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Changing behaviour improves after-tax outcomes

- **Australian equities managers measured on an after-tax basis are increasingly considering the tax consequences of their actions.**
- **Access to relevant information and an increased focus on tax is improving after-tax outcomes.**
- **Why do professional investment managers look at the date of purchase when considering a sale in their personal portfolios? Because it simply makes sense.**

Fact 1: PERSONALLY, MANAGERS THINK ABOUT AFTER-TAX RETURNS

When considering a sale of one of their personal investments, managers were asked whether they take notice of whether a stock was purchased less than 12 months ago. The answer was a consistent "yes".

Conclusion: Managers are tax aware when managing their personal investments because tax awareness "simply makes sense".

Fact 2: PASSIVE MANAGEMENT DOES NOT EQUAL TAX-EFFICIENT MANAGEMENT

Warakirri has been measuring a number of passive Australian equities managers on an after-tax basis. When managers use Index Futures to gain equity exposure, the after-tax result can be adversely affected. This is due to capital gains on futures being taxed at the higher nominal rate and pricing that may not reflect the value of franking credits.

Conclusion: What might look like Index performance on a before-tax basis may not be Index performance on an after-tax basis. Passive managers need to be aware that using Index futures, relative to using physical equities, will hinder after-tax returns. Assessment of passive managers should be based on after-tax returns.

Fact 3: FRANKING CREDITS ADD TO AFTER-TAX RETURNS

In October 2010, Healthscope was acquired by Asia Pacific Healthcare Group (APHG). APHG is a foreign owned company. Managers that Warakirri measures on an after-tax basis engaged in discussions with the companies in relation to the structure of the takeover offer. The managers successfully sought to improve their after-tax return by agitating for a fully franked dividend to be paid as part of the acquisition consideration. The franking credits were not valuable to the foreign acquirer.

According to the terms of offer, the takeover was to be a cash offer reduced by any dividends that Healthscope paid to its shareholders. On a before-tax basis, an investor would have been indifferent between receiving dividends or cash, but on an after-tax basis receiving a portion of the proceeds as a fully franked dividend would be more beneficial. The outcome was that two dividends were paid, a special fully franked dividend of 9 cents, as well as a 12 cent final fully franked dividend that was declared as part of the final takeover arrangement.

Conclusion: Awareness of after-tax consequences and putting a value on franking credits can generate opportunities to improve after-tax returns for investors.

Fact 4: OFF-MARKET SHARE BUYBACKS ARE NOT POSITIVE FOR ALL INVESTORS EVERY TIME

The value of off-market share buybacks varies depending on an investor's tax rate. Warakirri compared the participation of two of its "tax aware" funds in off-market share buybacks where stocks were held in common across the two funds. One of the funds is managed from the perspective of a tax-exempt (or pension phase) investor and the other from the perspective of an accumulation phase superannuation investor (15% tax rate).

Between November 2003 and June 2011 the fund managed for superannuation investors only participated in 10 of the 15 common buyback opportunities. Whereas the fund managed for tax-exempt investors participated in all 15. The total cumulative contribution to after-tax performance from participation off-market share buybacks for both funds is shown in Table 1.

Table 1:Value of off-market share buybacks

Tax-exempt Fund	Accumulation phase Superannuation Fund (15%)
5.2%	1.4%

Conclusion: Buyback participation is not beneficial for all investors every time. However, for pension phase investors off-market share buybacks have added significant value. Are your pension members receiving the full benefit of their tax-exempt status?

Fact 5: SOMETIMES FRANKING CREDITS ARE WORTH WAITING FOR

Having made the decision to sell New Hope Coal in September 2009, a manager deferred the sale of the stock as it was aware that the company planned to pay a substantial fully franked dividend in the near future. The manager collected the fully franked dividend before making the sale so as to earn the additional franking credits. The New Hope dividend was 77.25 cents with 33.11 cents of attached franking credits. The share price on the ex-dividend date closed at $4.78. For the strategy to backfire in absolute terms, the stock would have had to fall by more than the value of the franking credits before the dividend was paid. The share price was steady, improving the after tax returns

Conclusion: Managers may alter their investment decision-making process if they are provided with the appropriate benchmark .

