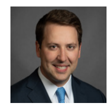
Active ETFs and Year-End Taxes

Evaluating the role of ETFs in managing capital gain distributions, tax loss harvesting, and annual tax consequences.

October 2023



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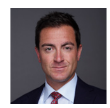

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KEY INSIGHTS

- Due to several operational features, ETFs generally have a more favorable structure for tax efficiency than some other investments, such as mutual funds.
- Actively managed strategies have delivered added performance during the past year, especially in small-cap blend equities and intermediate core bonds.
- Year-end tax loss harvesting opportunities are limited in 2023, but there are some categories that have been under pressure and in the red over certain time frames.

With year-end approaching, the time to evaluate capital gains consequences and "tax smart" strategies in nonqualified accounts is here. Opportunistically trading positions can have a meaningful impact on capital gains liability and after-tax performance. Whether there are tax losses to harvest or you have to realize a gain on a position to avoid a meaningful capital gain distribution, moving those assets into an exchange-traded fund (ETF) may have the potential to produce a tax-efficient portfolio moving forward. Active ETFs may be a good tool for investors to consider during this year's tax loss harvesting season. The active ETF market now offers investors access to well-known active asset managers, such as T. Rowe Price, along with the major ETF benefits of convenience, cost-effectiveness, and tax efficiency.

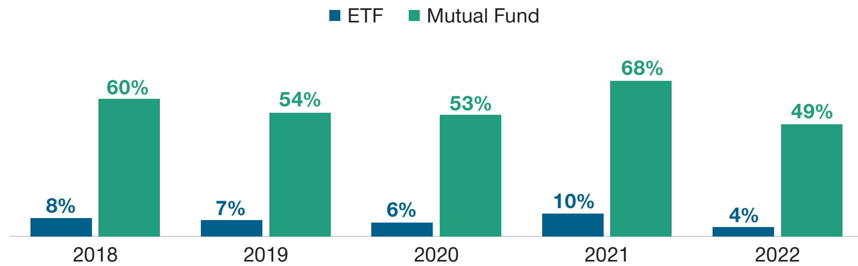
Why Consider Using an Active ETF as We Approach Year-End?

1. ETFs Have Been More Tax-Efficient

Historically, ETFs have been a more tax-efficient vehicle than some other investment structures, such as mutual funds. The main reason ETFs have been more tax-efficient is due to the ETFs' unique create/redeem mechanism and the ability for ETFs to facilitate outflows in kind. Even though ETFs may still generate a capital gain distribution, the impact of shareholders buying and selling doesn't play a role the way it does with mutual funds. Keep in mind, there are many factors that will impact the tax efficiency of an ETF and should always be taken into consideration (trading activity, issues procedures, time in market, etc.). For investors seeking a tax-efficient vehicle with the benefits of active management, active ETFs have the potential to add value to an investor's portfolio.

Percentage of Mutual Funds and ETFs That Distributed Capital Gains

(Fig. 1) Five years of historical data as of calendar year-end 2018–2022



Past performance is not an indication of future results.

Source: Morningstar Direct, calendar year data. Percentage of the total number of products that distributed long-term and/or short-term capital gains across all U.S.-listed mutual funds and ETFs. Percentages calculated on a per year basis at year-end, based on the Morningstar Direct database, and vary by year. See Additional Disclosure.

The graph above (Fig. 1) illustrates the percentage of all U.S.-listed mutual funds and ETFs that made capital gain distributions in each of the past five calendar years. It's a myth to say that an ETF will never generate a capital gain. But structurally speaking, they have done so at a rate far less than mutual funds.

2. Active Strategies Have Added Alpha in This Market

Dramatic shifts across equity market leadership, higher interest rates, and fears of an economic recession have presented an opportunity for active managers to deliver results. According to Morningstar's latest Active/Passive Barometer (as of 6/30/2023), 57% of actively managed mutual funds and ETFs were able to outperform their benchmark over the last 12 months. While active managers' performance varies between over- and underperformance relative to the passive benchmarks, there were specific market segments where active strategies showed significantly stronger relative performance. For example, according to the same Morningstar report, 75% of active small-cap blend funds and 60% of active intermediate core bond funds were able to add alpha against their benchmarks in the past year (see Fig. 2).

