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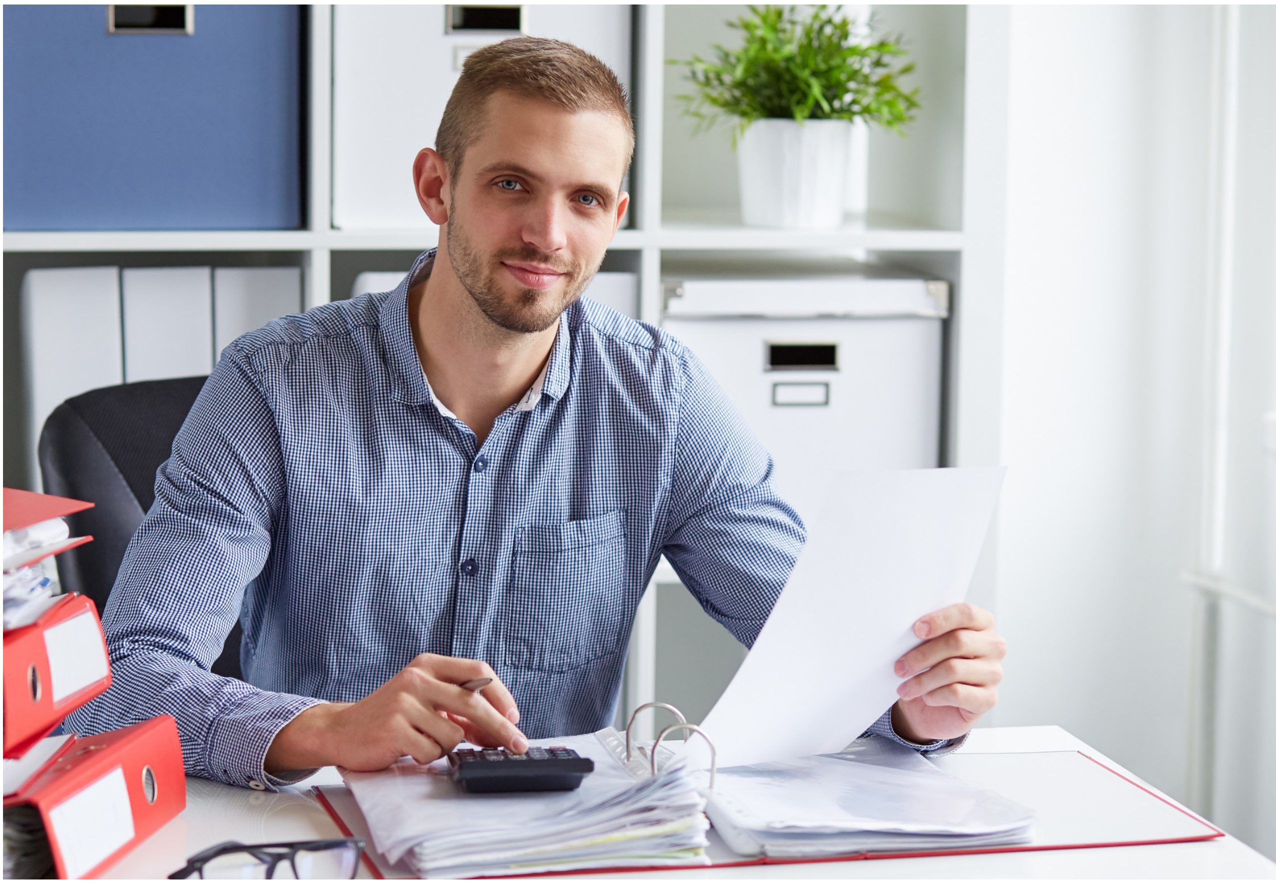
Ten questions to ask your investment manager and custodian on tax



