



# Industry Insights

FROM SMEAD CAPITAL MANAGEMENT

## The Renaissance of the American Mutual Fund

*Mutual funds can match ETF tax efficiency, and why nobody has told you*  
 By Cole Smead, CFA, CEO & Portfolio Manager

Most financial advisors believe ETFs hold a structural tax advantage over mutual funds. They don't. They hold an operational one. The tax code treats both vehicles the same. The mutual fund industry simply isn't using the rules it has at its disposal.

The provision at issue is Section 852(b)(6) of the Internal Revenue Code, added by the Tax Reform Act of 1969. It exempts a regulated investment company from capital gains when it distributes appreciated securities in kind to a redeeming shareholder. Congress wrote this for the mutual funds of the Nixon era. The ETF (exchange traded fund) did not exist for another twenty-four years. The ETF adopted a tool built for the mutual fund.

### Same rules, different practice

Most ETFs and mutual funds are governed by substantially the same provisions of the Investment Company Act of 1940 and the same Subchapter M regulated investment company rules in the tax code. The in-kind redemption mechanism that makes ETFs famously tax-efficient is available to mutual funds today. No new legislation is required. No rulemaking is required. What is required is willingness.

The ETF employs the in-kind provision continuously. An authorized participant delivers shares and receives a basket of securities, profiting from the spread between basket NAV and market price plus any arbitrage on the underlying securities. The mutual fund can do it episodically, at the discretion of the adviser, when a large redemption arrives and the fund's board has approved the policies and procedures to execute it. Both routes flow from the same statute. Both produce the same tax outcome at the fund level.

### Why nobody told advisors

Charlie Munger said, "Show me the incentives and I'll show you the outcome." It is important to look at who benefits from the current narrative.

The ETF business is dominated by the largest fund families in the world. It is, in effect, an oligopoly. These firms are the loudest voices in fund taxation. They have no reason to remind the market that mutual funds share the same tool. The ETF is their growth engine. Goliath isn't quick on his feet. Adopting in-kind practices on the mutual fund side would mean amending policies, changing operations, retraining boards, and explaining to distribution platforms why a vehicle they have, as of more recently, written off is suddenly competitive again.

Wall Street has its own reason for silence. The ETF is a spread business. The more speculative the ETF, the more it trades. The more it trades, the more the croupier makes. The shorter-term nature of ETF trading is good for Wall Street. The question advisors should ask is whether it is good for their clients. Where the money goes, Wall Street goes. It is not always about the customer's yacht.

Service providers tell the same story. Fund service providers are seeing revenue growth from ETF launches. None of these parties will write what is written here, because it is not in their interest. ETF issuers, in particular, do not want this conversation in the open.



## What the mutual fund still does best

This is not an argument that ETFs are bad. They are excellent for what they do. Investors who want intraday liquidity, short-term trading vehicles, or pure passive exposure are well served. Many speculative ETF prospectuses say outright that they are not long-term investment vehicles. Fair enough.

But the mutual fund is built for a different investor. It prices once a day at 4pm New York time, which is exactly what 401(k) plans need to give participants a single execution price. It does not require a brokerage account. The cheapest mutual fund share classes (Y, R6, Z) often carry no platform fee, no trading fee, and no spread paid every time money moves. And the investor always gets NAV. The value of a dollar invested is not having a corner clipped off as it passes between the fund and the shareholder.

Add tax-efficient in-kind redemptions to those structural advantages and the conversation changes. The mutual fund stops being the loser of the after-tax era. It becomes a serious option again for the long-term taxable investor.

## To the mutual fund industry: stop hiding

The mutual fund industry has spent the past decade watching assets bleed to the ETF. Some firms have responded by launching ETFs of their own, or by converting funds into ETFs. Those are real strategies, but neither guarantees success. They are not the only strategies.

Mutual fund firms have a story to tell, and they are not telling it. Advisors do not know that their actively managed mutual fund can defer taxable gains the same way the ETF on the next page of the lineup can. Boards do not know that adopting in-kind procedures is within their authority today.

Compliance officers do not know that large dealers stand ready to facilitate these transactions for funds that have done the work.

Avoiding this conversation is a choice. Some firms are making it because change is hard. Others because their service providers are quietly steering them toward ETF conversions. Whatever the reason, the silence costs shareholders real money in taxable accounts every year.

If Congress later decides to narrow Section 852(b)(6), it would likely affect all registered investment companies. All we can ask for is a level playing field for the long-term investment vehicle that we know the mutual fund to be. Until then, every mutual fund company that ignores the in-kind tool is choosing to leave shareholder dollars on the table.

## To the advisor: ask the question

When a wholesaler from a mutual fund family next walks into your office, ask one question. Does your trust have in-kind redemption policies in place, and have you used them? The answer will tell you whether the firm is serious about after-tax returns, or whether it is still treating tax efficiency as a problem to be solved by issuing yet another ETF or the future use of ETF share classes on a mutual fund.

The mutual fund didn't predict the rise of the 401(k) when it was created in the Revenue Act of 1978. It adapted to the rules that were on the books. The industry adapted in a pre-tax world then. It can adapt in an after-tax world now.

***The renaissance of the mutual fund is afoot.  
The rules permit it. The data demands it.  
The only question is which firms will lead, and  
which will be quietly doing nothing.***

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