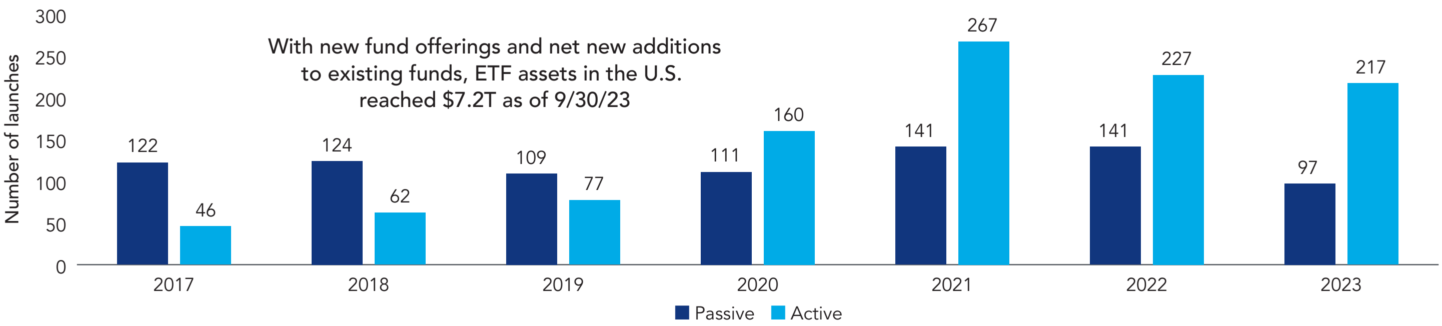
Three reasons investors value ETFs

Federated Hermes

Exchange-traded funds (ETFs) are popular with both institutional and individual investors. New funds continue to launch and investors continue to familiarize themselves with the features of ETFs compared to mutual funds. Below, we highlight three key reasons for their continued growth: tax efficiency, transparency and costs.

Exhibit 1 - New ETF launches



Sources: Morningstar, Inc., Federated Hermes; data as of 9/30/23

1 Potential for favorable tax treatment

Many taxable investors pursue strategies that seek to minimize their tax burden by using ETFs, as they tend to be more tax-efficient than mutual funds.

The same tax rules govern both mutual funds and ETFs, but mutual funds' structures limit their tax efficiency. Unlike mutual funds, ETFs (both active and indexed) can utilize in-kind redemptions (see more below) that can potentially mitigate year-over-year capital gains distributions. With an ETF's ability to reduce capital gains distributions, investors have better control over when they want to realize capital gains.

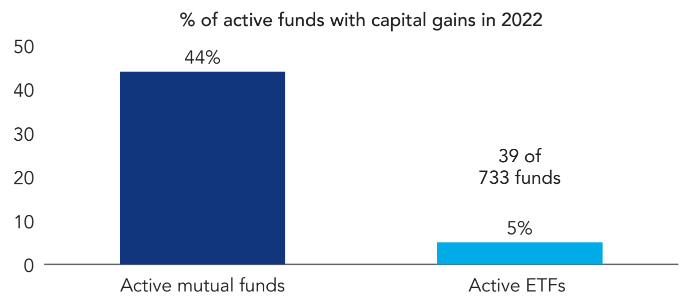
For individual investors with tax-deferred accounts, introducing more tax-efficient active ETFs into their taxable portfolios can allow them to increase overall portfolio tax efficiency by placing less tax-inefficient holdings, such as some fixed-income funds, into tax-deferred accounts.

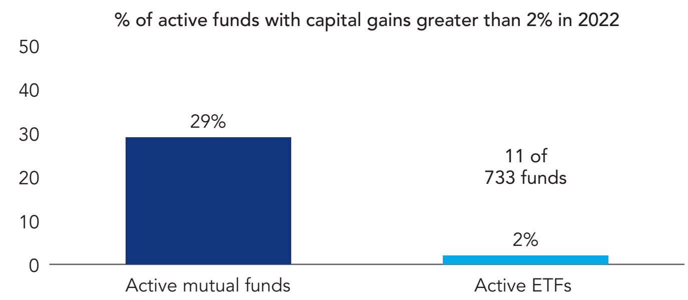
The potential to reduce exposure to unintended tax liabilities is an important element of an ETF's appeal. This is made possible in multiple ways, including:

- **In-kind redemptions:** The underlying shares that comprise ETFs are typically traded from one vehicle to another when a transaction occurs—called in-kind transactions—rather than through the sale of those securities on the open market. This does not create a taxable event and minimizes the buildup of large unrealized capital gains seen in mutual funds, which a shareholder is responsible for, even if they have only owned the fund for a short time. Remember, a capital gain (loss) would be realized if shares of the fund are sold at a higher (lower) price than at the time of purchase.

Exhibit 2 - Potential for reduced capital gains

With smaller distributions and the potential for better tax efficiency, active ETFs offer the opportunity to rethink how you build and allocate taxable portfolios.





Sources: Morningstar, Inc.; Federated Hermes. For illustrative purposes only and not representative of any specific investment. Data through 12/30/22.