Percentage of Active Funds Outperforming Their Benchmarks

(Fig. 2) Twelve months as of 6/30/2023, all U.S. mutual funds and ETFs

Past performance is not an indication of future results.

Source: Morningstar's U.S. open-end and exchange-traded funds database (excluding money market and fund of funds), 1-year performance as reported in its Active/Passive Barometer study as of 6/30/2023. Percentage (rounded) of the total number of actively managed U.S.-listed mutual funds and ETFs that outperformed benchmark-based investable passive funds across the average of "All" (377 active/206 passive) Morningstar categories in the study and across intermediate core bonds (125 active/33 passive) and small-cap blend equities (170 active/70 passive) categories. Number of funds in each category based on the start of each period, subject to survivorship. All data calculated and reported by Morningstar, illustrated by T. Rowe Price. See Additional Disclosure.

3. Lower Fees for an Active Approach

When considering a move from mutual funds to ETFs, actively managed ETFs may also offer investors a way to reduce overall portfolio expenses in the process. Reduced expenses can help with the overall long-term outcome. ETF operational costs are often streamlined relative to active mutual funds with fewer shareholder services, client statement reporting, and other expenses. Well-established firms may have additional pricing advantages. By leveraging the global scope and scale of our firmwide resources, T. Rowe Price active ETFs are competitively priced relative their peer groups. For example, illustrated below (Fig. 3) are some examples of where T. Rowe Price active ETFs offer competitive fees relative to category averages.

Are There Tax Loss Harvesting Opportunities This Year?

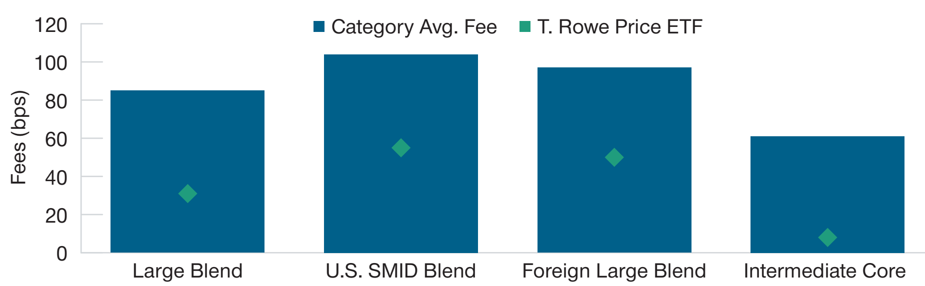
With solid market returns in 2023 (at the time of this writing), opportunities may be limited compared with last year. In 2022, with significant marketwide drawdowns, many negative return areas could be identified. There are a few themes in 2023 worth considering, depending on an investor's holding period and individual portfolio allocations. As always, personal investing circumstances do vary, so it's important to understand that these are general market-level observations and may not apply to individual investors. Investors should always consult their financial professional and tax advisors accordingly.

1. High Dividend Funds Are Ripe for Harvest

Dividend index funds, specifically those that screen for the highest dividend payers in the U.S., have faced some headwinds this year. These rules-based strategies tend to overweight more cyclical areas of the market like energy, financials, and utilities, which have been

Fee Comparison of T. Rowe Price Active ETFs

(Fig. 3) ETF total expense ratio versus category average of mutual funds



Mutual Fund Category	Category Avg. Fee	T. Rowe Price Active ETF Solution	Expense Ratio	Difference
Large Blend Equity	0.85%	TCAF	0.31%	54%
U.S. SMID Blend Equity	1.04%	TMSL	0.55%	49%
Foreign Large Blend Equity	0.97%	TOUS	0.50%	42%
Intermediate Core Bond	0.61%	TAGG	0.08%	53%

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Source: Morningstar Active/Passive Barometer study as of 6/30/2023. Percentage of the total number of actively managed U.S.-listed mutual funds and ETFs that outperformed their benchmark across all Morningstar categories, intermediate core bonds and small-cap equities. All data calculated and reported by Morningstar, illustrated by T. Rowe Price. See Additional Disclosure.

laggards in 2023. We think an active approach to U.S. dividend payers is a worthy alternative to rules-based passive dividend indices that lack the discretion to shift in changing markets and can be overexposed to just a handful of sectors.

