ABOVE THE FRAY

Derivative Income Can Be Costly

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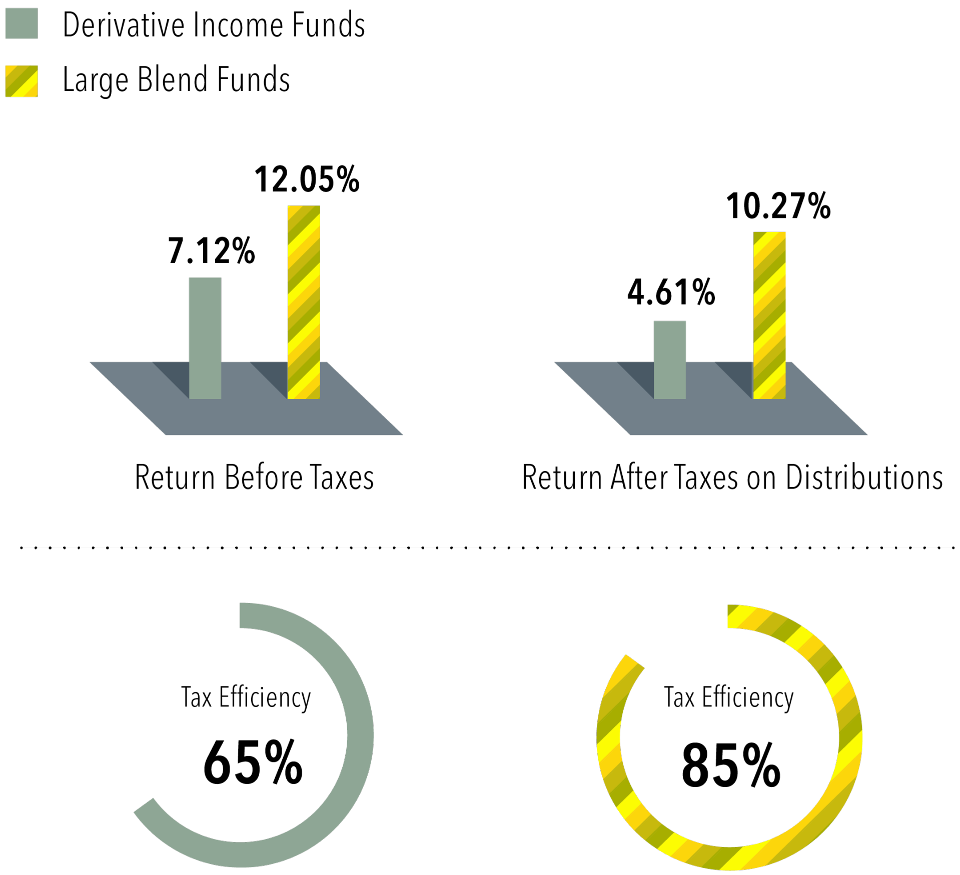
Investors seeking high yields in their stock allocations have been flocking to the category known as derivative income funds. This breed of products combines equity index exposure with options to generate income, producing higher-than-bond yields. In the first half of 2025 alone, 36 new derivative income funds were launched, and more than $30 billion in net flows were directed to the category.

Higher yields don't always equate to higher returns. Over the past 10 years, the net return to the derivative income fund category was 7.12%, compared to 12.05% for large blend funds.

But some investors prefer their total return to be disproportionately composed of income. These investors should be aware that the income generated by options in derivative income funds is often treated as ordinary income for tax purposes, and that may drive up an investor's tax bill.

This is apparent in the stark effect on returns that are preserved after taxes. Over the 10-year period ending June 30, 2025, only about 65% of returns survived taxes for the derivative income fund category, compared to 85% for large blend funds.

Exhibit 1
Tax Efficiency for the 10-Year Period Ending June 30, 2025



Past performance is not a guarantee of future results.

In USD. Performance includes reinvestment of dividends and other earnings. Source: Dimensional, using Morningstar. Both return after taxes on distributions and return before taxes are sourced from Morningstar. Derivative Income Funds and Large Blend Funds returns are the Morningstar category average returns for US Fund Derivative Income and US Fund Large Blend Morningstar categories, respectively. The after-tax returns used to calculate the Tax Efficiency Ratio are calculated using the historical highest individual federal marginal income tax rates and do not reflect the impact of state and local taxes. Actual after-tax returns depend on an investor's tax situation and may differ. As of June 30, 2025, there were 173 funds in the US Fund Derivative Income Morningstar category and 665 funds in the US Fund Large Blend Morningstar category.

This article originally appeared in Above the Fray, *a weekly newsletter for Dimensional clients.*

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