission. I'm not an ETF expert. So, for those of you that are listening that might be on the fence about a whole podcast on ETFs and their potential tax advantages, I promise you that we'll be learning together. Our plan for today is to one, break down how and why ETFs are typically more tax friendly than mutual funds. Two, walk through a real-world example that puts some numbers behind why ETFs could offer advantages over other investment vehicle types. And three, share some practical tips on how to use ETFs wisely in your portfolio.

Thankfully, I'm joined by not one but two ETF experts today, including Chris Murphy, who's joining us from sunny San Francisco and is head of ETF specialists and CERTIFIED FINANCIAL PLANNER® professional, Lindsay Theodore. Thanks for joining us.

**Lindsay Theodore:** Thank you so much for having us, Jessica.

**Chris Murphy:** Thanks for having us, Jessica. Appreciate it.

**Jessica Sclafani:** So, I figured we need to kind of warm up to this topic a little bit. Before we dive straight into the mechanics of ETFs, Chris and Lindsay, I'd love for you each to share a bit about your backgrounds and why you're excited about the ETF landscape today. Chris, let's start with you.

**Chris Murphy:** I think warming up is a good thing to think about before we get into the ETF mechanics, as it's pretty deep, but I think it's worth highlighting, as we will today. Thanks for the introduction. My name is Chris Murphy, head of ETF specialists at T. Rowe Price. I've spent my entire career in ETFs, ever since I graduated college and started off at one of the big three ETF providers and joined T. Rowe just four years ago to help T. Rowe Price build out our ETF capabilities and ultimately educate investors on the benefits of ETFs and bring product to market. So, I'm glad to be here. I'm excited to talk to the audience today and, as well as Lindsay and yourself, about the benefits and ever-changing landscape of ETFs.

**Jessica Sclafani:** Sounds exciting, Chris. I'm excited to learn from you today. So, Lindsay, how about you?

**Lindsay Theodore:** Great. Thanks for having me, Jessica. So, Lindsay Theodore, a CERTIFIED FINANCIAL PLANNER® professional, and I'm a thought leadership senior manager here at T. Rowe. Most of my background is in planning, financial planning so, I've been a CFP professional for ten years and before moving to this position two years ago, I was, an advisor for 15 years working with clients and their families. So, I am used to educating clients on some of these concepts, Jessica, you said you weren't too familiar with ETFs yet. We hope to make a lot of things clearer for our audience and for you after this.

**Jessica Sclafani:** Okay, great. Lindsay, I can only imagine that you've seen and heard it all as an advisor. So, I think you'll be able to share some really great perspective with us today on the practical aspects of where and why ETFs could be an ideal investment vehicle. Chris, I'm going to come back to you. And like I started out with today, I am an ETF neophyte. So, I thought we could just start at the beginning. Keep it simple. How did ETFs emerge and how has their more recent history made them attractive for investors?

**Chris Murphy:** Sure. Yeah. So, ETFs are in their mid-30s to put it in age, human-like perspective.

**Jessica Sclafani:** That's still very young, still, yeah let the record reflect.

**Chris Murphy:** It's still very young, yes...

**Lindsay Theodore:** I love that.

**Chris Murphy:** ...but maturing quickly, we'll put it that way. So, the first ETF here in the U.S. launched in 1993. And ironically enough, it was actually out of the wake of Black Monday. So, the 1987 market crash where the Dow dropped over 20% intraday. And, what happened from there was that exchanges and institutional investors realized if there was something trading intraday, like a stock, that allowed them to gain exposure or de-risk intraday through a basket of securities, say, tracking the S&P 500, it potentially could have negated some of the massive volatility and drawdown that we experienced, that the market experienced, on that day. And so State Street Global Advisors, the American Stock Exchange, and other regulatory bodies got their heads together and came up with the concept that the exchange traded fund. And again, tracking the S&P500, and allowing investors and market participants to exchange risk intraday.

Of course, the industry has evolved to over 4,000 different ETFs currently listed here in the U.S. But it solved, you know, an initial problem, which was instant liquidity into a broad, diversified portfolio of stocks. And at the time they were primarily tracking well-known indices. But as time evolved, right, as we went through kind of the evolution of product development within the ETF structure, you began to see other types of investment strategies come into the ETF wrapper. Smart beta or factor investing, right? Which, in other words, is just a way for you to gain exposure to a specific factor, like quality or low volatility or minimum volatility or size, so smaller cap stocks came to emerge, as products as well. And then allowed really investors to build diversified portfolios, typically at a lower fee than actively managed stock mutual funds via the ETF structure.

Fast forward to today and now we can access actively managed strategies in the ETF vehicle, which is which is obviously what we offer here at T. Rowe Price. And I think what's exciting is that now investors can leverage all the benefits of the ETF, right? The convenience, the liquidity, the transparency and the tax efficiency, which in a lot of cases is probably the primary benefit that the ETF provides, which I know we'll get into later, across both passive and active, again, allowing for investors to build durable, diversified portfolios that can hopefully last them through retirement beyond.