2. Intermediate Core Bond Funds Still Under Water

Most passive intermediate core and core-plus bond funds remained in the red over the last three years. While investors may be tempted to realize losses and shift to short- or ultra short-term bonds, we believe duration remains an important component of asset allocation with the potential of a risk-off environment. Active intermediate bond strategies that can shift across multiple segments of the risk and maturity spectrum or that attempt to mirror the risk of the benchmark but exploit structural index inefficiencies are worth consideration.

ETFs generally have a more favorable tax structure, however investors should consult with their financial and tax professionals. There are many factors and considerations that can impact the tax efficiency of any investment and individual investor circumstances will vary.

Potential Tax-Loss Harvesting Opportunities	Strategies to Consider
High Dividend Funds are Ripe for Harvest High Dividend Funds	TDVG*, TEQI*
Intermediate Core Bond Funds Still Under Water Intermediate Core Bond Funds	TOTR, TAGG

***This ETF is different from traditional ETFs.** Traditional ETFs tell the public what assets they hold each day. This ETF will not. This may **create additional risks** for your investment. For example:

- You may have to pay more money to trade the ETF’s shares. This ETF will provide less information to traders, who tend to charge more for trades when they have less information.
- The price you pay to buy ETF shares on an exchange may not match the value of the ETF’s portfolio. The same is true when you sell shares. These price differences may be greater for this ETF compared to other ETFs because it provides less information to traders.
- These additional risks may be even greater in bad or uncertain market conditions.
- The ETF will publish on its website each day a “Proxy Portfolio” designed to help trading in shares of the ETF. While the Proxy Portfolio includes some of the ETF’s holdings, it is not the ETF’s actual portfolio.

The differences between this ETF and other ETFs may also have advantages. By keeping certain information about the ETF secret, this ETF may face less risk that other traders can predict or copy its investment strategy. This may improve the ETF’s performance. If other traders are able to copy or predict the ETF’s investment strategy, however, this may hurt the ETF’s performance.

For additional information regarding the unique attributes and risks of the ETF, please see the Additional Disclosures as well as the fund’s prospectus.

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Important Information

Call 1-800-225-5132 to request a prospectus or summary prospectus; each includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.

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ETFs are bought and sold at market prices, not net asset value (NAV). Investors generally incur the cost of the spread between the prices at which shares are bought and sold. Buying and selling shares may result in brokerage commissions, which will reduce returns.

Proxy Portfolio: Active equity ETFs based on existing T. Rowe Price mutual fund strategies (discussed in this piece: TDVG, TEQI) publish a daily Proxy Portfolio, a basket of securities designed to closely track the daily performance of the actual portfolio holdings. While the Proxy Portfolio includes some of the ETF's holdings, it is not the actual portfolio. Daily portfolio statistics will be provided as an indication of the similarities and differences between the Proxy Portfolio and the actual holdings. The Proxy Portfolio and other metrics, including Portfolio Overlap, are intended to provide investors and traders with enough information to encourage transactions that help keep the ETF's market price close to its NAV. There is a risk that market prices will differ from the NAV. ETFs trading on the basis of a Proxy Portfolio may trade at a wider bid/ask spread than shares of ETFs that publish their portfolios on a daily basis, especially during periods of market disruption or volatility and, therefore, may cost investors more to trade. The ETF's daily Proxy Portfolio, Portfolio Overlap, and other tracking data are available at troweprice.com. Although the ETF seeks to benefit from keeping its portfolio information confidential, others may attempt to use publicly available information to identify the ETF's investment and trading strategy. If successful, these trading practices may have the potential to reduce the efficiency and performance of the ETF.

Risk Considerations: Past performance is not a reliable indicator of future performance. All investments are subject to market risk, including the possible loss of principal. Active investing may have higher costs than passive investing and may underperform the broad market or passive peers with similar objectives. As with all equity investments, the share price can fall because of weakness in the broad market, a particular industry, or specific holdings. Fixed income investing involves risks, including, but not limited to, interest rate risk and credit risk. Diversification does not guarantee protection against losses.

T. Rowe Price Investment Services, Inc.

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