

After-tax investing ... the evidence is now compelling

After-tax reporting and benchmarking is finally gathering momentum. To John Nolan, it is actually an indictment on the industry, including himself, that the development has taken so long. GREG BRIGHT reports.

After-tax and after-fees reporting of returns to super funds by their managers seems like a logical advancement. That is, after all, what the super fund members eat.

However, for many years when returns continued in the double-digits, reporting, measurement and benchmarking on an after-tax basis just seemed to be too hard. The hidden assumption, too, was that the amounts which might be saved by placing greater focus on after-tax at the manager level probably were not all that great.

With a couple of years of negative returns and the prospect of recovery looking like a long and windy road, people are now paying more attention. And that assumption about the potential savings is not correct – they can be very significant.

Warakirri Asset Management, the multi-management firm started by John Nolan as a way to better service some clients after he had founded what is now JANA Investment Advisers, has notched up three years of returns with a focus on after-tax outcomes, which required the development of bespoke benchmarks for managers.

The results are compelling, not the least reason being that the focus has changed funds manager behaviour. The evidence is clear



John Nolan ... 'Jeremy Cooper got it'

that super fund members are much better off for the move.

The final report into superannuation by Jeremy Cooper this year picked up on the importance of after-tax reporting. The report recommended amendments to the SIS Act to ensure trustees consider the taxation consequences of their investment management mandates.

"The relatively low tax rate on superannuation generally appears to cause trustees and managers to believe that the potential leakage from lack of careful tax management is minimal, but in a large super fund, even a few basis points can mean millions of dollars," the report says.

"The Panel has concluded that super fund tax issues are not being given adequate priority by the industry... Trustees should have express regard for taxation issues at all stages of the investment process: strategy, implementation and monitoring... Managers should manage portfolios in a tax-aware manner for the benefit of investors."

"Jeremy Cooper got it," John



Andrew Nolan ... 'franking credits alone can add or subtract 50bps'

Nolan says.

But pre-tax and pre-fee reporting has been the standard for the major asset consultants since the 1980s when Russell Investments and the former Towers Perrin pioneered the institutional investment advice segment of the market.

"Asset consultants haven't led the industry on this," Nolan says. "And I include myself in that. However, I've known since the mid-1990s that it should be done." Nolan also notes that "We (Warakirri) participated in buybacks and made a lot of money for investors." Off-market share buybacks typically include a fully franked dividend component, so thinking about the after-tax consequences of such buybacks is important in determining whether investors should participate.

Russell Consulting now has a director of after-tax investment strategies, Raewyn Williams. Towers Watson was scheduled to publish a paper on the subject as this issue of *Investment Magazine* was going to press.



Raewyn Williams ... 'cost of a pre-tax mindset is lost value for members'

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Russell's Williams agrees that share buyback opportunities represent lost value for super investors - what she calls "the cost of a pre-tax mindset".

According to Williams, the current Woolworths off-market share buyback offer can add around 30bps in returns after tax to a super fund holding the stock at benchmark weight – clearly a good deal even though it would cost the fund in pre-tax returns.

Perhaps one reason that some managers have ignored buyback opportunities is that from a

Good net outcomes depend on data

The only way a funds manager can hope to achieve optimal after-tax performance is to have its fund accounting system "talk" to its order management system, according to managing director of software vendor Simcorp, Peter Hill.

Simcorp has a vested interest in such integration, given its Dimension platform can, if fully implemented, unite a manager's front, middle and back offices on a single system. When the Danish company first established an Australian presence, it was insistent that clients sign up for this holistic system replacement. Those who have come closest to it in the region are Challenger Financial Services (including the boutique funds managers it incubates), Macquarie's funds management group and Singapore Monetary Authority, however when times got tight the vendor was forced to focus on component sales.

Indeed, Hill laments that what little momentum there had been towards an "after tax mindset" was stopped by the global financial crisis, and he struggles to think of more than a handful of managers operating in Australia that have enough information to trade in a way that optimises after-tax outcomes. Of course, many of them are not all that keen to do so, admits Simcorp senior business consultant Lewis Krimmer, who recently co-authored a white paper on after-tax performance reporting for the software vendor. "The portfolio manager will always think he adds the most value on a net basis if he's just allowed to get on and pick stocks as he sees fit."

One way of countering this resistance, according to Krimmer, is to have sufficient data which can allow a simulation to be run, and display the tax implications of a trade before it gets made.

"This is a big thing – it appeals to



Peter Hill ... the accounting system has to 'talk' to the OMS

a portfolio manager's instincts," Krimmer says. Ideally, a funds manager needs to group its clients into sub-funds depending on the type of taxpayer they are, to ensure that after-tax outcomes are best being managed for each client. He notes that few are doing this.

Ultimately, he predicts it will take regulatory intervention to convince the majority of funds managers to invest with a focus on after-tax outcomes.

"Economies of scale would help encourage the development of more and better after-tax indices. It's just so niche at the moment." Of course, after-tax management would be a lot simpler if investment products were taxed annually on a fair value basis – this is in fact an option under the new Taxation Of Financial Arrangements Regime.

However, Krimmer says this would mean 'mums and dads' would be taxed on gains they had not yet realised – political suicide for any Government brave enough to countenance it.

manager's performance perspective, when the consultants and clients are measuring returns pre-tax, participation in a share buyback will not positively impact published performance.

John Nolan, the executive director, investments, at Warakirri, was recently joined at the firm by his son Andrew, who is head

of investor solutions. Andrew completed an MBA at Georgetown University in the US and worked for Wellington Management Company LLP in Boston. He also had a variety of equity roles at Commonwealth Bank before going overseas.