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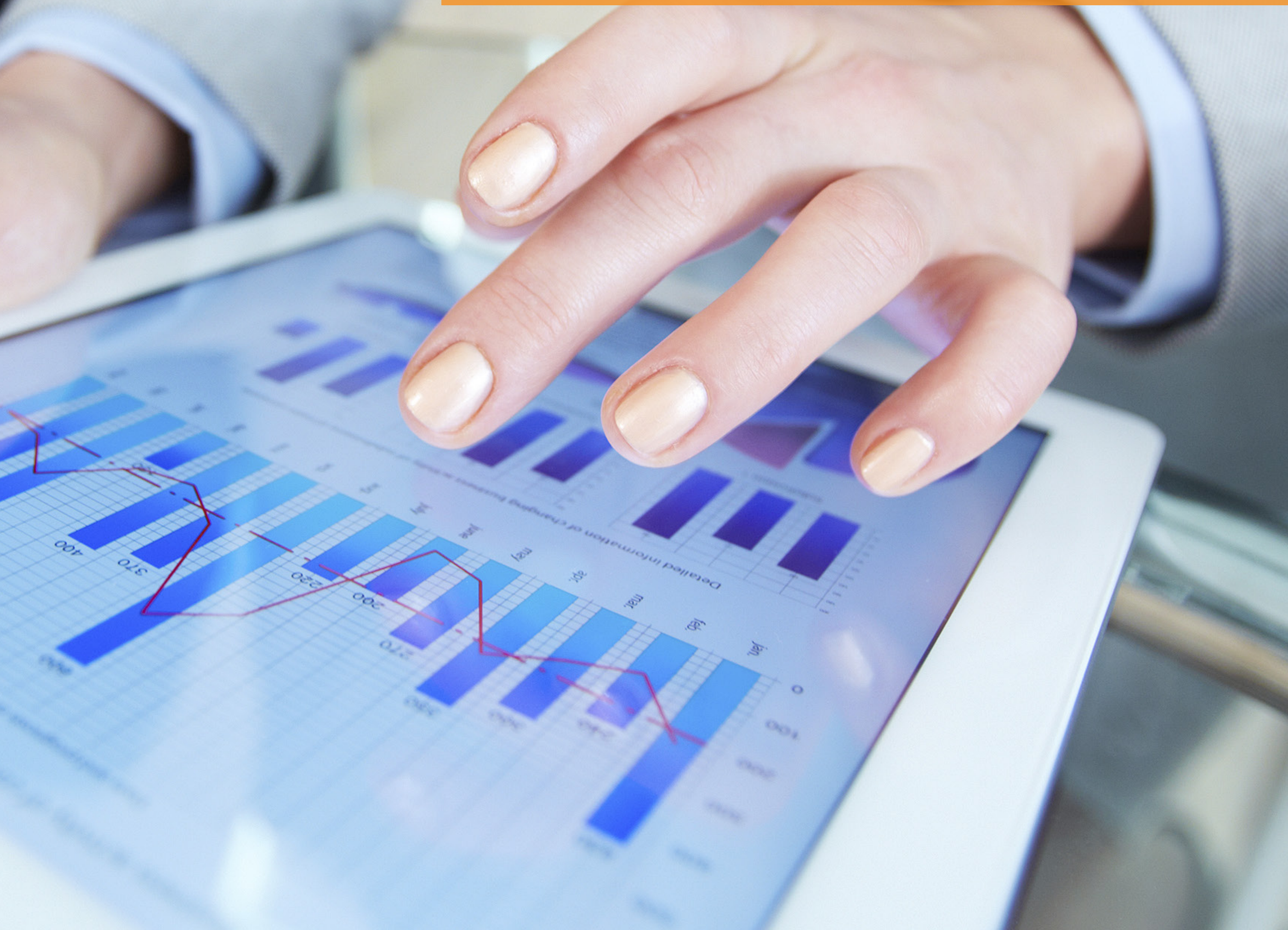
Introduction

Tax is generally regarded as a second-order issue in most investment arrangements.

Compared to more exciting factors like 'alpha' and 'risk', it is understandable that Trustees focus on these and not tax efficiency when appointing investment managers. But, perhaps they should, because tax efficient management can add significant return (50 basis points or more per annum has been claimed), and unlike alpha, which may be illusory and volatile, tax efficiency gains are real and consistent.



There are also classes of investors; for example, charities, foundations, universities and superannuation assets supporting pensions, which do not pay tax. The question is whether these clients' investments should be managed separately to capture the tax benefits from their tax-exempt status, and we think that there is increasing evidence to support segregation. The other argument for segregation is that if the expected returns are adjusted for tax differences, the optimal asset allocation would also change.

