

2010 Year End Tax Management: Tax Planning Amid Unprecedented Uncertainty

Ben Franklin famously quipped that there are two certainties in life: death and taxes. However with today's tax policy, uncertainty is the only certainty. There are more questions than answers this tax season. Will Congressional gridlock result in the expiration of the Bush tax cuts? Will investors have to stomach higher income taxes along with higher capital gains rates and dividends being taxed as ordinary income? Will Congress support President Obama's plan to increase taxes only for individuals earning more than \$200,000 and families that make more than \$250,000?

So how do you plan with so many fiscal and political unknowns? To protect your clients' portfolios in a variety of possible tax scenarios, you require the most up-to-date information and insights from tax aware practitioners. *2010 Year End Tax Management* presents the expert perspectives you need to get a jumpstart on tax season. In the following pages, Glenn Frank, CFP, CPA/PFS, a perennial *Worth* magazine Top Wealth Advisor and Director of Investment Tax Strategy at Lexington Wealth Management in Lexington, Massachusetts and Steven B. Young, CFA and Chief Investment Officer for the Asset Management Group at Curian Capital, LLC in Denver, Colorado where he is responsible for strategic asset allocation and capital market analysis and chairs the Investment Policy Committee, address the unique challenges of the 2010 tax planning season, present the strategies you'll need to plan amid unprecedented fiscal uncertainty and provide insights into how tax efficient ETFs can present seamless, transparent, and cost-effective investment options during this year's challenging tax planning process.

ACTIONABLE ADVICE: HOW TAX AWARE ADVISORS ARE ADVISING CLIENTS AT YEAR END

As you meet with clients for annual tax planning, you face a significant challenge: unprecedented uncertainty with future tax policy, exacerbated by acute market volatility. The following strategies can help you maximize your clients' after tax gains in 2010 and position their portfolios for increasing taxes in the future.

1. EVALUATE LOSS CARRYOVERS

With tax laws in such flux, it's a comfort to look back before looking to the future. In the view of Glenn Frank, a perennial *Worth* magazine Top Wealth Advisor and Director of Investment Tax Strategy at Lexington Wealth Management in Lexington, Massachusetts, all tax analysis should begin with a thorough evaluation of last year's federal and state tax returns to ascertain both the current marginal tax rate for the client and the size of any capital loss carryovers. "We'll also note whether they are

subject to the Alternative Minimum Tax (AMT) and, if they were snared by the AMT, how tight the hold might be," he explains. "Often, especially with our retired clients, we are the ones determining their tax bracket based on how they invest and from which accounts we take withdrawals. Capital loss carryovers can have implications on where we locate assets going forward and which accounts we liquidate first."

According to Frank, large capital loss carryovers are a valuable asset, a "get out of tax jail free card that you have to decide when to play." Job one, then, is to consider the size of a capital loss carryover and analyze how long it might last. "Some people may have such large capital loss carryovers that they may never use them up in their lifetime," Frank explains. "Others, with the return of some reasonably strong markets, could use them up in a few years."

Frank stresses that the lifespan of the capital loss carryovers heavily influences investment location strategies, gifting strategies, and drawdown strategies. For example, if it looks like a client will be hard pressed to use up his losses, Frank says one plan—assuming the client holds taxable and retirement accounts—is to shift bonds out of taxable accounts and replace them with equities, especially if a client is predisposed to hold high turnover equities. "When we move equities into the taxable account, we are not making any change to the overall asset allocation, just a change to the location of the fixed income and equities," he explains. "As the market returns to normal, equities ideally appreciate, and as we sell these appreciated equity positions, the clients' gains are all offset against their substantial capital loss carryovers."

Continues Frank, "If you do the math, relocating equities to a taxable account is pretty compelling. If equities were left in the retirement account, appreciation would be taxed as ordinary income when withdrawals were eventually made. However, if held in a taxable account, depending on how long my capital loss carryovers last, withdrawals could be tax free."

2. TAKE CURRENT LOSSES

"Take losses when you have them" is Frank's longtime tax planning mantra. This year, he will follow that advice to take losses to reduce long-term gains even when clients have had limited chances to realize gains in this uncertain environment. While many investors and advisors give up on tax loss "harvesting" in years when investors have not registered significant gains, Frank says the exercise is never a waste of time. What many are missing, Frank says, is that losses in excess of \$3,000 can usually be carried forward forever. Remember, harvested losses can offset your clients' gains and up to \$3,000 of net capital losses can be deducted from their ordinary income on their tax return for the year. Net losses above that \$3,000 can be carried over to future years until they've all been used up by future portfolio gains.

"Stockpiling losses today can enable an investor to keep more of future gains," Frank explains. "As the market transitions out of recession and moves securely into positive territory, particularly if we expect capital gains tax rates to increase (See Appendix, *Potential 2011 Tax Rates*), the tax loss "harvesting" approach makes even more sense. Simply, losses you book today mean gains that are otherwise likely to be taxed at a higher tax rate in the future could be tax free."

In fact, the imminent increase in capital gains rates may be enough to help advisors with clients who couldn't be persuaded to take substantial losses last year, and who still may harbor unrealized losses from the 2007 to 2009 bear market, to bank losses this year to offset future gains.

Steven B. Young, CFA and Chief Investment Officer for the Asset Management Group at Curian Capital, LLC in Denver, Colorado, stresses that tax loss "harvesting" should not simply be relegated to a year end activity. Rather, he says advisors should seek opportunities throughout the entire year to use extreme market volatility to their clients' advantage. "The ongoing harvesting of losses is especially important in a market like the one we are currently experiencing with dramatic swings in either direction,"

Young explains. "Advisors can seize upon the daily volatility in the stock market to lower the client's tax bill. Those significant drops in the market are opportunities to harvest losses. If you look at the market's historical tendencies, the summer and September have a reputation of being stressful and, therefore, prime times for looking for tax loss harvesting opportunities. If you are an advisor counseling a client through market turbulence, what a great value-add it is to point to something positive to do with those losses."