**Jessica Sclafani:** So, Chris, that was a helpful, we'll call it a 101, on the mechanics of ETFs and I have to admit I was being fresh when I said that 30 years was still young. Remembering that I'm the ETF newbie in the room, right? Now I know how they came about, but can you walk me through what is it about them that makes them attractive to investors, and particularly from the lens of tax efficiencies?

**Chris Murphy:** Yeah, so, I mentioned those three benefits right, Jessica? That typically are recognized with ETFs which are: convenience or liquidity, transparency, and then you know, I guess I mentioned the probably primary and most well-known benefit, which is tax efficiency and how really that in a lot of ways has driven the adoption and interest into ETFs, specifically with individual investors and wealth advisors. And, you know, I guess to stick on that tax-efficiency element, it's really the way in which ETFs are transacted that make them tax-efficient. You think about trading a stock, you go on exchange and if you're buying a stock, you're buying it from someone who's looking to sell and it's all happening on the exchange. The same thing happens with ETFs, given that they're exchange-traded, where you might be buying ten shares and there might be a seller of ten shares, and you're just being matched on exchange. Where a mutual fund, you're acting directly with that fund provider. So, if you're looking to sell you actually have to go to that fund provider, ask them for cash, they have to raise cash and deliver you that cash. There's no exchange at which you can be matched with a seller. And that's what makes ETFs tax efficient, is that ability to trade on exchange, limiting the selling pressure of the individual fund manager. And then in which when there is additional selling pressure, so, for example, if there's more sellers than buyers, what can happen is that the fund will get met with a redemption, the ETF that is. And when the redemption is met at the fund level, that transaction happens in-kind. In other words, instead of having to raise cash, the fund manager is actually able to redeem out the individual shares of the stocks inside the ETF, in-kind, to a market maker. That allows the ETF to remain much more tax-efficient, in the fact that it doesn't have to sell stocks or bonds in the portfolio to raise cash happening in-kind, limiting the potential capital gains and realization of capital gains of those stocks and bonds in the mutual fund or ETF portfolio.

**Jessica Sclafani:** Got it. I'm with you. I was about to say, you know, in my reading, doing a little bit of homework before I spoke with both of you, I saw the term "no for sales" mentioned a couple of times. And now I understand what that means based on what you just explained. Lindsay, what else would you add in terms of why ETFs could be attractive?

**Lindsay Theodore:** Well, to piggyback on what Chris was saying, so, yeah, the thing that could drive capital gains distribution in a mutual fund is if a redemption is needed and the fund manager has to sell securities, in an ETF, they can transfer out that basket in-kind without selling, so, less likelihood for capital gains.

The other nice thing about active ETFs is that if the fund manager wants to sell a security, an underlying security, for a gain because they're happy with the investment they made, they want to redeploy that cash, they can also handle that transaction in-kind with an authorized participant. So that's a nice benefit in that the fund manager can act in a way that they think is going to benefit the shareholders, but without worrying about generating capital gains when they make investment decisions. A fund manager, depending on kind of the manager's philosophy and how much they want to account for taxes, they might also sell securities within the portfolio to pocket a loss to carry forward against gains. Because ETFs, certainly, can still generate year-end capital gains distributions, they're just less likely because of that in-kind mechanism. So, I love that you can marry all the benefits of active but use that in-kind delivery process to really limit taxable gains that would need to be distributed.

**Jessica Sclafani:** Sure.

**Chris Murphy:** The other element too, Lindsay with the in-kind, and that was a really good synopsis of specifically how active ETFs can be just as tax efficient as passive ETFs is that we're able to also choose the tax lots in which we are redeeming out those individual stocks from the portfolio. In other words, we're able to choose the lower cost basis lots of all the stocks, for example, when we're met with the redemptions, so that we're effectively stepping up our cost basis in the ETF portfolio over time.

**Lindsay Theodore:** Yes.

**Chris Murphy:** So, when that active manager does decide to sell that stock, he or she is effectively selling that stock potentially at a loss, at a higher basis than they might have been if they weren't able to redeem out those lower cost basis lots of those stocks over time.

**Lindsay Theodore:** And that's still, when the investment, that underlying security where you've delivered out the tax lots to manage for eventually selling to limit the taxes, the investment could have made money and done well performance-wise, but you're just managing how much of that gain actually needs to be passed on to the shareholder. So, it's a really nice benefit for individuals. Because if you look at like one of the big benefits of individual stocks for the everyday investor is that they are tax efficient. You buy a stock, XYZ. It appreciates in value. You can sell shares, but you'll just owe capital gains tax on the difference between what you purchased it for and what you sell it for. But to diversify across many stocks and manage tax lots and make investment decisions about where to redeploy that stock if you sell it, it's a lot I think for many investors to handle.

**Jessica Sclafani:** It is a lot.

**Lindsay Theodore:** And so, it's just nice to be able to pass that on to a fund manager but also benefit from the tax-efficiency that individual securities have.