The performance of superannuation funds and investment options is typically measured on an after-tax basis in the published surveys, but investment sector performance, for example in Australian shares, is usually measured on a pre-tax basis. For example, most Australian equity manager mandates compare portfolio (pre-tax) returns to the S&P/ASX200 index return. The argument has always been that tax is paid at the entity level not at the investment level, and depending on the type of entity (individual, super fund, tax exempt and so on) the taxation treatment can be quite different.

In recent years, there has been a move towards measuring asset class portfolio returns on an after-tax basis; however, we make the following observations:

- Not all funds measure after-tax asset class portfolio returns
- Measuring the impact of capital gains taxes on a manager fund (trust) is difficult, unless access is provided to the portfolio data within the fund. There are also issues with trading to manage cashflows from other investors. As a first step, including the value of franking credits would be an improvement, and it does not require the same level of custom data
- Is the existing measurement of after-tax portfolio and benchmark returns conducted using a robust and meaningful methodology?
- How are after-tax portfolio and benchmark returns used within the manager monitoring and decision-making processes? Is the after-tax return the primary measure of manager success?

Investment managers are not rewarded or penalised in the published (pre-tax) investment surveys for tax management (imputation credits received and capital gains tax paid), a factor which directly impacts the outcome for super fund members. Consequently, the focus when appointing managers for single asset class mandates has traditionally been on pre-tax performance and the management of the tax cost has not been given its due weight. Investors are effectively assuming that the rankings of investment managers on a pre-tax basis will be the same as on an after-tax basis. Research suggests that this is not the case – see 'To Disclose or Not To Disclose After-Tax Returns of Mutual Funds' Mawani (2003).

APRA's prudential standard on investment governance (SPS530) requires superannuation Trustees to document for each investment option how the investment strategy has regard to each of a set of factors, which include the 'tax consequences for the entity'. The prudential practice guide for SPS530 indicates that Trustees should consider tax consequences when selecting investment managers. It is not clear from the guidelines exactly how this requirement should be interpreted. In our experience, it is often interpreted fairly loosely such as the Trustee having an understanding of the level of turnover and investment style of the manager and the broad implications that this would have on the tax cost. Our interpretation is that understanding the tax consequences requires measurement and analysis of the after-tax investment return.

If you agree with this view, then here are 10 questions to ask your investment manager.

1. Do you have a strategy to maximise after-tax returns?
2. What impact does your style of investing and portfolio turnover have on the fund's after-tax returns?
3. Does the custodian efficiently allocate tax parcels, and on what basis? What information is the custodian providing to you on what tax parcels are available?
4. Do you consider tax implications before trading?
5. Would you delay or bring forward an investment decision because of the tax implications?
6. Do you participate in off market buy-backs?
7. Do you manage the portfolio specifically for my tax status (individual, super, tax-exempt, pension)?
8. Is after-tax performance systematically measured?
9. Is the existing measurement of after-tax portfolio and benchmark returns conducted using a robust and meaningful methodology?
10. Can you operate under a Centralised Portfolio Management (CPM) approach?

The 10 questions

1

Do you have a strategy to maximise after-tax returns?

Your investment manager should be aware of the tax implications of its trading. This does not mean that the investment process needs to be modified or compromised in any way, but each investment decision needs to be made on an after-tax basis. If a trade results in a capital gains tax liability, the loss of franking credits, or higher execution costs, these costs need to be considered as part of the decision to make the trade. The manager should be managing these costs as part of its trading.

In Australian shares, the manager's ability to influence tax outcomes largely comes down to (i) The value of franking credits generated by the portfolio and making sure that the franking credits are not lost because of the 45-day rule (a requirement that the shares are held for a minimum of 45 days to claim the tax credit), (ii) The level of capital gains, the timing of realising gains and losses, and reducing short-term gains which have a higher tax cost, and (iii) Whether the manager participates in off-market share buybacks, which often include a component as a fully franked dividend and can be particularly attractive to low or zero tax paying entities. Buybacks can also help reduce capital gains tax liability in cases where the buyback is at a lower price than the current market price. In international shares, franking is not available but managers still need to pay attention to capital gains tax and withholding taxes.

2

What impact does your style of investing and portfolio turnover have on the fund's after-tax returns?