3. EXCHANGING ASSETS

Behavioral finance teaches us that investors have a strong aversion to selling under-performing positions because they believe such holdings will bounce back in time. Advisors can manage this anxiety by selling a losing position and simultaneously purchasing a comparable security that allows them to maintain their exposure to the asset class without violating wash sales rules which prohibit selling and then buying the same security within 30 days.

Explains Young, "Clients get focused on not wanting to take a loss, but I stress that taking a loss and exchanging for a comparable asset does not affect the value of their account. If I take the loss and take the proceeds from that loss and keep it exposed to a comparable asset class with an ETF, then if the market does rebound, the portfolio benefits from that. However, when investors choose to let those losses disappear and not take advantage of them, they are costing themselves money."

In fact, through Young's approach, once selected positions are liquidated, the proceeds are immediately invested in an ETF that has been pre-selected according to the client's investment model, so there is no time out of the market.

"Interestingly, while today's volatile and transitioning market creates the ideal scenario for advisors to add value by using tax losses and exchanging assets, the approach is still underused as a value-add," explains Young. "In fact, a recent Cerulli report, *Managed Accounts 2009*, found that just 27% of advisors engage in these practices."

Using ETFs for Year End Planning

The increasingly broad array of low cost ETFs makes using tax losses and exchanging assets an easier tactic to employ. For example, financial stocks are an area that could be considered this year. Someone with one or more stock holdings in the sector could sell to create losses and then direct the proceeds into a financial sector ETF, such as the Financial Select Sector SPDR® (XLF). ETFs also are effective replacements for losing mutual funds. Suppose an investor owns shares of a US large cap equity mutual fund that has declined even more than the S&P 500® Index. In lieu of waiting 31 days to reinvest the proceeds from the sale of the mutual fund, a more effective strategy may be to immediately reinvest the proceeds in an ETF based on an index that offers similar exposure—such as the SPDR S&P® 500 ETF

(SPY). Through this approach, the investor maintains closely comparable market exposure while harvesting losses that can be used to offset gains within the overall portfolio.

ETFs can be effectively used as temporary placeholders in transition management situations when, after selling out of a position the investor needs time to evaluate potential asset managers. But across a broad array of asset classes, styles and capitalizations, the ETF provides a compelling buy and hold strategy due to their increased diversification, low fees, tax efficiency and low turnover which should result in fewer capital gains when held over the long term.