**Chris Murphy:** And the diversification that you get.

**Lindsay Theodore:** Correct. Oh, absolutely.

**Chris Murphy:** It has all the benefits of that stock, that intraday liquidity....

**Lindsay Theodore:** Exchange traded.

**Chris Murphy:** Exchange traded, controlling your...

**Lindsay Theodore:** taxes.

**Chris Murphy:** ...capital gains and tax situation. But you're diversified.

**Lindsay Theodore:** Right.

**Chris Murphy:** That's the difference with a lot of ETFs is that you're in a diversified basket of stocks either passive or actively managed.

**Lindsay Theodore:** Right. Yep.

**Jessica Sclafani:** So, let me stop us for a second. Let's pause here. Let me make sure that I'm with you. We've so far covered, I'm going to call it the nuts and bolts of ETFs and what makes ETFs more tax efficient. I feel like we've got our brains wrapped around that. But my experience is that people are not always rational, right? So, we've kind of gone through the rational piece. I'd love to hear from you, Lindsay, especially as someone who has experience as an advisor, how do you talk people through this? And is there kind of a behavioral element that we have to account for, too?

**Lindsay Theodore:** It's a great question. I think, with a mutual fund, if you hold it in a retirement account, these year-end distributions make no difference for you because that account is already tax deferred. So, if it's in Roth or a pretax 401(k) or a traditional IRA, capital gains distributions come and go, and you don't even realize it. Right?

**Jessica Sclafani:** And let me just double underline on that.

**Lindsay Theodore:** Double down?

**Jessica Sclafani:** Right, yeah. I mean it matters where...

**Lindsay Theodore:** Yeah.

**Jessica Sclafani:** ...we're talking about here.

**Lindsay Theodore:** Correct. Exactly. Because mutual funds still make a lot of sense, there are over 20,000 mutual funds and they've been around a lot longer, they have longer track records. So, there are lots of reasons to still have a mutual fund. It's just that they might be more appropriate in an account that's already tax deferred. Clients who want to invest in taxable accounts, they want the diversification, and they don't want the headaches of managing individual stocks, mutual funds.... I would get calls around October of every year saying, "what is the damage going to be this year?" Knowing that they have this many shares of this one fund that's done very, very well for them over the years, they just knew that they were going to have a big tax bill that they would have to save up for over the holidays to be able to pay in April, simply because holding that fund meant that likely they were going to have some capital gains distributions. It might have performed well, but it's just part of the process of investing in funds. The nice thing about ETFs is you can still participate in those gains, but you won't feel as much of a need to call your advisor and say, what's the damage this year in October because it's likely that it'll be minimal capital gains distributions in a taxable account.

**Jessica Sclafani:** Sure, sure. What's the damage?

**Lindsay Theodore:** Yeah.

**Jessica Sclafani:** And just kind of the unknown or...

**Lindsay Theodore:** Yes.

**Jessica Sclafani:** ...that surprise tax bill. No one, no one, likes that...

**Lindsay Theodore:** ...no one loves that. And it makes it hard to plan, like how much you're going to spend around the holidays. You know, what expenses, what vacations are you going to book for next year? All of the surprises with year-end tax bills that come from capital gains distributions, again, with a mutual fund held in a taxable account, it just can be a real behavioral, like, disincentive to save more in taxable accounts if that's what you're facing, right?

**Jessica Sclafani:** And then maybe if we were to, to flip that around, maybe understanding that ETFs can take the surprise tax bill out of the equation, maybe investors could be more motivated to invest in taxable accounts in addition to their retirement accounts.

**Lindsay Theodore:** Yes.

**Jessica Sclafani:** So, we're not, we're not trying to talk about what you should be doing in your 401(k) plan, we're really thinking about how can you have more tools in the toolbox...

**Lindsay Theodore:** Yep.

**Jessica Sclafani:** ....so that could be a taxable account. And then if we're talking about a taxable account, maybe the ETF would be more appropriate there, given that it can help us navigate some of the uncertainties around that October surprise that you mentioned.

**Lindsay Theodore:** Right. Right. Like you can still grow the money for the future, complement your other retirement savings with taxable savings, but not worry as much about that tax bill that you might owe at the end of the year. And the benefit, too, to saving in taxable just from a financial planning standpoint, and we've been through this before on other episodes, but, basically for folks who want to retire earlier or who just want to have a real diversified kind of mix of options for where they can source income from in the future, having some pre-tax, Roth, and then also taxable money--that will be, when they sell, is going to be taxed at capital gains rates--there are a lot of benefits to having diversification there. So...

**Jessica Sclafani:** Got it. So, it's not just diversification of equities, bonds, it's diversification by...

**Lindsay Theodore:** taxation.

**Jessica Sclafani:** Got it. Diversification by taxation. You heard it here first. And it even rhymes.

**Lindsay Theodore:** It does.

**Chris Murphy:** Let me add one more thing to that, and it might segue well into maybe what we're going to talk about next, but when you think about the ETF market and how it's grown and what you now as an investor have access to in the ETF wrapper, which has been predominantly passive or index-based strategies. Now having actively managed, institutional, high quality active management in the ETF wrapper for your taxable, nontaxable portfolios, you can now create some symmetry, right? Whereas you used active managers, maybe in your nontaxable or retirement accounts, but you just didn't have access to active management in the ETF, which is obviously more favorable in those non-qualified or taxable accounts, you can now create some symmetry between certain asset classes that maybe you want to go active in. Right? Where you just simply didn't have the chance to up until about five years ago, and I think that's a really powerful story, too, when you think about the growth of ETFs and the growth of active ETFs, is that now investors have the benefits of active management in the ETF wrapper that is much more favorable for taxable money whereas before they did not. And it can allow them to meet their goals and stay consistent across their portfolios more effectively.

