Measuring performance on an after-tax basis aligns investment manager behaviour with member returns, writes ANDREW NOLAN, BRIAN HENDER, KATE MISIC and ANDREW KATEIVA.

Since the introduction of tax on Australian superannuation funds in 1988 the industry has known that investment performance should be measured on an after-tax basis to align manager behaviour with member returns.

Simply stated, member returns are after tax, therefore superannuation funds should award, measure and review Australian equity mandates on an after-tax basis. The current mismatch of objectives is potentially hazardous from a governance perspective.

Historically, the task of measuring managers on an after-tax basis has been seen as too difficult and complex. Now the industry has the systems and expertise required to take the next step. Superannuation fund risks being at a competitive disadvantage if they don't move to after-tax management.

Discussion of after-tax returns and performance measurement raises a number of questions, including:

- What are the keys to improving after-tax returns?
- Do my managers already manage with after-tax returns in mind, even though they are not measured that way?
- Can I measure the after-tax performance of my Australian Equity managers?
- Is there an after-tax benchmark readily available?
- Should my managers be managing pension assets differently to accumulation assets because of the different tax rates that apply?
- Where should I start?

Galileo wrote "Measure what is measurable, and make measurable what is not so."

Our experience in the area of after-tax investing enables us to help superannuation funds answer the above questions and offer ideas for funds interested in moving to after-tax management for their Australian equity mandates.

Although not all superannuation funds are moving to measure managers on an after-tax basis, we expect that competition between funds, increasing member sophistication and a continued focus on corporate governance will result in the logical movement to after-tax measurement of Australian equity mandates.

> Super funds should award, measure and review Australian equity mandates on an after-tax basis.

IMPROVING AFTER-TAX RETURNS

Measuring managers on an after-tax basis and increasing manager awareness by providing managers with relevant information changes manager behaviour and improves after-tax outcomes for superannuation members.

Warakirri has long experience in measuring Australian equity mandates and trusts on an after-tax basis and our experience reveals that measuring managers on this basis increases awareness of tax and changes behaviour.

In 2005, before we introduced after-tax mandates:

- Less than 20 per cent of managers knew their tax parcels.
- Only 1 in 4 managers would participate in off-market buybacks if not directed by their investors.
- On average managers valued franking credits at 50 per cent of their value to superannuation fund members.

Now:

- All of our managers have access to their tax parcels to assist with trading decisions.
- Managers proactively make tender decisions in off-market buy-backs.
- Increasingly, managers are incorporating the full value of franking credits in their stock valuation processes.

Managers who have transitioned to after-tax mandates have made the following comments:

- "We are treating tax as another transaction cost…and are looking to integrate franking credits into our valuation methodology."
- "Valuing franking credits at 100 cents in the dollar adds 15 per cent to Woolworths, 2 per cent to Brambles."
- "At the margin we have changed portfolio construction – we only track tax parcels of Warakirri portfolios."
- "From an after-tax perspective, listed property trusts are less attractive, as are overseas earnings – higher quality companies (profitable companies that pay fully-franked dividends) are worth more."
- "In valuing the company…(it has) $8 million of cash and $16 million of franking credits."

TAX EFFICIENT MANAGEMENT

Managing an Australian equities portfolio with an after-tax focus requires the manager to have access to and use information that currently exists, but in many cases is not easily accessible for the manager.

Tax efficient management requires information including:

- Franking credits: Franking credits can be incorporated into security valuation.
- Tax parcels: Knowing tax parcels is necessary so that CGT can be considered as part of the sale process.
- Investor's tax rate: Knowledge of an investor's tax rate is important so that informed transaction decisions can be made (including off market buybacks).
- Reporting: Comparing after-tax performance to a relevant after-tax benchmark is important to assess managers.

MEASURING AFTER-TAX PERFORMANCE

Measuring managers on an after-tax basis is essential to ensure that managers

Maximising after-tax returns

are acting in the best interests of superannuation members. While some managers may say that they are focused on after-tax returns, the only way to be sure is to measure managers on an after-tax basis. It makes sense to explicitly align the incentives of the manager with the superannuation fund's members.

After-tax performance is different to pre-tax performance and the difference can be significant. Also note that managers with the same before-tax returns will most likely have different after-tax returns (see Manager 5 and Manager 8 in the table at right).

Before-tax performance is easier to measure, but we as an industry have all the information required to measure after-tax performance.

Calculation of after-tax performance adjusts for:

- Realised capital gains and losses

AUSTRALIAN EQUITY MANAGER RETURNS*: 2007-08

	Before-Tax	After-Tax	Difference
Manager 1	-11.0 per cent	-9.0 per cent	-2.0 per cent
Manager 2	-11.6 per cent	-10.1 per cent	-1.5 per cent
Manager 3	-15.2 per cent	-13.4 per cent	-1.9 per cent
Manager 4	-8.7 per cent	-6.7 per cent	-2.0 per cent
Manager 5	-12.5 per cent	-11.3 per cent	-1.2 per cent
Manager 6	-16.7 per cent	-14.7 per cent	-1.9 per cent
Manager 7	-9.3 per cent	-8.3 per cent	-1.0 per cent
Manager 8	-12.5 per cent	-10.6 per cent	-1.9 per cent
Manager 9	-22.0 per cent	-18.7 per cent	-3.3 per cent
Manager 10	-9.3 per cent	-7.6 per cent	-1.7 per cent

*Portfolios managed against after-tax benchmarks independently calculated by ITG Australia.