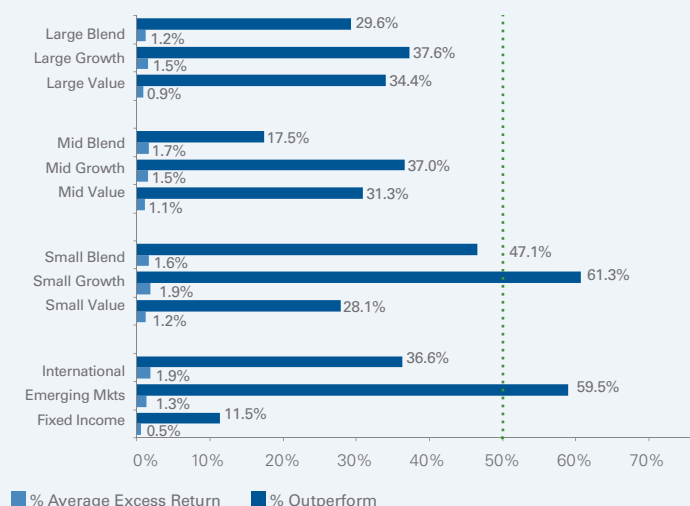
FIGURE 1: BROAD ASSET CLASS LOSSES AND ETF TO CONSIDER AS SWAPS

| | YTD 2010 (%) | 1 YEAR (%) | 2 YEARS (%) | 3 YEARS (%) | SPDR ETFs TO CONSIDER |
|--|-----------------|---------------|----------------|----------------|---|
| US EQUITY (INDEX) | | | | | |
| LARGE CAP (S&P 500 INDEX) | 3.89 | 10.16 | 1.27 | -7.16 | SPDR S&P 500 (SPY) |
| MID CAP (S&P MIDCAP 400 INDEX) | 11.57 | 17.78 | 6.82 | -1.67 | SPDR Dow Jones Mid Cap (EMM) |
| SMALL CAP (RUSSELL 2000® INDEX) | 9.12 | 13.35 | 1.25 | -4.29 | SPDR Dow Jones Small Cap (DSC) |
| TOTAL MARKET (RUSSELL 3000® INDEX) | 4.78 | 10.96 | 1.90 | -6.59 | SPDR Dow Jones Total Market (TMW) |
| INTERNATIONAL EQUITY (INDEX) | | | | | |
| DEVELOPED INTERNATIONAL (MSCI EAFE® INDEX) | 1.46 | 3.71 | 3.75 | -9.06 | SPDR S&P World ex-US (GWL) |
| CHINA (FTSE XINHUA 25 INDEX) | 1.80 | 7.37 | 15.91 | -8.23 | SPDR S&P China (GXC) |
| RUSSIA (DAXGLOBAL® RUSSIA+ INDEX) | 6.34 | 20.87 | 9.44 | -9.33 | SPDR S&P Russia (RBL) |
| JAPAN (MSCI JAPAN INDEX) | 3.09 | 0.25 | -0.10 | -9.95 | SPDR Russell/Nomura PRIME™ Japan (JPP) |
| SECTORS AND INDUSTRIES (INDEX) | | | | | |
| ENERGY (S&P ENERGY SELECT SECTOR INDEX) | -0.21 | 6.03 | -4.35 | -7.57 | Energy Select Sector SPDR (XLE) |
| HOMEBUILDERS (S&P HOMEBUILDERS SELECT INDUSTRY INDEX) | 5.50 | 6.44 | -9.18 | -8.30 | SPDR S&P Homebuilders (XHB) |
| OIL EQUIPMENT (S&P OIL & GAS EQUIPMENT & SERVICES SELECT INDUSTRY INDEX) | 5.05 | 7.94 | -3.85 | -8.51 | SPDR S&P Oil & Gas Equipment & Services (XES) |
| FINANCIALS (S&P FINANCIAL SELECT SECTOR INDEX) | 0.52 | -2.81 | -13.76 | -23.28 | Financial Select Sector SPDR (XLF) |
| BANKS (KBW BANK INDEX) | 8.91 | -1.20 | -15.81 | -22.03 | SPDR KBW Bank (KBE) |
| CAPITAL MARKETS (KBW CAPITAL MARKETS INDEX) | -9.75 | -14.10 | -7.85 | -19.70 | SPDR KBW Capital Markets (KCE) |
| MORTGAGE STOCKS (KBW MORTGAGE FINANCE INDEX) | 1.72 | -0.29 | -12.33 | -35.77 | SPDR KBW Mortgage Finance (KME) |
| REGIONAL BANKS (KBW REGIONAL BANK INDEX) | 4.20 | 9.17 | -17.49 | -17.04 | SPDR KBW Regional Banking SM (KRE) |
| US REITS (MSCI US REIT INDEX) | 19.63 | 30.54 | -3.16 | -6.07 | SPDR Dow Jones REIT (RWR) |

Source: MSCI, DAX Indices, FTSE, Russell, S&P, KBW, SSgA Strategy & Research as of 9/30/2010.

The active versus passive argument also supports the decision to use an ETF for a long-term “swap and hold” position. Recent research indicates that active works best in less efficient markets, whereas passive tends to outperform its active opponents in efficient markets. State Street Global Advisors’ whitepaper, *Passive and Active Management: A Balanced Perspective*, suggests that over the long term, a fifteen year period ending December 31, 2009, active managers beat their corresponding benchmarks in only three asset classes—small cap blend, small cap growth, and emerging markets. In comparison, passive fared best in the fixed income, large cap value, large cap blend, large cap growth, mid cap blend and mid cap value asset classes.¹ In many cases, an ETF is more diversified than its portfolio predecessor. Especially in today’s uncertain market, increasing diversification can temper portfolio risk and improve risk-adjusted performance.

FIGURE 2: PERCENT OF ACTIVE MANAGERS OUTPERFORMING WITH AVERAGE EXCESS RETURN FOR OUTPERFORMING FUNDS—15 YEAR ANNUALIZED PERIOD



Source: Morningstar Direct, SSgA Strategy & Research as of 12/31/2009.

Based on Morningstar data for the past 15 years, ending 12/31/2009. Chart shows the percent of active strategies that outperform the corresponding benchmark by category. Mutual fund performance is net of fees; index performance is gross of fees. The following indexes were used as benchmarks: Barclays Capital Aggregate Bond Index for Fixed Income, Dow Jones U.S. Total Stock Market Indexes for the respective domestic equities, the MSCI EAFE Index for international equities and the MSCI Emerging Markets Index for emerging market equities. For illustrative purposes only. Past performance is not indicative of future results.

ETFs’ TAX EFFICIENCY POTENTIALLY MORE VALUABLE IN CURRENT ENVIRONMENT

One way risk-adverse investors can squeeze out return in a difficult rising tax environment is to keep an eye on investment costs and favor tax efficient investment products. Among their many advantages—intraday liquidity, transparency, and ease of use—ETFs are highly touted for their low cost and tax efficiency. Note that tax efficiency

refers to how well an investment protects investors from paying taxes while they own it.

First and foremost, unlike mutual funds, it is rare that ETFs generate significant capital gains distributions. Traditional mutual funds are required to pass any realized capital gains on to investors as a capital gains distribution. These realized capital gains could be the result of portfolio turnover related to portfolio manager decisions. Capital gains can also be realized due to fund redemptions, when the portfolio manager must sell securities to raise cash for a redemption. This distribution is taxable to the investor regardless of how long he or she held onto the fund shares (the decisive factor is the record date for the distribution). Mutual fund investors can receive big capital gains tax bills, even in years when those funds register double-digit losses.

Index mutual funds and ETFs often follow an index and tend to have low turnover, which reduces the potential for capital gains. Due to the way ETFs are structured, capital gains distributions for ETFs have historically been only a fraction of the average capital gain distribution for a mutual fund. For most investors, ETFs are bought and sold on the secondary market. As a result, when an investor sells ETF shares, there is no impact to the portfolio and the portfolio manager is not required to sell securities to raise cash for the redemption—unlike a traditional mutual fund. For very large purchases and redemptions, there will be a creation or redemption of ETF shares as a basket trade with the ETF’s market makers. This is considered an in-kind transaction. Such transactions are not subject to capital gains taxes. In fact, most trading in ETFs takes place between shareholders, shielding the funds from the need to sell stocks to meet redemptions.