**Lindsay Theodore:** Great point.

**Jessica Sclafani:** It is a great point. And that is something that I had on my list for us to talk about today, how I've always thought of ETFs as being really passive. And based on what you just shared and, and where I think we'll go today, that is no longer accurate. But I did want to come back to at the top of our discussion, I did say that we would share an example. So, we've kind of walked through how ETFs work. Why they offer potential tax advantages versus other



investment vehicles, like mutual funds or stocks. Lindsay, could you share an example with us so we can try to put some numbers behind this for folks?

**Lindsay Theodore:** So, my colleague Roger Young and I recently did an analysis. And we looked at two investors: one ETF investor and one mutual fund investor. Each started with \$100,000. The strategies are similar: active, large cap stock strategies, okay? So, they're attempting to outperform the index. That's the goal. Both investment vehicles performed similarly over five years and each of the account holders ended up with \$183,000.

**Jessica Sclafani:** Okay.

**Lindsay Theodore:** The difference was that the ETF, because of the in-kind redemption mechanism was able to generate virtually no capital gains. And the mutual fund, however, distributed over \$40,000 to the shareholder over those five years, resulting in about \$6,000 in taxes that were paid from other sources, in order to just have that \$183,000 at the end of the period. So, it's not that the ETF investor won't owe taxes, it's just that the mutual fund investor, if they reinvested, they are kind of paying the taxes as they go. And if they sold at the end of five years in one lump sum, they would owe less in taxes, theoretically. The ETF owner will owe more in taxes, but they'll pay capital gains, on their timeline, when they're ready. So just think of it as mutual funds are going to kind of have you pay a toll as you go, especially if you're reinvesting those distributions. You pay the taxes, you add to your basis. ETFs just give you the opportunity to grow that money, and then you pay the taxes when you're ready to sell your shares. Control is key.

**Jessica Sclafani:** Control is appealing, too.

**Lindsay Theodore:** It is. The taxes don't vanish, right? But you have more control over how and when you pay them.

**Jessica Sclafani:** Okay.

**Lindsay Theodore:** Which for a lot of investors is really appealing because at some point they'll retire, and they won't have as high income and they won't be putting kids through school, so, they won't be as sensitive to the taxes and maybe that's when they'll want to take gains, not in their peak earning years. Right?

**Jessica Sclafani:** So, they get to choose when.

**Lindsay Theodore:** And how much. Exactly. Because it doesn't have to be all the shares.

**Jessica Sclafani:** Helpful. So, Chris, I could see you getting excited about the active ETF discussion. So, I do want to come back to you to hear more. Just as a quick reminder for our listeners, when we talk about passive, we just mean an investment that's tracking the index. Chris, tell us what we should know about active ETFs.



**Chris Murphy:** Yeah, so, to your point, Jessica, passive means index based or a strategy that follows rules and a methodology, right? And ETFs are in a lot of ways synonymous with passive, and for good reason. I think like 90% or so of the assets are in passively managed or index-based strategies within the U.S. listed ETF market. Active ETFs are gaining share, right? 10% market share. But it's for good reason, right, that they're synonymous with passive. That's how they started. And that's where the assets are.

I think it's important to break apart ETFs meaning passive and mutual funds meaning active and them just being different wrappers in which you can access passive or active management, especially in...

**Jessica Sclafani:** I love that. Let me just stop you there because I think that, like for me, that was a light bulb moment. So, passive should not necessarily equate ETF just like active should not necessarily equate mutual fund.

**Lindsay Theodore:** Right.

**Chris Murphy:** Exactly right.

**Jessica Sclafani:** Yeah, that's great okay. We're with you. Keep going.

**Lindsay Theodore:** Just the wrapper.

**Jessica Sclafani:** Tell us more.

**Chris Murphy:** Yes. And so, you know when I think about indexing and the benefits and drawbacks, right, the benefits are it's rules-based, simplistic, it's usually at a lower cost given that it's a kind of a rules-based model type of investment strategy. But the drawbacks are you're indentured to those rules, right?

**Lindsay Theodore:** Right.

**Chris Murphy:** You can't be nimble and thoughtful about the way in which you're getting exposure to specific asset classes, whether it's equities or fixed income or international equities, that you can with an active manager that still can somewhat stay involved in those rules, understand kind of what the metrics are and which makes up that large cap growth, international large cap cohort of stocks that they can pick and choose from, but then pick and choose, do the bottom-up funnel research to decide which stocks they prefer and which stocks they don't want to own that I think is the real benefit of active management. Being able to go beyond the index, in a lot of cases, specifically in fixed income, potentially, to add additional opportunities to generate returns is a really important element of active management that passive simply can't do. And so when I think about how active ETFs are beginning to, kind of, make their name in the ETF market, in a lot of ways active ETFs have been a resurgence for active management.