- **Tactical positioning, including tax-loss harvesting:** Many mutual funds have frequent trading policies that protect shareholders from transaction costs and taxable events. ETFs don't have these same trading restrictions and can be used to create more tactical exposures with shorter holding periods without penalty. The in-kind transaction policy for ETFs allows for more frequent trading without incurring some of those costs that other shareholders might otherwise have to absorb.

  In addition to providing a way to quickly initiate a tactical allocation, ETFs can be part of a tax-loss harvesting strategy—selling a security at a loss, then replacing it with an ETF that provides market exposure. While waiting the 30 days to repurchase the security to effect the tax-loss, investors cannot replace the sold security with one "substantially similar."

While tax-loss harvesting can be implemented with any security or mutual fund, investors may find that daily holdings transparency, real-time pricing, intra-day trading and a wide variety of investing options may make a harvesting strategy using ETFs more appealing.

2 Daily transparency

Unlike the majority of mutual funds, the majority of ETFs allow investors to see daily holdings. Daily transparency provides the potential for investors to build more efficient portfolios by helping mitigate portfolio overlaps and avoiding unintended risk exposures.

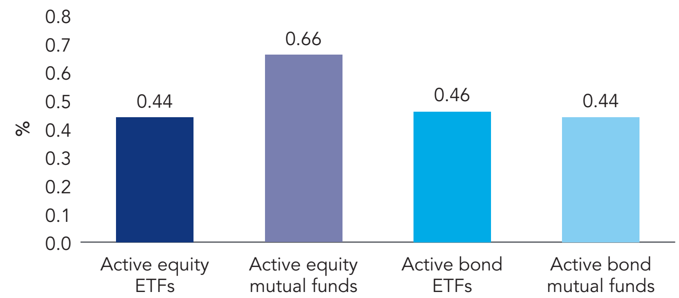
Markets and information move quickly. Daily holdings allow you to know what you own. This can be crucial in fast-moving markets. Like stocks, ETFs can be traded using limit orders, stop-loss orders and other trading features that target desired transaction prices. For investors who use active trading strategies to reduce portfolio risk, transparency may allow for more precise timing of trades at a desired price. The immediate pricing information may allow quicker position adjustments, helping mitigate risks.

3 Costs

An ETF may have lower associated operating costs than a similar mutual fund. These cost savings could be passed along to investors through lower expense ratios.

Actively managed equity ETFs have a much lower average expense ratio than mutual funds, with actively managed bond ETFs and mutual funds having similar expense ratios.

Exhibit 3 – Comparative expense ratios



Note: Expense ratios are measured as asset-weighted averages except for active bond ETFs, which is equal-weighted. Data exclude mutual funds available as investment choices in variable annuities.

Sources: Investment Company Institute, Lipper and Morningstar, Inc. See ICI Research Perspective, "Trends in the Expenses and Fees of Funds, 2022."

However, expense ratios do not capture all associated costs. Because ETFs utilize in-kind transactions when moving assets into/out of the funds, the costs associated with buying/selling securities in the fund are also minimized, accruing to the investors' benefit.

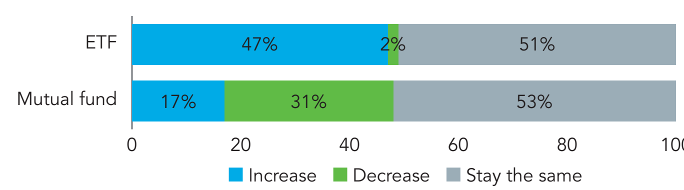
Also, because ETFs trade like stocks in a brokerage account, there may be commissions, but these are often minimal or non-existent, as commission-free trading is becoming more common. Similarly, mutual funds may have sales charges or 12b-1 fees, or be no-load funds available without a sales charge.

An attractive option for many investors

The popularity of ETFs is well-founded. By offering transparency and the potential for lower costs and tax efficiencies, ETFs tap into the needs and preferences of many investors. This alignment with investor demands positions ETFs as essential investment tools for the foreseeable future. According to a recently conducted internal survey, mutual funds are still utilized by over 30% of the registered investment advisers surveyed. However, in that same survey, advisors indicated that ETFs would become a bigger factor in their portfolios.

Exhibit 4 – ETF usage could increase

Planned vehicle usage by registered investment advisers



Source: Federated Hermes 2023 survey of RIAs and Independent Advisors. Data as of July 2023.

Investors should carefully consider the fund's investment objectives, risks, charges and expenses before investing. To obtain a summary prospectus or prospectus containing this and other information, contact us or visit FederatedHermes.com/us. Please carefully read the summary prospectus or prospectus before investing.

Mutual funds and ETFs are subject to risks and fluctuate in value.

Funds whose investments are concentrated in a specific industry, sector or geographic area may be subject to a higher degree of market risk than funds whose investments are diversified.

There is no guarantee that active ETFs will outperform passive ETFs and they may underperform. Active ETFs typically have higher expenses than passive ETFs, which can reduce performance.

This should not be construed as a recommendation regarding tax information. Consult your tax professional for more information.

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