High turnover in a portfolio can result in lower tax efficiency, but the extent of any tax cost resulting from turnover will depend on the tax management skills of the manager. This is because shares held for longer than 12 months attract a lower rate of capital gains tax, the more frequent the trading the more likely the manager is to violate the 45-day rule and lose franking credits, and turnover will bring forward the realisation of gains and losses. On top of this, higher turnover results in higher transaction costs.

A more active manager will most likely lead to a higher tax and transaction cost to the fund in the long-term, and in evaluating that manager consideration should be given to the higher hurdle that they have to overcome before they are actually adding net value.

The focus in the industry on pre-tax and pre-fee alpha therefore overstates the value added by active management in the long-term.

Understanding the manager's style and how it manages the tax costs allows an assessment to be made of the expected after-tax and after-fee alpha.

3

Does the custodian efficiently allocate tax parcels, and on what basis? What information is the custodian providing to you on what tax parcels are available?

If you own shares in a company, you might think that each share has the same value. From the investment manager's perspective they are the same, but from a tax perspective the shares are separate assets which can be grouped into 'tax parcels' with a common purchase date and price. For many investors these tax parcels will be spread over a number of years and at many different prices. When a sale is made the investor needs to specify which asset (or tax parcel) is being sold. The selection of tax parcels allows the investor to manage the timing of when gains and losses are realised.

There are various approaches to the selection of tax parcels, including First In First Out (FIFO) where the first purchase is the first one sold, through to 'specific identification' where the taxpayer gets to choose which parcels are sold. The after-tax return is maximised when selecting parcels which realise losses sooner (to get the tax benefit) and defer realising gains (which will result in a tax payment). Care needs to be taken; however, with respect to short and long term gains. For example, parcel A might have a purchase price of $15 but it realises a short-term gain while parcel B might have a lower purchase price of $14.98, but it is a long term gain and therefore results in a smaller tax cost. Selecting parcels with the minimum tax cost will maximise the after-tax return.

If selling a stock will generate a tax benefit then this enhances the attractiveness of the trade. However, in order to incorporate this into the decision making process the manager must have information on the tax parcels that are available.

4

Do you consider tax implications before trading?

In order to maximise after-tax returns, an investment manager needs to have a system in place to calculate the tax impact, which may require information from the custodian to know what tax parcels are available, and will need to have all of this available before making the decision to trade. Given that tax is assessed at the fund level, ideally the manager will need access to the tax cost or benefit of a potential trade calculated using all of the tax parcels of the fund. This can be implemented in practice, but it may involve a change in the way that managers and custodians normally interact. It is possible that a decision to sell stock A and buy stock B would make sense for one client, but for a second client that had significant unrealised capital gains in stock A the required hurdle rate of return may not be met.

There are third-party systems available that can sit on a fund manager's desk and provide this information in real time.

5

Would you delay or bring forward an investment decision because of the tax implications?

The manager's pre-tax alpha generation is the critical input to any trading decision. However, there may be times when a manager decides to trade and a delay of a few days could make the difference between a long gain or a short gain, or losing a franking credit. A well-designed and implemented after-tax performance measurement and benchmarking process should provide managers with the correct incentive.

6

Do you participate in off market buy-backs?

Companies can use off market buy-backs to return capital to investors, and these can be attractive to low or zero tax-paying investors in cases where the company has franking credits available and the investor has other capital gains that it can offset. The ATO generally allows the buyback at a discount of up to 14%, which is attractive to the company, so the investor receives a price up to 14% below the current market price. However, the buy back is generally structured in a way that includes a franked dividend so the investor obtains the benefit of the franking credits whilst also deriving a lower capital gain and in many cases a capital loss which it can use to offset against other capital gains. Therefore, participating in the buyback can lead to a reduction in the pre-tax return of up to 14% for the manager, but on an after-tax basis the investor may be better off depending on the value of the franking credit and their cost base of the shares (capital gains tax impact).

Investment managers face a difficult choice because participating in the buyback may be detrimental to their pre-tax performance in the published surveys and the benefit to the client(s) will depend on their individual tax rates. If the vehicle is a trust some of the unitholders may benefit and others may not. This is a good example of why portfolio management should ideally be conducted for specific tax-rate groups, rather than pooling for investors of different tax rates (please refer to question 7).