Fact 6: CAPITAL GAINS TAX VARIES DEPENDING ON WHEN GAINS ARE REALISED

How sensitive are managers to the fact that, for superannuation investors, gains realised before 52 weeks (nominal) are taxed at 15% and gains realised after 52 weeks (discount) are taxed at 10%?

Comparing the financial year before the introduction of after-tax measurement (FY2006/07) by Warakirri to the first financial year of after-tax measurement (FY 2007/08), Warakirri found that, when measured on an after-tax basis, managers reduced their sale of short term gains in weeks 51 and 52 of ownership by between 35% and 91%.

Conclusion: Once measured and assessed on an after-tax basis, managers have changed behaviour in order to maximise after-tax performance.

Fact 7: THE VALUE OF FRANKING CREDITS SHOULD NOT BE UNDERESTIMATED

Before the introduction of after-tax performance measurement, managers would on average, consider franking credits at 50% of their actual value to investors. Since Warakirri introduced after-tax performance measurement in 2007, managers have told Warakirri that…

Manager 1
"We have analysed the "after-tax" drag from a low income/low franking portfolio over a 10 year period. The drag on after-tax performance is significant and as a result we have adjusted our investment process."

Manager 2
"We have always valued franking credits, but have increased the assumed value from 60% to 85% - we could go to 90%. We have increased awareness of franking credits from the perspective of analysing companies."

Manager 3
"We value franking credits for the Warakirri measured portfolio at 100c in the dollar, for others on average 63c in the dollar. The different valuation of franking credits changes expected returns and stock rankings. We have been putting pressure on companies to pay out excess franking credits."

Conclusion: Once measured and assessed on an after-tax basis, managers give credence to the factors that will maximise their after-tax performance, which could otherwise be ignored in a before-tax world.

Fact 8: ACCESS TO RELEVANT INFORMATION CAN IMPROVE AFTER-TAX RETURNS

One tax efficient manager has developed a pre-trade system that allows the portfolio managers to analyse the effect of trading on particular dates.

The manager detailed examples that showed implementing the pre-trade system added 8-10bps to its after-tax performance for the period. The manager could only use this for managing the portfolios measured by Warakirri as they did not have the relevant tax related information for their other mandates. After detailing the example, the manager summarized by stating:

"These gains might seem low individually but this represents a combined gain of approx 8bp - 10bp (depending on calc methodology) in a 12 month period for 2 stocks within a portfolio of 65. Given these results it is probable that the benefits over a 12 month period are going to be higher than I originally indicated to you in our meeting."

Conclusion: The manager was able to add value on an after-tax basis for two portfolios because it could access relevant information. The manager's other institutional mandates did not benefit.

Fact 9: BEFORE-TAX FOCUS CAN DAMAGE AFTER-TAX RETURNS (AND MEMBER BALANCES)

One tax sensitive manager was considering a switch from Australian-listed BHP shares to the London-listed BHP shares due to the London listed shares trading at a larger discount than had historically been the case. The manager looked at the tax consequences and as a result of the large capital gains tax liability that would have been realised, the manager decided not to undertake the switch.

Had the manager only been considering the before-tax outcome, the switch would have been completed, to the detriment of the fund's members.

Conclusion: After consideration of the impact on its after-tax performance, the manager made a decision not to proceed with an investment decision which would have been attractive on a before-tax basis.

Fact 10: DIVIDEND CYCLES CAN PROVIDE OPPORTUNITIES

A manager noted that the Commonwealth Bank is on a different dividend payment cycle to the other major banks and trades ex-dividend in February rather than May. As a result of this difference, the manager recognised the opportunity to switch into one of the other banks after CBA goes ex and pick up the May dividend and franking credits paid by another bank – potentially improving after-tax performance. This strategy is particularly attractive for tax-exempt (pension) assets as these do not incur capital gains tax.