FIGURE 3: AVERAGE CAPITAL GAINS DISTRIBUTIONS OF ETFs VS MUTUAL FUNDS

| | AVERAGE MUTUAL FUND CAPITAL GAIN DISTRIBUTION | AVERAGE ETF CAPITAL GAIN DISTRIBUTION |
|------|---|---------------------------------------|
| 2000 | 1.79 | 0.13 |
| 2001 | 0.33 | 0.02 |
| 2002 | 0.11 | 0.00 |
| 2003 | 0.13 | 0.01 |
| 2004 | 0.45 | 0.03 |
| 2005 | 0.76 | 0.05 |
| 2006 | 1.03 | 0.04 |
| 2007 | 1.48 | 0.08 |
| 2008 | 0.32 | 0.00 |
| 2009 | 0.04 | 0.04 |

Source: SSgA Strategy & Research. Based on Lipper data as of 12/31/2009. Past performance is not indicative of future results. ETF capital gains are exclusive of inverse and leveraged products.

ETFs also potentially offer tax advantages relative to other types of index funds. In comparing the average capital gain distribution for the SPDR S&P 500 ETF (SPY) relative to the average S&P 500 Index fund, 1996 marked the only year that SPY distributed a capital gain since the funds' inception—with a distribution of 0.16%. In the same year, the average S&P 500 Index mutual fund distributed an average capital gain of 2.43%. Over the analysis' 15-year period, SPY distributed an average of 0.01%, versus 1.64% for the average S&P 500 Index mutual fund.

FIGURE 4: CAPITAL GAINS DISTRIBUTIONS AS A PERCENTAGE OF NAV*

| | SPDR S&P 500 ETF (SPY) | AVERAGE OPEN END S&P 500 INDEX FUND |
|------------|------------------------|-------------------------------------|
| 1995 | 0.00 | 4.76 |
| 1996 | 0.16 | 2.43 |
| 1997 | 0.00 | 3.72 |
| 1998 | 0.00 | 2.24 |
| 1999 | 0.00 | 1.79 |
| 2000 | 0.00 | 2.20 |
| 2001 | 0.00 | 0.51 |
| 2002 | 0.00 | 0.11 |
| 2003 | 0.00 | 0.14 |
| 2004 | 0.00 | 0.50 |
| 2005 | 0.00 | 0.81 |
| 2006 | 0.00 | 0.99 |
| 2007 | 0.00 | 1.75 |
| 2008 | 0.00 | 1.34 |
| 2009 | 0.00 | 0.33 |
| Average | 0.01 | 1.57 |
| Cumulative | 0.16 | 23.62 |

Source: Bloomberg, Morgan Stanley, as of 12/31/2009.

*Year-end NAV

Further, due to their passive management strategies, ETFs generally offer a fee advantage—not just over actively-managed mutual funds, but also over index mutual funds. Some ETFs have expense ratios as low as 0.06%, but ratios are typically between 0.30% and 0.95%. That's compared to the mutual fund average of about 1.5%.²

FIGURE 5: THE ETF EXPENSE ADVANTAGE

| ASSET CLASS | INDEX MUTUAL FUND AVERAGE EXPENSE RATIO | ETF AVERAGE EXPENSE RATIO | ETF EXPENSE ADVANTAGE |
|------------------|---|---------------------------|-----------------------|
| MID CAP VALUE | 1.69 | 0.48 | 1.21 |
| SMALL CAP GROWTH | 1.47 | 0.39 | 1.08 |
| SMALL CAP VALUE | 1.47 | 0.44 | 1.03 |
| MID CAP GROWTH | 1.37 | 0.48 | 0.89 |
| LARGE CAP GROWTH | 1.07 | 0.41 | 0.66 |
| LARGE CAP VALUE | 0.86 | 0.39 | 0.47 |
| SMALL CAP BLEND | 0.92 | 0.53 | 0.39 |
| MID CAP BLEND | 0.81 | 0.45 | 0.36 |
| INTERNATIONAL | 0.85 | 0.51 | 0.34 |
| FIXED INCOME | 0.42 | 0.19 | 0.23 |
| LARGE CAP BLEND | 0.65 | 0.48 | 0.17 |
| EMERGING MARKETS | 0.84 | 0.68 | 0.16 |

Source: Morningstar Direct, SSgA Strategy & Research as of 12/31/2009. Morningstar average net expense ratio for index mutual funds, and exchange traded funds by size and style categories.

TAX SWAPS AND THE "WASH-SALE" RULE

A tax-swap is defined as the sale of one security followed by the simultaneous purchase of a similar investment. The sale of a security purchased at a higher price may trigger a loss, which can be used to offset gains elsewhere in the portfolio. This may help reduce taxes due for the current year. In addition, losses can be carried forward (up to a \$3,000 annual maximum deduction)⁸ and used to offset gains in future years. Most importantly, tax swaps provide investors with the opportunity to maintain or alter their desired market exposure when they do take a loss.

Investopedia.com defines the Wash-Sale Rule as "an Internal Revenue Service (IRS) regulation prohibiting a taxpayer from claiming a loss on the sale of an investment when the same or a materially similar investment was purchased within 30 days before or after the sale date."

To put this into context, remember a time when a stock within your portfolio decreased in value. At the time, you very clearly lost money yet, due to existing tax laws, you could not take the loss on your federal tax return until you sold the stock. Seemingly simple concept, right? Such a situation could prove to be a problem if you sell the stock and deduct the loss only to find that in reflecting upon the value you may potentially miss, you decide to buy back the stock right away. This scenario is precisely where the wash-sale rule comes into play. If you buy a materially similar replacement stock shortly after the sale—or shortly before the sale—the investor does not qualify to deduct the loss so that your tax benefit is squandered or "washed away".