- Unrealised capital gains and losses
- Imputation credits

Indeed, some superannuation funds have started to measure their managers on an after-tax basis and some investment managers offer Australian equities portfolios that are measured on an after-tax basis against after-tax benchmarks.

Currently there are at least 20 Australian Equities managers being measured on an after-tax basis. In July 2009, the large industry fund HESTA hired Warakirri Asset Management to assist its Australian equities managers to shift to after-tax mandates. Rob Fowler, Executive Manager – Investments and Governance, commented "post-tax measurement and remuneration will necessitate a paradigm shift in fund manager thinking which will significantly benefit HESTA members".

AFTER-TAX BENCHMARKS?

Awareness of after-tax benchmarks has increased with the recent launch of the FTSE ASFA Australia Index Series.

While the Index Series may be useful for tax exempt investors, given there are no capital gains tax complications, there are a number of reasons why the use of a single after-tax benchmark cannot be used across multiple mandates or managers for superannuation funds.

In the next two years we expect a significant shift to performance measurement based on after-tax benchmarks that are uniquely calculated for each particular portfolio.

After-tax benchmarks vary significantly from pre-tax benchmarks and are more complex. Consistent with the measurement of Australian equity portfolios on an after-tax basis, additional information required for calculation of after-tax benchmarks includes realised capital gains and losses, unrealised capital gains and losses, and franking credits. Taking into account the taxation components, one after-tax benchmark can also vary significantly from another.

The table above shows after-tax benchmark returns for various Australian equities portfolios. Note the 0.5 per cent spread between the highest and lowest after-tax benchmark returns (see Benchmark C and Benchmark D above) even though they all have the same pre-tax benchmark return.

BENCHMARK RETURNS BASED ON S&P/ASX300 INDEX: 2007/08

	Before-Tax	After-Tax*	Difference
Benchmark A	-13.7 per cent	-11.7 per cent	-2.0 per cent
Benchmark B	-13.7 per cent	-11.7 per cent	-2.0 per cent
Benchmark C	-13.7 per cent	-12.1 per cent	-1.6 per cent
Benchmark D	-13.7 per cent	-11.6 per cent	-2.1 per cent
Benchmark E	-13.7 per cent	-11.8 per cent	-1.8 per cent

*After-tax benchmarks independently calculated by ITG Australia.

Measurement of the after-tax performance of two superannuation mandates (or managers) requires two different benchmarks. This is because the timing of the initial investment and subsequent cash flows has an impact on the cost base and capital gains tax rate applied to realised and unrealised capital gains. For example, consider two Australian equities mandates funded with cash – one in January 2005 and another in October 2008.

Even if the mandates are managed by the same manager in an identical manner, the after-tax benchmark outcomes for 2008/09 would be different because timing of initial share purchase and hence cost base vary significantly. After-tax benchmarks need to reflect the different cost bases and share purchase dates of the portfolios in order to create a "fair game" for managers.

> When measured "after-tax", managers make investment decisions consistent with the tax status of the underlying investors.

COMPARING AFTER-TAX PERFORMANCE ACROSS MANAGERS AND FUNDS

Given that unique after-tax benchmarks are required, the question is often asked, "How can we compare the after-tax performance of our managers with the after-tax performance of other funds?"

The most accurate solution is to compare after-tax "value add" (i.e. alpha) or the difference between the after-tax performance of the portfolio and the after-tax performance of the benchmark.

A single benchmark would be "nice to have" but in the context of after-tax returns, having a single benchmark just doesn't make sense. Having one benchmark would imply that after-tax returns can be compared across managers or funds.

Comparing raw after-tax returns of Australian equity managers is like comparing apples and oranges. The tax-adjusted components of the after-tax return make direct portfolio return comparisons problematic. Using similar logic, after-tax investment returns for investors that have different tax rates should not be directly compared.