Conclusion: Some managers are paying closer attention to the subtleties of market cycles which may increase the probability that after-tax outcomes are improved.

Fact 11: TAX DEFERRED DISTRIBUTIONS AND OVERSEAS PROFITS MAY NOT MAKE SENSE FOR AUSTRALIAN INVESTORS

One manager told Warakirri that due to the nature of listed property trusts (i.e. that they typically do not distribute franking credits), they are generally less attractive on an after-tax basis. This view extended to companies with susbstantial overseas earnings as any dividend would have limited franking credits.

The same manager told Warakirri that it had changed its portfolio construction at the margin as a result of its performance being assessed on an after-tax basis.

Conclusion: After-tax measurement makes managers consider the construction of their portfolio in a different light and enables them to make decisions based on maximising their after-tax performance not before-tax performance.

Fact 12: PORTFOLIOS SHOULD BE MANAGED SEPARATELY WHEN INVESTORS HAVE DIFFERENT TAX RATES

One manager that Warakirri measures manages separate portfolios on behalf of pension phase investors (0% tax with franking credits) and accumulation phase investors (15% tax with franking credits). Given the tax-exempt status of the pension investors, the manager is less concerned about turnover and crystallising gains. Not surprisingly, the portfolio managed for pension investors has exhibited consistently higher turnover than the portfolio managed for accumulation phase investors. On the margin, shorter term trading opportunities can be more attractive for tax-exempt investors.

Conclusion: Managing pension phase assets separate to accumulation phase assets can result in improved after-tax outcomes for pension phase investors.

Fact 13: SOME COMPANIES HOLD A LARGE AMOUNT OF FRANKING CREDITS ON THEIR BALANCE SHEETS

Tax aware managers are increasingly agitating that companies pay fully franked dividends when there are “excess” franking credits on a company’s balance sheet. Franking credits are valuable in the hands of Australian superannuation investors but are not valuable sitting on balance sheets. A manager commented to Warakirri that Santos had the equivalent of high single digit percentage of the company’s market value in franking credits.

Conclusion: Franking credits are increasingly being valued by Australian equities managers. The increased focus on franking credits can, on the margin, change the relative attractiveness of certain companies.

Fact 14: SUPERANNUATION MEMBERS RECEIVE AFTER-TAX RETURNS

Australian equities managers should be assessed and remunerated based on after-tax returns. Why? Because superannuation members receive after-tax returns. An increasing number of funds are becoming more tax aware. A move towards tax aware investing is underway. Some funds are now assessing what is typically their largest asset class on an after-tax basis.

These funds have access to relevant information that allows them to accurately assess performance and make more informed decisions with regards to allocating capital.

Conclusion: Superannuation members receive after-tax returns, therefore managers should be assessed on the same, after-tax, basis.

This is the sixth Occasional Paper in a series focused on the after-tax management of Australian equities.

Occasional Paper 1: *After-tax management of Australian equities: an introduction*

Occasional Paper 2: *After-tax management of Australian equities: the importance of capital gains tax*

Occasional Paper 3: *After-tax management of Australian equities: demystifying after-tax benchmarks*

Occasional Paper 4: *After-tax management of Australian equities: two elephants in the room (and they are both growing!)*

Occasional Paper 5: *Off-market share buybacks: "money for jam?"*

The first five Occasional Papers are available on Warakirri's website at www.warakirri.com.au.

Warakirri Asset Management

Warakirri provides an industry leading After-Tax Performance Analytics service for Australian superannuation funds and fund managers in the Australian equities asset class. The service is a turnkey solution that allows funds to implement after-tax assessment for their managers with minimal impact on either the fund's daily operations or their managers. Warakirri has been assessing the performance of Australian equities managers on an after-tax basis against unique after-tax benchmarks since 1 July 2007.

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