4. MANAGE SHORT-TERM GAINS

In normal market environments, short-term gains should be carefully monitored and matched up with short-term losses, especially for high-net-worth clients. This avoids having those gains taxed at ordinary income rates versus the current 15% rate on long-term capital gains. In today's volatile market with higher taxes on the horizon, managing short term gains takes on additional importance. This year, taxing assets at regular income rates tops out at 35%, but if the Bush tax cuts sunset in December, that top rate will increase to 39.6% (For additional discussion on potential future tax policy, please reference the Appendix, *Potential 2011 Tax Rates*).

The extra attention is especially necessary, says Young, because today's choppy market has many investment professionals practicing tactical asset management, either as a replacement for strategic asset allocation or as an enhancement or overlay to a strategic asset allocation model. While strategic asset allocation establishes a "set it and forget it" initial asset mix of equities, fixed income and cash to be rebalanced annually, tactical asset allocation views the initial asset mix not as a constant, but as a starting point. Based on evaluations of macroeconomic and leading indicators for various markets, sectors, and asset classes, tactical investors identify emerging opportunities and make more frequent trades to capitalize on opportunities to boost total portfolio return and reduce risk. They might hedge the portfolio against a declining dollar or inflation, or invest in a sector where forecasts indicate strong short-term growth. Representing every asset class, sector, and global region, ETFs enable tactical investors to easily pinpoint the exact places in the market where they see opportunities.

Young stresses that moving amongst asset classes depending on where we are in the market cycle obviously results in more frequent trading than with a buy and hold approach. And the quest to create additional alpha has the potential to generate more short term gains to manage for a tax standpoint. "Tactical asset allocation may be a more effective investment strategy in a cyclical market, but those advisors who move away from a more strategic asset allocation need to increase their diligence with regard to the tax implications of their increased trading," says Young. "If they are not careful, the taxes due on short term gains could offset the benefit of their tactical management."

Frank adds that a portfolio's banked capital loss carryovers are useful in negating short term capital gains from a tax standpoint. "I don't mind using up some of the carryover losses in order to realize some short term gains," he notes. "However, for portfolios with no capital loss carryovers, we need to keep taxes in mind as we contemplate tactical shifts."

Ideally, however, the advisor has built in some flexibility in the portfolio construction to allow room to rebalance without these concerns. Explains Frank, "If a client has only a small proportion of his net worth in retirement accounts, where we can normally rebalance without tax consequences, we know at some point in time that will set us up for a rebalancing problem because we'll have to do the bulk of the trading to rebalance within taxable

accounts. This will trigger taxable gains as we pare back asset classes that have outperformed. In that case, we might buy a low cost variable annuity and house a variety of asset classes for future tax-free rebalancing flexibility. Because capital gains rates have been so low in recent years, the value of this annuity strategy was diminished, but we could go back to the strategy when capital gains rates increase."

5. ACCELERATE GAINS

With a likely capital gains tax rate of 20% or more in the future, investors may want to take gains at the maximum rate of 15% now. (Please see Appendix, *Potential 2011 Tax Rates* for additional detail.) However, magazine articles urging investors to accelerate gains on all appreciated positions are overly simplistic. "If a client has a low basis position and has specific expenses coming up in the next year or two, I'm thinking let's pay taxes now," says Frank. "The time value of money isn't going to kill you paying it early."

Before deciding to accelerate portfolio gains, Frank always asks: Is the portfolio appropriately allocated for the client? Are we about to compromise something for the fear of paying taxes? He explains, "If there is no compromise, then the decision to sell now or later is strictly a mathematical question. Again, if there is an expense looming and you had clearly been planning to meet the expense with a particular investment in the next few years, then, yes, take the gain today. Otherwise, if the expense is more than a few years out, I'm not sure I'd jump to sell what I would consider a buy and hold position. In some cases, investors will never sell these low basis positions and so their heirs may get a step up in basis, something that I hope will survive future estate tax reform."

Frank adds that investors should also evaluate a potential sale from a risk management standpoint. "Accelerating gains with the sale of a single stock is almost always a smart thing to do from a risk management perspective," he says. "In today's environment, you sell now, pay presumably lower taxes, and also eliminate the volatility typically associated with a single stock."

Frank explains that an Excel spreadsheet can help advisors mathematically illustrate for clients the benefits of selling a low basis position today to potentially help temper their portfolio volatility in the long term. As loss years are compounding killers, keeping the frequency and size of losses to a minimum can dramatically enhance long-term compounding. Frank explains, "Usually the response I get from clients when I recommend to sell is, 'Gee, I could sell it, but you can't guarantee me a higher rate of return than I will get with this stock and the capital gains taxes are going to cost me real money today.' My response is to ask, 'Would you agree that a diversified portfolio of equities has less volatility than a single stock?' When the clients quickly agree, I again illustrate how much the loss years can negatively impact the portfolio and tell them that while I can't promise a higher return on a diversified portfolio, they should expect reduced volatility and a larger accumulation if the diversified portfolio has a comparable average return."

Young says the opportunity to reduce overall portfolio risk is especially significant when a client has inherited a security that has been in the family for years. “We’ve all seen how a very concentrated position to an oil stock, for example, can be extremely risky,” he says. “The challenge, of course, is convincing the client that increased diversification is worth what they may have to pay in taxes. However, this year, we have the added push that diversifying in a low tax environment is more favorable than diversifying in a high tax environment.”

Frank says that the umbrella question that should sit over all sell decisions are: is the portfolio allocated appropriately? He explains, “Taxes should not wag the dog, but they are a material part of the dog. If we are going to pay an extra 5% in capital gains (assuming capital gains tax rates increase in 2011) if we wait and sell in five years, for example, then we need to calculate how that compares to paying 15% now given the time value of money. In many cases, however, an exact analysis is impossible as it would require, with a mutual fund, for example, guessing at future capital gains distributions. Our analysis is somewhat easier when we are contemplating selling ETFs because many rarely distribute capital gains.”