MANAGING TO A SPECIFIC TAX RATE

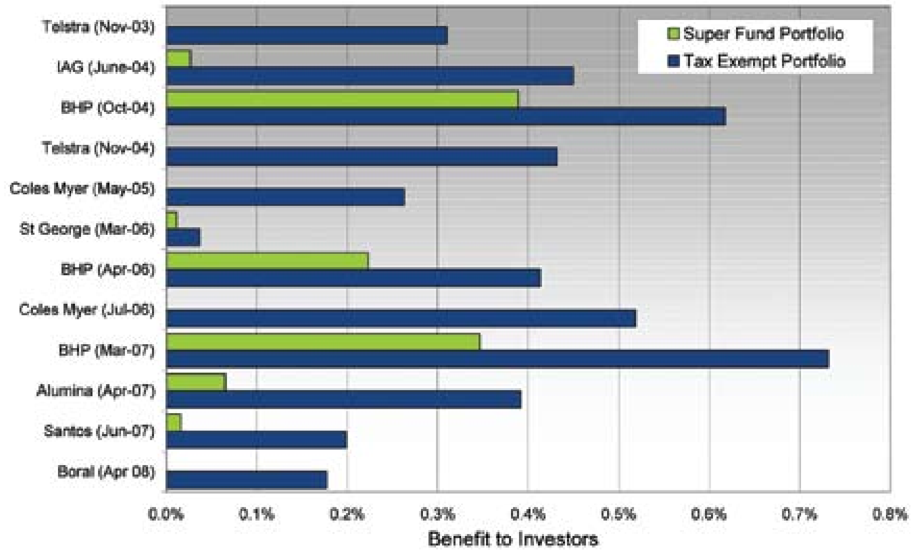
Being measured on an after-tax basis implies that managers should make different investment decisions based on the investor's tax rate.

Indeed, after-tax management and measurement implies that a portfolio or investment approach should focus on investors that share the same tax rate. Our experience shows that when measured on an after-tax basis, managers make investment decisions consistent with the tax status of the underlying investors.

Off-market buybacks provide a useful illustration of this point. An off-market buy-back is usually made up of a capital component and a franked dividend component. On a pre-tax basis (excluding franking credits) participation in a buyback is generally unattractive, but on an after-tax basis (including the value of franking credits) the buyback may positively contribute to portfolio performance.

The table (opposite page) provides an example of participation in buybacks by funds measured on an after-tax basis for investors that have a 15 per cent tax rate versus 0 per cent tax rate and the benefit of

BENEFIT OF PARTICIPATION IN OFF-MARKET BUYBACKS BY TAX AWARE MANAGERS



participation to those investors. The stocks shown were held in both funds and position sizes varied.

The tax exempt investor receives full credit for franking credits and the 15 per cent tax payer pays some tax.

The participation in 12 of 12 buy-backs by the manager focused on tax exempt investors compared to participation in 7 of 12 for the manager focused on superannuation fund investors demonstrates that buybacks are most attractive to tax exempt investors and least attractive to investors with a high tax rate. It is clear that an Australian equities manager should be managing portfolios differently for investors with different tax rates.

> Funds and investment managers who don't work towards after-tax management risk being left behind.

In the context of a superannuation fund, it follows that 'accumulation' Australian equity assets should be managed separately from 'pension' Australian equity assets.

Using the chart above as an example, if your superannuation fund assets are managed as one pool your managers almost certainly did not participate in some buybacks that would have benefited your pension members.

Buyback decisions would have been made with pre-tax returns in mind (so the manager would not have participated) or a 15 per cent tax rate in mind in which case significant value was left on the table.

PENSION ASSETS

Traditionally superannuation fund assets have been managed ignoring tax. Both the accumulation and the pension assets of a superannuation fund should be invested with specific consideration of their tax status.

Pension assets should be managed to reflect the tax exempt status, the ability of pension members to receive the full benefit of franking credits. We estimate that managing Australian equities assets with specific consideration for the tax status of pension phase members could add between 0.5 per cent and 1.5 per cent to annual returns. The additional return is very meaningful for large superannuation funds.

ACCOUNTING METHODS – PENSION ASSETS

A superannuation fund is entitled to an exemption for so much of its income as is attributable to its liability to pay current pensions. According to the Australian Master Tax Guide (CCH, 2008, 42nd Edition), there are two methods of determining the exempt amount:

Attributable proportion method – superannuation assets are not segregated and the proportion of exempt income is based on the proportion of unsegregated superannuation liabilities.

Segregated current pensions – pension assets are segregated and ordinary and statutory income is tax exempt.

We believe that segregating only the Australian equities asset class is the most practical strategy for a superannuation fund that currently has relatively small pension assets. The Australian equities asset class provides the greatest opportunity to enhance returns for pension members.

We note that the size of pension assets will grow quickly as the first group of baby boomers reach the age of 65 in 2011.

WHERE SHOULD I START?

Measuring Australian equity managers on an after-tax basis is a good place to start. You have most of the information you need. Developing a methodology for measuring after-tax returns and applying an appropriate after-tax benchmark are obstacles that can be overcome. Segregating accumulation and pension assets for the Australian equities asset class is a logical next step.

The Australian equities asset class provides the greatest opportunity to enhance after-tax returns for pension members, primarily because of the franking credits attached to company dividends.

In the longer term, as the size of pension assets increases, segregating all pension assets from accumulation assets should be a goal.

CONCLUSION

There is an increasing focus on after-tax returns. Funds and Australian equities investment managers who don't move towards after-tax management risk being left behind. Member returns are after-tax, therefore superannuation funds should award, measure and review Australian equity mandates on an after-tax basis if they want to deliver superior returns to their members. **SF**

Andrew Nolan, CFA, Brian Hender, Kate Misic, CFA, and Andrew Kateiva are all employees of Warakirri Asset Management.