The value of the franking credit component of off market buy-backs increases dramatically as the tax rate falls. The actual impact will depend on the client's tax position and the details of the buyback, but for pension assets and other tax-exempt investors it is generally beneficial to participate.

"...participating in the buyback may be detrimental to the manager's pre-tax performance, but make sense on an after-tax basis..."

7

Do you manage the portfolio specifically for my tax status (individual, super, tax-exempt, pension)?

Superannuation funds in pension phase and other tax-exempt entities such as charities do not pay tax and therefore don't care about generating capital gains, and they receive greater value from franking credits. The benefit from managing Australian shares with specific consideration for the tax status of tax exempt investors will vary over time, depending on market conditions and the number and pricing of off-market buybacks. However, various estimates have put the benefit at between 0.5% and 1.5% per annum. Tax-exempt investors can therefore benefit significantly from selecting an investment manager that is tax-effective and seeks to harness the extra tax benefits that are available.

As pension assets increase relative to accumulation assets, we think that superannuation funds will increasingly look to segregate assets so that investment mandates can be tailored and managers can be appointed to optimally manage the after-tax return for the underlying client.

"...we think that superannuation funds will increasingly look to segregate pension assets..."

8

Is after-tax performance systematically measured?

In order to answer most of these questions, managers and funds need to measure after-tax performance. Each portfolio will have its own unique benchmark because the tax cost base and cashflows will vary from portfolio to portfolio. In addition, the index has some turnover due to corporate actions and companies moving into and out of the index. After-tax performance will need to be measured on an excess return or 'after-tax alpha' basis, in order to make comparisons between managers. Care needs to be taken when comparing after-tax returns because the market conditions experienced over the period (composition of returns) as well as the tax profile of the portfolio, affect the opportunity to earn tax alpha.

Measuring after-tax performance is therefore not as straight-forward as measuring pre-tax performance, but it will enable a better understanding of the tax impact of different styles of investing (eg growth vs value, high vs low turnover), and a more meaningful comparison between managers.

There are a number of companies that offer services to assist managers and funds to calculate after-tax performance.

We estimate that about half of the large superannuation funds are doing some sort of after-tax performance calculations.

We see this increasing in the future, particularly with respect to published investment performance surveys and manager selection.

After-tax reporting and analysis is not simple or cheap. However, the anecdotal evidence is that any investment in this area will be repaid very quickly through increased returns (ie tax alpha). Most managers say that they pay attention to tax costs, but the old adage that what gets measured gets managed is probably true, and broader adoption of after-tax measurement would result in a change in behaviour of investment managers.

Funds should be asking their investment managers how they manage the tax cost, and whether they can demonstrate that after-tax returns are being maximised. The easiest way to accomplish this is for funds to start measuring managers on an after-tax basis against an after-tax benchmark.

9

Is the existing measurement of after-tax portfolio and benchmark returns conducted using a robust and meaningful methodology?

One of the issues in after-tax return calculations is whether the calculations are done on a pre-liquidation or a post-liquidation basis. The difference relates to whether the shares are assumed to be sold at the end of the measurement period, therefore realising all capital gains taxes.
After-tax returns calculated for Stronger Super, for accounting purposes, and for unit pricing need to be calculated on a post-liquidation basis. Accounting regulations and equity considerations require that taxes which have been accrued, but not yet paid, are included in unit pricing calculations.

From an investment perspective though, the deferral of a tax payment is valuable. Therefore, measurement on a pre-liquidation basis more accurately reflects reality (the shares are not actually sold at the end of the period) and provides the manager with the appropriate tax incentive to not sell the stock. Under the post-liquidation approach the stock is sold at the end of the period regardless, which removes a large part of the incentive for the manager to retain the stock.

The approach utilised in Australia is mixed, with large parts of the market adopting a post-liquidation approach.

PwC believes that while post-liquidation is appropriate for account and unit pricing purposes, pre-liquidation is more likely to provide insights into and improvements in manager behaviour.

10

Can you operate under a Centralised Portfolio Management (CPM) approach?