Note, too, that the “wash sale” rule, which requires investors to wait thirty days before repurchase, applies only to recognition of losses, not gains. Therefore, investors who wish to keep their investments can sell a security, recognize the gain, and immediately repurchase that security to reestablish the position. Or, they can redeploy the proceeds to investments that offer stable growth and downside protection, a strategy that might be prudent in these uncertain times.

6. DIVERSIFY RETIREMENT SAVINGS FROM A TAX STANDPOINT

Having taxable and non-taxable accounts to draw from in retirement makes sense in an uncertain tax environment. Traditional planning views pre-tax savings accounts, such as 401(k) accounts, as benefitting investors who have a lower income in retirement; after-tax savings accounts, such as a Roth IRA, can be advantageous in the event an investors’ income increases in retirement. However, because today’s income tax rates are at historic lows, it is possible that an investor’s income could decrease in retirement, but that the tax brackets might be adjusted such that he would be paying higher taxes on that lower income. If the Bush tax cuts sunset, for example, the marginal tax rates for all brackets would increase at least 3%. As the federal deficit continues to grow, it’s not outrageous to assume that taxes could increase further over the next few decades. Accordingly, now may be a good time for investors to ensure they have both taxable and non-taxable accounts to draw from in retirement.

This year, for the first time, many investors have the opportunity to diversify with a Roth IRA. With a Roth IRA, after-tax dollars grow tax-deferred and qualified distributions are tax-free, but Roth’s income limits prevent many investors seeking tax diversity from opening a Roth account. However, on January 1, 2010, the income limits for *converting* traditional, rollover, SEP, SIMPLE IRAs, and 401(k) or other workplace savings plans with former employers, to

a Roth IRAs were *removed*. Before this change, only investors—single or married and filing jointly—with modified adjusted gross incomes of \$100,000 and below could convert.³ Although there are still income limits for *contributing* to a Roth IRA, today anyone—regardless of their income—can convert retirement assets from a traditional IRA to a Roth.

A Roth IRA offers three major benefits: tax-free growth that is especially attractive considering income tax rates are increasing; tax diversification that provides flexibility in retirement income distribution planning; and no required distribution at age 70½ that helps transform your retirement savings into a financial legacy.

Notably, investors who make conversions in 2010 have the option to spread taxes due over 2011 and 2012. However, in promoting the extra time to pay conversion taxes, you must consider that impending tax legislation may result in the top tax bracket likely increasing to 39.6% from 35% in 2011. Accordingly, an investor converting a \$300,000 traditional IRA to a Roth IRA in 2010, and who is seeking to avoid potentially higher tax rates in 2011, might elect to report the entire \$300,000 conversion income on his 2010 tax return. If, however, paying the taxes is difficult in 2010, he could choose to report no income from his Roth conversion in 2010 and instead report \$150,000 (one-half) of the Roth IRA conversion in 2011 and \$150,000 (the remaining half) of the conversion in 2012.

The greater the tax-free growth, the higher future income tax rates go, and the longer an investor remains in the top income tax bracket, the more beneficial converting to a Roth would be. What’s more, investors interested in investing in low-cost ETFs after having converted to a Roth IRA can ensure that more of their assets grow tax-deferred, increasing the tax-free dollars available for qualified distributions in retirement.

“Tax flexibility is always a good thing, but it’s important to do the math, not just rubber stamp a Roth conversion,” says Frank. “Someone in a low tax bracket now might convert enough that he is pushed into a higher current tax bracket. Determining future benefits requires a year by year analysis on the Roth conversion. For someone who will not need to spend the retirement account money and wants to maximize what he leaves his children, the Roth conversion is compelling. For other clients who are still working, in the highest marginal tax rate, and expect to need all that money to fund retirement, the conversion decision may be less clear cut, especially if they will be in a lower tax bracket when they retire.”

One advantage of a Roth account that must also be factored into analysis of the conversion question is that in retirement all withdrawals of Roth savings are tax-free and do not increase taxable income. By comparison, if a 401(k) participant decides to make a large withdrawal of pre-tax savings, the result will be higher taxable income, and possibly a shift into a higher tax bracket. Roth savings offer the flexibility of spending savings without worrying about an unexpected tax bill in retirement.

Additionally, while investors have long been advised to max out their 401(k) and other retirement savings plans, if future income tax rates truly skyrocket, tax qualified plans may lose some of their appeal. Although investors would still want to contribute to their workplace plan, certainly enough to qualify for any available company match, the question of whether they truly will be in a lower tax bracket in retirement, might prompt them to consider funding accounts outside the 401(k) arena for some tax diversity.

Various calculators can help investors determine the best option. Generally, however, if an investor is taxed at the same rate in retirement as in his working career, the 401(k) and Roth IRA are equally advantageous. If, however, the investor is taxed at a higher rate in retirement, the Roth is more beneficial than the 401(k). While previously investors had to weigh only whether they thought their income would increase in retirement, today, they must evaluate the very real prospect that tax rates themselves will increase dramatically.

7. THINKING HOLISTICALLY

While tax management strategies change every year with the tax code, Frank says what remains constant is the ability to trigger losses and rebalance portfolios to assess whether various asset classes are appropriately located in taxable and non-taxable accounts from a total portfolio perspective.

"Most investors tend to look at their assets in various pots, or buckets—the retirement money is here and the college money is over there," he says. "While behavioral finance has shown it's easier to save when working toward a specific goal, it's the advisor's job to present and evaluate the client's big financial picture and determine the proper location for each asset based on how each account will be taxed for both income and eventual estate tax purposes—this should maximize family after-tax wealth."