**Jessica Sclafani:** And I think, you know I have to bring it up. Fees. We haven't talked about fees yet.

**Chris Murphy:** Yes.

**Jessica Sclafani:** But maybe you can just touch on that for ETFs and then active as well. I'll just share with you, I know in my research I tend to see that people say they're inclined to choose passive management, not because they think active management can't add value, but because they think the price tag or the fee is the most important component. It just reminds me we have to think about fees. So, I just would love to hear a few quick thoughts on fees.

**Chris Murphy:** Yeah. It's a really important point. And I think what, again, another benefit of now having active in the ETF wrapper is that the ETF is just more operationally efficient than a mutual fund. Meaning, it just...the costs associated with running an ETF are a lot less and don't eat into the investor's net expense ratio as much as a mutual fund would. And so therefore you're able to bring your fees down as well when you bring an active strategy into the ETF wrapper. An active ETF is going to be about half the average fee in that category relative to an active mutual fund. So, you're already coming at a head start, just simply on the operational costs of managing an ETF relative to a mutual fund. And getting closer to that pure competition of passive and the expense ratios that a lot of passive ETFs have, allowing that hurdle to be a lot lower for the active manager to have to beat, just simply on fees alone.

**Jessica Sclafani:** I must admit I am someone who often thinks about okay, well, what am I? What am I missing? Right? What could go wrong here? What am I forgetting to ask? So, I would love to hear from both of you, what are some of the aspects of ETFs that are important for investors not to overlook when they go to select an ETF?

**Chris Murphy:** I'll touch on more of the technical side of things, Lindsay, if you want to get into more of the practitioner side.

**Lindsay Theodore:** Sure.

**Chris Murphy:** Listen, these are exchange traded, like we mentioned. And so, you have to buy and sell your ETFs on exchange. And therefore, you have to be smart about how you introduce your trade into the market. Right? Just like a stock, setting a limit order, market order, not held order, are all the same order types you can do with an ETF. And you just need to be mindful of how you want to introduce that order into the market. You want to look at the liquidity profile. In other words, how often or how many shares on average does that ETF trade? And how much of my order is going to be that average daily volume? That will dictate the order type that you want to use. So, I think that's something that we spend a lot of time on in our ETF specialist team, educating investors and advisors on how to think about best execution when buying and selling an ETF, and thinking about introducing your order effectively and smart, throughout the market hours.

**Jessica Sclafani:** And I'm glad you brought up advisors in your comment there, Chris. I think for a lot of our listeners, maybe they won't necessarily be the one, to use your term, Chris, "introducing the order". But hopefully our conversation today can give them some questions or some thoughts to talk about with their advisor to understand how the advisor is introducing that order for them.

**Lindsay Theodore:** Yeah, I mean, I remember when ETFs first became more popular and mutual fund investors would be like, "why is it asking me for the order type?" like, because normally with a mutual fund you just purchase by dollar amount, and at the end of the day, you'll get whatever number of shares that buys you. Yeah, so ETFs if an investor is not familiar with stocks and how you have to put in the order type and you might have to put in a target price or something like that, it's just good to familiarize yourself with order types and talk to your advisor about the options there. Because Chris is right, you want some control.

**Jessica Sclafani:** What are some other aspects that maybe, because that was a great one, I don't think a lot of people would necessarily know that.

**Lindsay Theodore:** Yeah.

**Jessica Sclafani:** Any other aspects that investors might be overlooking when thinking about selecting an ETF?

**Chris Murphy:** Yeah, I think we touched on it earlier, Lindsay, if you want to go a little deeper on just, you know, asset location, right? And matching the ETF with the proper account type. Thinking about, you know, okay the benefits of the ETF, tax efficiency being one of the primary benefits really being realized, more pronounced, in a taxable account. Right?

**Lindsay Theodore:** Right.

**Chris Murphy:** Just about asset location where you're buying the ETF. What type of account you're buying them in.

**Lindsay Theodore:** Yeah, no I mean I think that's great and how we talked about earlier like when Roger and I did that analysis of the ETF versus the mutual fund...

**Jessica Sclafani:** The example.

**Lindsay Theodore:** And then the tax treatment. Yeah. The example, that was hypothetical, but it represented what realistically we've seen with active funds. You know, I think it's just really important to keep in mind that the type of account matters, even though the investment performance could be similar. If you have to pay \$6,000 or \$20,000 out of pocket from your savings or from your income sources to pay the taxes every year, then it just might be more beneficial to look for something more tax efficient where you have more control over when

those taxes are realized. So again, ETFs make a lot of sense in taxable accounts, but mutual funds can still make a lot of sense in your pretax or Roth accounts.

**Chris Murphy:** One more element, too, to think about is like we talked about earlier, the synonymy of ETFs and passive and all the indices that are out there, and one large cap growth index and another being very different than one another. And really doing your due diligence properly on passive ETFs, just as you would on an active strategy, is really critical. Going under the hood and understanding the methodology of that index.

