How ETNs Win Over ETFs

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You may have a client who is looking for a solid explanation of the difference between ETFs and ETNs. As an advisor, one thing you can tell them is that, while exchange-traded notes have their risks, they can also be much more tax-friendly than ETFs.

ETNs do have many of the same characteristics of ETFs, so it's understandable if clients don't easily comprehend their differences. For one, ETNs can be redeemed by the issuer just like an ETF. This redemption mechanism is what can give clients comfort that the ETN or ETF won't stray very far from its value, because a market maker can redeem each at the end of the day for fair value.

ETNs are, on the other hand, very different from ETFs when it comes to form. ETNs are debt issued by an investment bank, and clients investing in these vehicles would take on the credit risk of the issuer/sponsor. ETFs, which are funds, hold securities and do not depend on the sponsor's credit rating to get paid off in full.

If an ETF issuer went under, presumably the assets would revert to the fund owners and the issuer's credit problems would not affect ETF holders. But holders of ETNs are taking on the credit risk of the issuer; if the issuer went bankrupt, the ETN holders would become creditors of the issuer, not owners of a portfolio.

TAX DIFFERENCES

Because ETNs are not funds, they are taxed differently. ETN holders are only taxed if they sell or receive a distribution. ETFs must distribute all realized gains, dividends and interest each year, or risk losing their status as non-taxed funds.

Here is where the differences come into play.

ETNs are not invested in a portfolio; instead, each ETN will make a payoff at its maturity tied to a referenced portfolio or index. Portfolio changes made to the referenced portfolio will not create taxable distributions in an ETN, as changes to an ETF portfolio will.

A good example is the Dogs of the Dow Index. Here, every Dec. 31, the portfolio looks at the 30 stocks in the Dow, then readjusts so it will now own the 10 highest-yielding stocks for the following year. At the end of that year, the portfolio is readjusted again.

These portfolio changes will create taxable events in an ETF and create no taxable event to the holder of an ETN. This is because the ETN is debt referencing an index and it makes no distributions connected to the portfolio changes. If the ETN does make a distribution, it will be taxed as interest income. Thus, if one can stomach the counterparty risk of the issuer, clients pursuing the Dogs of the Dow strategy would be well-served by buying the ETN, not the ETF. ETNs are most useful for investing in portfolios that can change without triggering taxable distributions.

The ETN with the most assets is tied to MLPs; we believe this is because of the ETN's debt structure. This ETN would allow clients to get exposure to MLPs without receiving K1s or dealing with recapture at ordinary income rates. It can even be bought by tax-exempt entities that would not buy MLPs directly because of unrelated business taxable income worries.

The ETN pays interest to its holders equal to what one would have received if they held the MLP. MLP price swings can create gains/losses only if the ETN is sold. Most ETF funds flunk the test to be a mutual fund and must pay tax on the MLP distributions they receive, making them less attractive than the ETN, even given the credit risk in the ETN.

Another example in which the ETN affords favorable tax treatment relates to investments in gold. The ETF on gold is a Grantor Trust that owns physical gold. The gold ETF is taxed just like physical gold. A long-term gain on the gold ETF will be taxed as a collectible, with a maximum of 28%. The ETN tied to gold is taxed differently. Here, clients would be taxed as if they held a bond for more than one year. A long-term gain on the gold ETN would be taxed at a maximum of 20%.

Providing your clients this information should help them decide whether ETFs or ETNs are the right investment for them.