Continues Frank, "There was a time when advisors dealt only with stocks, bonds, and cash but the incredible proliferation of investment vehicles makes this location exercise much more challenging." Accordingly, he organizes all assets in a spreadsheet he calls the 'Family Investment Matrix.' "It sounds simple, but for many clients this is the first time they see a complete view of their wealth," he notes.

Frank offers advisors the following asset location guidelines:

- **CERTAIN ASSETS ALMOST ALWAYS BELONG IN TAXABLE ACCOUNTS.** Examples include buy-and-hold equities, most index funds, and most ETFs. Unlike mutual funds, because a separately managed account (SMA) can trigger losses during the year, SMAs also can work very well in a taxable account. Additionally, for charitable gifting purposes, housing buy-and-hold equities in taxable accounts allows for a full deduction while avoiding tax

on unrealized gains. If high turnover assets are housed in taxable accounts, because capital gains taxes are continually paid, there won't be much capital gains tax avoided when they are gifted.

- **OTHER ASSETS ALMOST ALWAYS BELONG IN TAX-DEFERRED ACCOUNTS.** Examples include high yield bonds, REITs, and high turnover managers. Hedge funds can be very tax inefficient as well. Frank adds that the younger you are, the more sense it makes to house the highest expected return investments in tax deferred accounts. Decades of growth with zero tax interference can create a tremendous accumulation even after ordinary tax rates are paid at the end.
- **CONSIDER LOCATING FAMILY FIXED INCOME IN 529 PLANS.** If a child's 529 plan will not cover the total costs of the child's education, then Frank suggests that rather than being considered "college money," the assets should more appropriately be considered part of the family portfolio and allocated appropriately. He explains. "If it's the parents who will need to make up the shortfall when the account fails to meet all of the student's college costs, the 529 plan with its tax-free status is an ideal place to put fixed income assets. While many clients want to invest in equities in a 529 for young children with the notion that they have a decade or more of growth to look forward to, those equities can be located somewhere else under parental control, outside the 529 plan. This should create roughly the same pre-tax performance and a superior after-tax family performance."
- **BUY LOW COST ANNUITIES TO HOUSE TAX INEFFICIENT ASSET CLASSES.** If there is no room in the retirement account for tax inefficient assets, Frank recommends low cost variable annuities to house these otherwise heavily taxed asset classes.

Next, Frank initiates an ordering process where he ranks all the mutual funds, ETFs, SMAs and other money managers used by their own tax efficiency. For example, a large cap US equity ETF would be considered highly tax efficient because it rarely generates capital gains and any dividends would currently be taxed at the highest rate of 15%. At the other end of the spectrum, Frank would dig deeper into high turnover REIT mutual funds which are very tax inefficient due to short term capital gains and rent yields being taxed at an investor's marginal rate. Accordingly, the ETF would be the first choice to hold in a taxable account while the REIT mutual fund might be the first investment placed in an IRA.

With no estate tax in 2010 and future reform uncertain, Frank hesitates to share estate planning guidelines. However, he counsels advisors to always consider the ultimate disposition of each investment account. He notes if buy and hold equities are held in taxable accounts that are likely to pass to the next generation (and step-up in basis laws remain in effect), then appreciation will never incur a capital gains tax. Note that there will probably never be a step-up in basis for appreciated retirement investments.

8. REBALANCING AFTER A TAX REVIEW

Frank's asset location exercise, selling various positions may create the need to rebalance a client's portfolio. As advisors decide where to place assets, they must also factor in potential changes in tax policy. For example, rising income tax rates make the federal tax-free income of municipal bonds more attractive. As tax rates rise, the effective interest rate on municipal bonds increases. For instance, a municipal bond paying 3% interest pays a tax-equivalent yield of 4.6% in a 35% tax rate environment. However, if tax rates rise to 40%, the tax-equivalent yield on the same bond rises to 5%. And, with the current maximum tax rate on qualified dividends of 15% scheduled to revert to back to regular income tax rates in 2011, dividend paying stocks are less attractive from an income standpoint.

In deciding where tactical opportunities may be in the years ahead, Frank relies on his long-held belief that the very best indicator of future returns are current valuations. "Basically, if an asset class is overvalued, it is more likely to underperform in the coming years," he says.

Given his belief that valuations will prevail, Frank looks across the spectrum of asset classes today and does not see "too many screaming bargains." He explains, "Cash is a guaranteed loss from a real return perspective. Bonds are coming off a 30-year bull market, if interest rates increase, bond values will drop. In the meantime investors are getting paid a historically low yield to wait for that to happen. Probably the most attractive asset classes are emerging markets, and large international to some extent. The real outlier is domestic large quality US stocks. Even though I love small cap domestic stocks, they just don't look that attractive today from a valuation perspective. I caution clients that valuations can remain askew for years but at least while they are waiting for this 'reversion to the mean' their portfolio has lower risk."

A LOOK AHEAD

Remember, it's not what your clients make, but what they keep that counts. Ironically, while the US Congress could choose to put tax reform on the back burner, the potential for a tax increase is a pressing issue for all investors. This year in particular, advisors will need to make numerous decisions in a less than ideal environment in order to manage the tax liability generated across clients' portfolios.

Planning this year is particularly challenging because the prospect of higher taxes comes on the heels of the recession and in an environment of slow economic growth, diminished investment return expectations, tighter credit, and the threats of inflation and rising interest rates. In this uncertain environment, evaluating client portfolios from a tax perspective and implementing some proactive tax management strategies to protect them against higher taxes can be seen as a vital opportunity to add value independent of investment performance.