**Jessica Sclafani:** Lindsay, my ears perked up earlier when you said that ETFs can generate taxable income.

**Lindsay Theodore:** Right.

**Jessica Sclafani:** Can you tell us more about that?

**Lindsay Theodore:** Yeah. So, it's a very good point. So, two things, stock ETFs can generate capital gains, or potentially not, because of the in-kind delivery mechanism. But it's also important to remember what kind of underlying securities you are investing in. If it's dividend paying stocks, or if it's REIT's (Real Estate Investment Trusts) or fixed income, Those all pay income, they pay interest. And so just like in a mutual fund, that interest, unless it's in a tax deferred account, is going to be subject to ordinary income tax. So, you just want to be mindful of the types of underlying investments. What do those actual securities pay in income? And then be prepared that you might have some taxes generated just because of what the underlying securities are. Okay?

**Jessica Sclafani:** I'm with you so kind of my ETF to do list things for me to look at would include to check the tax treatment of the underlying securities held in the ETF?

**Lindsay Theodore:** Correct.

**Jessica Sclafani:** Got it. Yep.

**Lindsay Theodore:** Because a Muni bond ETF could still be quite tax-efficient, especially if it focuses on Muni bonds from your state, then it can be triple tax free, for the most part, that income that you get. So yeah, be mindful of what is the ETF designed to do? If it's an income-oriented ETF, bond or stock income oriented, then likely it's going to generate some income. So, you just want to be aware of that. Yeah.

**Jessica Sclafani:** Good rule of thumb. Okay. I'm with you. The other thing that I again, you know ETF 101 person over here, I've read a bit about turnover. Can you talk about the implications of the turnover within the ETF?

**Chris Murphy:** Yeah so, in a lot of ways if you again depending on the index, if it's a passive ETF or even the manager's strategy in an actively managed ETF, turnover can be almost more pronounced in a passive index-based strategy than some actively managed strategies. And the ETF though allows to insulate a lot of what that turnover could potentially do, meaning generate capital gains for the shareholders because of that in-kind redemption process. Right? So again, going back to the in-kind process. When an index reconstitutes, or an active manager wants to sell and buy a new stock, that all is done in-kind. So, no matter how high a turnover, and ironically enough, the higher the turnover, the more applicable it probably is for the ETF because of that in-kind create redeem process.

**Lindsay Theodore:** Yeah. Yeah, and I think for investors who really like the concept of active management, they like the idea of attempting to outperform the index and lose less on the downside, as we believe one should aim for, I mean, there are some benefits to turnover in their mind, if the turnover means selling what's done well and buying what's undervalued. But the nice thing about the ETF wrapper is that that turnover, like switching of securities to get the best possible performance doesn't have to result in taxes to the shareholder.

**Jessica Sclafani:** Because of the assets in kind.

**Lindsay Theodore:** The in-kind delivery out and into the portfolio.

**Jessica Sclafani:** See we're learning.

**Lindsay Theodore:** We're learning. Exactly. So, turnover without the tax hit.

**Jessica Sclafani:** Got it.

**Lindsay Theodore:** Potentially.

**Jessica Sclafani:** And maybe the last thing that just occurs to me is we haven't really touched on liquidity. I know at the beginning we learned that ETFs, I think we said as of 2025, 4,000 to 4,500 listed ETFs. I think Chris, correct me if I'm wrong as of 2025, about \$12 trillion in ETF assets? About?

**Chris Murphy:** Yeah a little over \$12.5 trillion.

**Jessica Sclafani:** A little over \$12.5 trillion, okay. So, this is a big market that we're talking about. But what should investors be thinking about from a liquidity perspective?

**Lindsay Theodore:** I think part of the reason there are so many ETFs now is because there's certainly desire for diversified strategies, different types of approaches for investing, but also it's just easier than it once was to start an ETF and list it on an exchange. So, for investors the thing to be aware of is really look into what's the actual history of the ETF? What are the assets in it? Because the whole benefit of the ETFs is first and foremost that you can trade it on exchange.

When you go to sell, someone else will buy it from you. You just want to vet the ETF the way you would vet a mutual fund or an individual security. Right? What would you add to that, Chris?

**Chris Murphy:** Yeah, no, I think that's a really good point. And, you know, the fact that an ETF is exchange traded makes it really attractive to traders.

**Jessica Sclafani:** Right.

**Lindsay Theodore:** Right.

**Chris Murphy:** Right? And their ability to trade in and out of certain sectors or industries or asset classes, intraday, the snap of a finger. Is one of the real, I think, compelling aspects of the ETF structure for institutions, hedge funds, traders.

**Lindsay Theodore:** Yeah.

**Chris Murphy:** That value that intraday liquidity. But a lot of a lot of new ETFs that have come to market, aren't really portfolio building blocks, right? In other words, they're not really strategies you want to build around to create a diversified balanced portfolio.