Andrew Nolan says that managers need to be measured

on an after-tax basis. It makes sense to focus first on Australian equities for after-tax measurement and reporting because it is still the largest asset class for most funds and Australian equities are actively traded.

"Franking credits alone can add or subtract 50bps from (benchmark relative) returns," he says. "When you take account of capital gains tax as well, for managers to be measured and rewarded on a pre-tax basis just doesn't make sense."

John Nolan says he has seen instances of managers trading in the 51st or 52nd week, of a stock being owned by the super fund, yet the nominal gains realised before 52 weeks are taxed at 15 per cent and discount gains realised after 52 weeks are taxed at 10 per cent.

In a live example, when measured on an after-tax basis, managers reduced their sale of nominal gains in weeks 51 and 52 of trading by between 35-91 per cent.

In another live example over the 12 months to June 2010 two managers delivered the same before-tax alpha but with a variance of 0.54 per cent after tax (below).

Actual Performance July 1 2009 to June 30 2010

	Before-tax Alpha	After-tax Alpha
Manager A	2.92%	3.07%
Manager B	2.92%	2.53%
Variance	0.00%	+0.54%

In this example, Manager B realised more gains on shares held for less than 12 months than Manager A and was therefore subject to more capital gains tax at 15 per cent. Manager B also earned less franking credits than Manager A.

It took Warakirri a couple of years to develop its methodology for after-tax benchmarking, which was introduced across most managers in July 2007.

Andrew Nolan says that proper comparisons require that the benchmark has the same embedded loss or gains at the start of the measurement period as the portfolio. When there is an inflow or distribution from the portfolio, you have to adjust the benchmark to mirror these.

Warakirri sends each manager the tax status of all share parcels every month so the portfolio managers can make rational decisions. Then they are given a reconciliation of pre-tax and after-tax returns so they can understand the difference.

"We're not saying 'if you think the company's going to go broke tomorrow you should delay the trade to reduce tax'. But at least you should have all available information to make the right decision for the client," John Nolan says.

Warakirri now provides its after-tax measurement and reporting service (that includes benchmarking) as a standalone offering to super funds. It currently has three funds using the service, including HESTA.

Rob Fowler, executive manager, investments and governance,

for HESTA, says: "Given the weighting to Australian equities for most super funds, there are clear benefits for our members that can be achieved through our fund managers focusing on delivering after-tax, rather than pre-tax, returns. We are observing changed practices at many of our fund managers and our experience to date has validated our expectations."

For Warakirri's multi-manager clients, they have piece of mind that

the managers are being measured with their best interests in mind. The one and three year numbers across Warakirri's four multi-manager funds indicate value added on both a before and after-tax basis. The average net three-year before and after-tax alpha of the Warakirri multi-manager funds has been 2.9% and 3.8% respectively.

Perhaps the simplest way to look at the difference between before-tax returns and after-tax

of the extent of the potential value-add previously.

Andrew Nolan quotes one manager who said that they had always valued franking credits, for instance, but now they have increased their assumed worth from 60 per cent to 85 per cent, and this could go to 90 per cent.

Another said that focusing on the franking credits, at 100c in the dollar, changes the manager's expected return stock rankings.

Warakirri Australian Equities Pensions & Charities Fund 1 year to June 30, 2010

	Before-tax	After-tax
WAPECF	14.7%	16.5%
S&P/ASX 300 Accum Index*	13.1%	14.5%
Outperformance	+1.6%	+2.0%

*The after-tax benchmark includes franking credits and is based on the S&P/ASX 300 Accumulation Index.

returns is to consider performance for tax-exempt investors. For tax-exempt investors the difference is simply franking credits. The table below illustrates that franking credits can significantly add to the return of an Australian equities portfolio. For the past year, franking credits have added 1.8 per cent to the return of the portfolio and 1.4 per cent to the return of the benchmark.

To be fair on the managers who have provided the better outcomes because of the new focus, they were largely unaware

of the extent of the potential value-add previously. So the difference puts pressure on companies to pay out excess franking credits.

In a takeover of an Australian company by an offshore one, the franking credits issue can be very important. For example, Healthscope, which had significant franking credits on its balance sheet when subject to a foreign takeover, attracted some lobbying from institutional shareholders for part of the consideration of the bid to be paid out as a fully franked dividend

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as franking credits are not valuable to overseas shareholders.

For big super funds, the after-tax story can go a step further through the use of propagation programs at the custodian level. Andrew Nolan points out that this is a related, but separate issue, as it involves making sure the optimum after-tax position is accounted for at the whole fund level after the manager decisions have been taken.

Russell's Williams gave a presentation at the firm's 2010 annual investment summit last month, where she used an extended analogy between wine tasting and after-tax investing. One of the after-tax investing approaches

'tasted' at these presentations was the custodians' offering, referred to as 'propagation'.

With propagation, tax parcel selection is done at the widest possible level, across different accounts within a super fund's portfolio, to choose tax parcels with the lowest taxable gains on trades. The custodian nets off all the fund's trades at the end of the period, so that those which may have attracted more tax are offset by those which would have paid less.

Russell was also a pioneer of emulation services, whereby a fund appoints a "master manager" to trade more efficiently on its managers' daily buy and sell decisions. Williams says that Russell's emulation strategy has, since inception, demonstrated some innate tax efficiencies, including producing only half the turnover of a standard multi-manager strategy.

However Williams offers a cautionary note for super funds. As with 'good' and 'bad' wine, the after-tax investing process needs to be put into context with a budget, the sophistication of the tasters and whether it is a match with the food. That is, the budget and resources of the fund, the sophistication of its management and whether the process is a good match with the portfolio structure and reporting framework. ■

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