In considering how to respond to implement these various tax management strategies, remember that while tax policy may be in flux, ETFs—with their low costs and rare distribution of capital gains—are a prudent product for all tax seasons. The structure of ETFs provides your and your clients with expanded opportunities to improve overall tax efficiency, lower costs and rebalance portfolios. Simply put, the SPDR family of ETFs helps investors maintain desired market exposure and achieve strategic asset allocation targets through their ability to precisely track a vast array of asset classes and benchmarks. SPDR ETFs span an array of international and domestic asset classes across equity and fixed income markets.

APPENDIX: 2011 POTENTIAL TAX RATES

A soaring federal budget deficit. Stimulus spending that continues to support financial institutions and provide benefits to out-of-work families. A precipitous drop in federal tax revenues due to the recession. Common sense would dictate that tax rates, currently at historic lows, will increase one day soon, whether Congressional gridlock results in the expiration of Bush tax cuts or a new tax policy is crafted and enacted.

However, it's the scheduled expiration of the Bush tax cuts, officially known as Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) that has been in the headlines. Collectively, EGTRRA and JGTRRA reduced tax rates on ordinary income, long-term capital gains, and qualified dividends; mitigated marriage penalties; expanded the child tax credit and the child and dependent care tax credit; and phased out limitations on itemized deductions and the phase-out of personal exemptions. When those tax provisions sunset at the end of 2010, tax rates on ordinary income, long-term capital gains, and qualified dividends will revert to higher, pre-2001 levels.

Expiring tax provisions (or sunsets) have long been a feature of Uncle Sam's tax code, but they usually involve minor provisions. The sweeping tax legislation created through EGTRRA and JGTRRA is a major exception. All tax provisions sunset by the end of 2010.

HOW COULD POTENTIAL TAX INCREASES IMPACT YOUR CLIENTS?

Perhaps the number one question on your clients' minds is this: how might income tax rates in 2011 (after the sunset at the end of 2010) compare with today's rates? During the presidential campaign, President Obama said he would make the Bush tax cuts permanent for low- and middle-income taxpayers, and that wealthy Americans would pay more. The administration's recently released *General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals* sets forth the President's recommended increases. The proposal specifies increasing the tax rate from 33% to 36% for individuals with taxable income greater than \$200,000 for individuals or \$250,000 for couples. Also, it recommends that the top income tax rate of 39.6% be reinstated on income over \$373,650. Since 2003, the highest statutory individual income tax rate has been 35 percent.⁴

This table illustrates the differences in marginal tax rates:

| MARGINAL TAX RATES FOR 2010 | MARGINAL TAX RATES, AS OF JANUARY 2011 |
|-----------------------------|--|
| 10% | 15% (indexed and expanded) |
| 25% | 28% |
| 28% | 31% |
| 33% | 36% |
| 35% | 39.6% |

What's more, in addition to shouldering an increase in income tax, investors will also face higher capital gains tax rates. On January 1, 2011, the capital gains tax rate is scheduled to revert from the current maximum rate of 15% back to the 20% that was in effect prior to 2003.

Also, dividends, which under the Bush tax cuts were taxed for the first time at the same low 15% rate as capital gains, will be reclassified and grouped with interest to be taxed at the higher tax rates levied on wages. Unless Congress acts before the end of 2010, next year the top dividend rate would revert to 39.6%, diminishing the value of dividend-paying stocks in a retirement income stream for those in the highest tax brackets.

SCHEDULED TAX RATE INCREASES FOR CAPITAL GAINS AND DIVIDENDS

| TYPE OF ASSET | CURRENT TAX RATE | POTENTIAL POST-2010 TAX RATE |
|---------------------------------|--|--|
| SHORT-TERM CAPITAL GAINS (STCG) | Ordinary income tax rates, up to 35% | Ordinary income tax rates, up to 39.6% |
| LONG-TERM CAPITAL GAINS (LTCG) | 0% for taxpayers in the 10% and 15% tax brackets 15% for taxpayers in the 25%, 28%, 33%, and 35% tax brackets | Capital gains taxes will revert to pre-2003 rates, which in most cases were 20% and 18% for qualified five-year property |
| QUALIFIED DIVIDENDS | 0% for taxpayers in the 10% and 15% tax brackets Maximum rate of 15% in higher tax brackets | In the past, qualified dividends were taxed at ordinary income rates, up to 39.6%. That's how they likely will be taxed again. |

Source: http://www.taxpolicycenter.org/taxtopics/2011_continue_2001cuts.cfm

ABOUT THE EXPERTS

GLENN FRANK, CFP, CPA/PFS, Director of Investment Tax Strategy, Lexington Wealth Management, Lexington, Massachusetts, develops customized financial and investment related tax strategies for clients and contributes to the overall investment decisions of the firm. With more than 20 years of experience in investment consulting and financial planning, Frank has been consistently recognized every year since 1998 by *Worth* magazine as one of the country's top Wealth Advisors. He is the Founding Director of the Master of Personal Financial Planning program at Bentley College, a member of the program's advisory board and teaches two graduate level courses within the program.

Glenn received his MBA from West Virginia University graduating with high honors, and a MST (Masters of Science in Taxation) from Bentley College graduating with high distinction. He is a Certified Financial Planner Professional (CFP) and a Certified Public Accountant with a designation as a Personal Financial Specialist (CPA/PFS).

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¹ *Passive and Active Management: A Balanced Perspective*, Thomas Guarini, State Street Global Advisors. January 2010.

² <http://www.etftrends.com/2010/07/switching-from-mutual-funds-to-etfs-having-the-talk-with-clients>

³ <http://www.rothira.com/>

⁴ <http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf>

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