A fund also has a role to play in tax efficiency where it is large enough to use individual mandates rather than unit trusts. This is because the owner of the shares is the fund, and not the manager, and the managers are trading on behalf of the fund. Hence, if a stock is sold the custodian can search all of the tax parcels for the fund and find the most optimal parcel to sell. Therefore, manager A may initiate the sale of a parcel of shares that was originally purchased through manager B. This commingling of tax parcels is known as 'propagation' and more funds are considering its adoption, subject to the views of the ATO. The fund benefits from more efficient tax management, but if manager A uses a tax loss that was created by manager B, how is that apportioned for performance calculations. We understand that there are now systems that can do this, so neither manager is advantaged or disadvantaged.

One step further is Centralised Portfolio Management (CPM) which brings all of the trading and execution under a single implementation manager, which implements all of the other managers' trading decisions in a cost and tax-effective manner. This may include avoiding sales from one manager to another, plus other strategies to reduce transaction costs and various taxes. The implementation manager is given a small tracking error budget to deliver the recommendations of the underlying managers. This approach can generate even greater savings because one manager is tasked with the efficient implementation of all the investment decisions.

Despite the obvious attractiveness of CPM, only a few funds currently utilise this approach. There are a number of issues that need to be addressed when considering CPM:

- Will the underlying managers participate in the CPM program? Many managers do not like participating in these types of arrangements as they are forced to provide their intellectual property (stock views) to a third party. If the manager won't participate, should you retain them outside the CPM program or terminate them?

- Does the separation of investment idea generation from execution/trading impact the pre-tax alpha provided by the manager?
- Are there any types of trades or segments of the market where the timing between the decision and its execution is critical, or that the investment decision and trading strategy are integrally linked? For example, in less liquid markets the opportunity or cost to trade can impact the decision to trade. Also, some trades need to be considered in combination with other trades, so the trades need to be executed at the same time, eg arbitrage trading and some derivative trading.
- Is there any loss of alpha from any delay, however small, between the trading decision of the underlying manager and the trading of the CPM manager? How are other decisions like off-market (discounted) placements, IPO's, corporate actions and voting/shareholder activism communicated promptly and effectively to the CPM manager?
- Does it make sense for the underlying active managers to take no account of taxes in their investment decisions? While the CPM manager may be skilled in tax management, its benchmark, the weighted average of the underlying manager (paper) portfolios, may be tax inefficient because it was constructed on a pre-tax basis. A decision that makes sense on a pre-tax basis, but not on an after-tax basis, cannot be reversed by the CPM manager.
- The underlying managers will not be generating brokerage through trading for the client, which may impact the value that the manager gains from brokers (eg research).
- How are the pre-tax and after-tax returns of the weighted average of the underlying manager portfolios as well as that of the central portfolio calculated? Shouldn't this measurement be done by an independent third party, and not the CPM manager?
- What are the costs and resources required to implement a CPM program? In addition to the challenges and costs of setting up a CPM program, CPM adds an additional manager which will result in an increase in the headline pre-tax fee. However, proponents of CPM argue that the after-tax benefit of CPM will be many times the size of the additional fee.

These issues are not to suggest that CPM is not a viable option for superannuation funds. However, they do warn funds considering CPM that there are many issues to be carefully considered and analysed before embarking on such a strategy. The decision with respect to the potential effectiveness of CPM requires funds to devote time and resources to fully understand the pros and cons of a CPM structure.

Conclusion

The investment management and asset consulting industry in Australia has traditionally reported Australian equity returns on a pre-tax basis. However, after-tax returns are what investors and members actually receive, and various studies have shown that the tax cost can vary significantly between investment managers. In addition, efficiencies in implementation for large funds can reduce the tax cost further.

There are a number of investment managers now offering tax-effective investment strategies, strategies targeted to particular types of investors (eg tax exempt), service providers offering after-tax performance measurement, large funds measuring their investment managers on an after-tax basis, 'propagation' by custodians, systems to tell investment managers what tax lots are available, and a few funds that have implemented Centralised Portfolio Management (CPM).

APRA has encouraged this by including a requirement in SPS530 that Trustees consider tax when making investment decisions. While the industry has come a long way with respect to after-tax management, we think that it has further to go.

We think it is incumbent on Trustees to fully understand the tax consequences of their investment strategies and the capabilities of their investment managers. Funds should investigate tax efficiency strategies like propagation and centralised portfolio management. Investment managers should be incentivised to provide better tax management through after-tax measurement, tax-management criteria in manager selection, and after-tax sector performance surveys. The benefits of efficient tax management are consistent and significant.

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