**Lindsay Theodore:** Yeah.

**Chris Murphy:** Whereas a lot of the products are more geared towards trading.

**Lindsay Theodore:** Right.

**Chris Murphy:** But still at the same time, you need to think about that, what that liquidity profile, to your point, Lindsay, looks like, in introducing your order, as I've said before, appropriately into the market. One other thing there around, you know, convenience and maybe taking a step back, I think that nothing underscores more of a stamp of approval for ETF liquidity than what we saw in 2020, when obviously, we all remember that, that time in the markets, very stressful time in the markets.

**Lindsay Theodore:** Was it?

**Chris Murphy:** Just a little bit, just a little bit.

**Jessica Sclafani:** You had to bring it up.

**Chris Murphy:** But I mean, at the height of that market stress, Jessica and Lindsay, the Federal Reserve actually stepped in and purchased nearly \$7 billion worth of fixed income ETFs.

**Lindsay Theodore:** Oh, yeah.

**Chris Murphy:** To put that in perspective, right, that accounted for like 45%, I think, or something, 50% of the net inflows into some of those funds over like a four week stretch in which they began that purchasing program. You know, for the Federal Reserve to have their stamp of approval on ETF liquidity and access, I think it should rest assured that individual investors, feel confident that when they're buying and selling ETFs, that it's a viable strategy and a viable product, that they can build their assets in.

**Lindsay Theodore:** And it goes back to what you were saying, Chris, about why ETFs came on the market in the first place. We need to be able to stabilize and add a bit of liquidity in cases where there is a panic, like in the pandemic or on a Black Monday or whatever. So yeah.

**Chris Murphy:** Yeah.

**Lindsay Theodore:** It's nice to know that.

**Jessica Sclafani:** Okay, so we're going to switch gears again. Lest we forget, this is a retirement podcast, let's think about and talk about how ETFs can fit into overall retirement planning.

**Lindsay Theodore:** Great. Thanks Jessica. Yeah. So, some of this we've talked about that basically really important to diversify future sources of income in retirement. I have had many clients go into retirement with only pretax money and it makes it tough when RMDs kick in, Social Security kicks in and all of their income needs to come from pre-tax sources. So.

**Jessica Sclafani:** Taxation diversification.

**Lindsay Theodore:** Taxation diversification for the future is huge.

**Jessica Sclafani:** Yes, you talked about that.

**Lindsay Theodore:** And ETFs can help you get there because of less surprises at tax time, more money staying invested, all of those things. So, use those as a tool to diversify future income. And then similar to any investment strategy, have the right types of investment vehicles or investment wrappers across your taxable Roth and pre-tax accounts. An advisor can help you come up with the right mix and make sure your overall asset allocation is in line with your risk tolerance. Also think about with ETFs, if this is your taxable money and, you know some of it is earmarked for retirement, some of it's earmarked for near- or short-term goals, as you would for anything, make sure that the investment that the ETF focuses on is appropriate for your time horizon. General investing principles: Make sure that you've earmarked the money, you know what the goal is and have the right risk profile for the underlying securities.

And then definitely think about, when it comes to withdrawals or when it comes to sales of the ETF, as we've discussed, you don't necessarily add to your cost basis with capital gains distributions because you don't have very many at the end of the year. So, if you have a large, embedded gain in your ETFs down the road, be strategic just as you would with a large stock



position, individual stock position--take some gains in lower income years, Have a plan for how you're going to unwind the position because the whole benefit is that you can plan better for the income, cash flow, taxes with an ETF since you don't have the surprise tax bills so, use it to your advantage and have a plan for how you're going to eventually draw down on that position and pay the taxes on it. Because over time, imbedded gain can grow.

**Jessica Sclafani:** And that's what we heard from you earlier.

**Lindsay Theodore:** Yes.

**Jessica Sclafani:** Pay the taxes when you want. That's the control element that you've talked about.

**Lindsay Theodore:** Correct. Absolutely.

**Jessica Sclafani:** Okay. You also just, you used the word withdrawal. And I'm willing to venture that some of our listeners are already in retirement. So, if that applies to you, listener, congrats on being in retirement. If we have someone who's in retirement drawing income from investments, how should they think about ETFs in that drawdown plan?

**Lindsay Theodore:** Conventional wisdom is that you pull from your taxable accounts first in retirement, and then from your pre-tax accounts and then from your Roth. We find for many people there's a more optimal way of doing it. And that might mean actually pulling from your pre-tax investments, so, taking withdrawals from your traditional IRAs and pre-tax 401(k)s, in those years before Social Security starts and before Required Minimum Distributions start around 73 or 75, depending on your age. This way, you can defer your withdrawals from your taxable accounts for when you want your additional income to come from something that you pay capital gains tax on versus ordinary income tax on, because typically capital gains tax is more favorable, a lower percentage than ordinary income tax. So that's just an example of how you might think about managing your distribution strategy. This is where an advisor can really help to offer value on ways to think about that, based on the makeup of your assets, the embedded gains in the ETFs or funds you hold, and how to manage that over time.

