

DUNSTAN

After-tax returns are what count

The industry is slowly adapting the way it reports, bringing it in line with the Cooper recommendations, writes **Barrie Dunstan**.

The move to after-tax investment and reporting by Australian superannuation funds is slowly gathering momentum — though it is yet to reach bandwagon speed.

But Melbourne boutique investment group Warakirri Asset Management is now poised to produce a regular survey of after-tax performance numbers for a group of local equity managers running shares for local funds.

At the same time, US group Parametric Portfolio Associates is entering the local market with its first deal, supplying after-tax measurement services to leading industry fund performer Catholic Super to allow it to measure six of its active equity managers' performances.

And major asset consultant and super fund operator Mercer recently also added its weight with a paper, which said risk-adjusted, after-tax performance was the true measure for fund returns and suggested that superannuation regulators would intensify the focus on after-tax figures.

Apart from this service and a competing approach now from Parametric (owned by Eaton Vance, one of the oldest US investment management firms) there is also an off-the-shelf system from FTSE/Association of Superannuation Funds of Australia that provides after-tax indices. All this is in anticipation of eventual adoption of after-tax reporting, in line with the recommendations in Jeremy Cooper's review.

This said fund trustees should expressly have regard for tax consequences, that managers should



Figuring it out . . . Brian Hender, left, and Andrew Nolan of Warakirri Asset Management.

Photo: LUIS ASCUI

run portfolios in a tax-aware way and that returns should be reported on a pretax and after-tax basis.

In the absence of any ruling by superannuation's prudential regulator, the investment management standard is to measure performance (and pay fees) against pretax benchmarks. Fund managers will only move to an after-tax basis if pushed, Andrew Nolan, Warakirri's head of investor solutions, suggests.

Moving to after-tax reporting will require significant changes in the investment chain and involve extra costs — at a time when there is pressure on funds to reduce or hold down their costs.

Catholic Super's chief investment officer, Garrie Lette, says his group has long believed that returns should be measured on an after-tax basis "because this is what matters to our members".

Nolan says after-tax reporting and management is vital because super funds are allocating long-term capital — but unless they know the after-tax numbers they can't do this sensibly.

He cites two managers surveyed that both earned 2.92 per cent before tax. But trustees can't assume there is no difference in after-tax performance — one manager's after-tax return is 2.53 per cent while the other earns 3.07 per cent after tax.

That half percentage point difference, Nolan says, represents \$500,000 more after tax on a

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\$100 million portfolio, adding to the returns of fund members.

He says managers should run separate portfolios for investors with different tax rates. If a portfolio has a mix of investors on different tax rates, he says, managers can't make rational decisions on things like buybacks.

"The big super funds ought to be able to segregate pension assets," he says.

Nolan has collected examples in a paper of how tax-aware investment managers can improve returns for fund members. One example was in the Healthscope takeover by foreign-owned Asia-Pacific Healthcare Group.

Managers using an after-tax approach successfully agitated for a special fully franked dividend to be paid as part of the consideration, which was more beneficial on an after-tax basis for local investors. For those overseas, the franking credits were not valuable.

Nolan says the tax status of investors in super funds is important. (The tax rate is 15 per cent in the accumulation stage but zero in the pension phase.) This means there is a big difference in the value of an off-market share buyback for the two different categories of investors.

Warakirri studied what tax-aware managers did in 15 buybacks from late 2003 to June 2011 and found the tax-exempt fund got a value of 5.2 per cent after tax from the buybacks. The 15 per cent tax paying fund's return was only

1.4 per cent. He says studies have also shown that, when they are measured on an after-tax basis, fund managers become more sensitive to the lower tax treatment for capital gains made after holding for 12 months.

In the first year of after-tax measurements, Warakirri found managers reduced their sales for short-term gains in the last two weeks of a financial year by between 35 and 91 per cent.

Super funds face much higher payouts of pensions as their members reach retirement age and the percentage of members in the pension phase will continue to rise, lifting pressure on funds to manage their pension money in a more tax-efficient way.

For instance, managers may avoid taking capital gains over less than 12 months because of the tax penalty. But in a pension fund, there is no tax payable on capital gains, which means managers can take profits when they like.

Warakirri's proposed quarterly after-tax analysis will cover returns for two and three years (as available) by various equity managers. It will provide after-tax returns compared with each manager's individual customised after-tax index.

The survey will include after-tax returns from Concord Capital, Cooper Investors, Goldman Sachs Asset Management, Greencape Capital, Invesco, Karara Capital, Maple-Brown Abbott, Orbis Investment Management, Orion Asset Management, Paradise Investment Management, Perpetual Investments, Renaissance Asset Management and Sterling Equity.

In addition, Westpac's BT Investment division has agreed to take part, although its numbers won't appear in the first survey.

Warakirri is talking with other leading managers who are not yet committed. The survey will not be distributed publicly but will go privately to managers in the survey and to subscribers.



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