**Jessica Sclafani:** That does add a lot of nuance and...

**Lindsay Theodore:** It does.

**Jessica Sclafani:** ...but it's helpful. We need to know the nuances to make these decisions

**Lindsay Theodore:** Sure.

**Jessica Sclafani:** or at least to ask our advisors.

**Lindsay Theodore:** Know the right questions to ask.

**Jessica Sclafani:** Right.

**Lindsay Theodore:** Totally.

**Jessica Sclafani:** And I have to tell you both, I now understand why we decided to devote a whole episode to the advantages ETFs can offer retirees to manage income and taxes, in sync. Yeah, there's a lot to cover there. And I hate to be the Negative Nelly, again, just looking out for my listeners here, what are some of the mistakes that you see clients making when it comes to ETFs?

**Lindsay Theodore:** I do think that some clients, especially when ETFs first came about and even today, the idea of an active ETF, they're like they're skeptical of it because it's like, "well, ETFs are only tax-efficient because they're passive." We've discussed how that's not the case.

**Jessica Sclafani:** We know that's not true.

**Lindsay Theodore:** It's because of their structure, active managers can be equally tax efficient. So, I just think getting over that behavioral roadblock of just "I'm not going to invest in them because I'm not familiar with what they are. I'm used to my mutual funds or my individual stocks" getting over that skepticism is key, because there's no catch. It's just the way they're structured. You can still benefit from the underlying investment strategy. And then over-diversification, I think like having ten ETFs that track the S&P 500, that is not diversification. So, overlapping holdings is a problem with ETFs the same way that it's a problem with mutual funds, or stocks or anything. Right.

**Jessica Sclafani:** Same problem. Okay.

**Lindsay Theodore:** So, you don't want to have too much overlap. And then the last thing I'd say for clients to be really, really cautious of is just chasing fads. So, because right now, there are ETFs that track the wine market, the rare artwork market, that track cryptocurrencies. If you want exposure there, just be mindful of, again, the risks, the liquidity, and then of course not having too much or a high percentage of your portfolio in those types of more speculative strategies.

**Jessica Sclafani:** So, I have to say, I have learned so much I feel a lot smarter. I hope that our listeners do, too. I'm going to go back to you, Chris, maybe just to wrap us up. And don't worry, Lindsay, I'm going to ask you the same question. Do you have any final takeaways for our listeners?

**Chris Murphy:** Yeah, I'll reiterate again, the ETF is just the vehicle. It's not a strategy. It's not passive, right. It's just the way to access either passive or active investing. So, think about what you're trying to achieve. Whether that's pure passive market exposure, active management, a specific theme or outcome that you want exposure to. Most likely an ETF can deliver that. So, I think reiterating that the ETF is just a vehicle.

Second is, and Lindsay just hit on this, look under the hood. Focus on quality, not just the type of investment strategy but who the issuer of that ETF is. Really get to understand what's their commitment to the ETF market? How are they constructing their portfolio? How does that ETF trade? What does this average daily volume look like? It's really important to you to make sure you're kind of dotting those I's and crossing those T's before you put that that order in and knowing who you're partnering with from an ETF issuer perspective and how that ETF is going to trade.

And then finally, you know, to the last point, there's a lot of options. It's a very complex market. You got to do your own research and ask the right questions. Be curious about what's out there, because it's a big, long, extended ETF market these days that I think makes it one, exciting and great that you have choice as an investor but also makes it more complex. So, asking those questions, being curious about what is available, what makes the most sense for you and your retirement strategy? Because, you know, you don't want to get caught off guard by not owning the right ETF for your own investment strategy.

**Lindsay Theodore:** Those are great points. I'll just follow on with what Chris was saying.

**Jessica Sclafani:** Go for it.

**Lindsay Theodore:** Totally agree that there are a lot of options out there, it can be overwhelming. Make sure that it aligns with your retirement strategy, with your financial plan. It's just a vehicle to get you to what your goals are in retirement or what your goals are down the road. So be mindful of that. work with an advisor if necessary.

And just because ETFs trade and are priced throughout the day doesn't mean you have to, not everyone buys ETFs for tax efficiency. Some people like, like Chris was saying do trade them actively, but many investors are fine just making sure that they're in the right set of investments and sticking to those for the long-term.

ETFs are a great complement to any retirement plan, so really think about where they fit in, how can you save more in taxable accounts but still manage to control your tax situation and diversify future income sources. And yeah, mutual funds are still valuable, really a great tool in, in pre-tax or in retirement accounts.

**Jessica Sclafani:** Well, thank you so much, Chris and Lindsay. That wraps up our deep dive into the tax savvy world of ETFs. Hopefully we're all feeling a little bit more tax savvy after today's discussion. We covered how in-kind exchanges can curb surprise distributions, why controlling when you realize gains matters, and practical ways to weave ETFs into a disciplined retirement strategy.

Again, I'm Jessica Sclafani, thank you for listening. Please tune in to our next episode when we'll be discussing tax planning to maximize savings and extend the life of your retirement portfolio. And if you like this podcast, and I know you do, please rate us and subscribe wherever you get



your podcasts. And remember, the numbers matter, but so does knowing you have the freedom to live with purpose and peace of mind.



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