The why and how of after-tax funds management

With US research showing that after-tax can outperform pre-tax funds management by up to 200 basis points, the Cooper Review is examining the tax governance of the superannuation funds supervised by APRA, and the extent to which trustees take an interest in the taxation of the underlying portfolio.

THERE ARE THREE IMPORTANT ASPECTS of the after-tax performance of superannuation funds. Why do it? How is it done? How is it reported to investors?

The Australian School of Taxation (Atax) has been researching this issue for a couple of years. Our academic interest is founded very much in the real world. We had been made aware of a very large Australian life company that, at the instigation of its then deputy managing director, about 10 years ago, recalculated the before-tax returns on a $15 billion portfolio and found that when tax was taken into account the pre-tax returns started to look a bit 'overinflated'. Or, to put that another way, investors had lost value because the fund was not being managed on an after-tax basis.

After having our interest tweaked in managing funds for after-tax rather than pre-tax returns, we subsequently surveyed the tax people in the large Australian financial institutions to get their views about how tax was managed by their investment managers. What we observed was that there was very little integration between tax management and funds management in the financial services companies that responded to the survey. That lack of integration meant that fund managers in those companies had limited regard to tax when managing their portfolios. Anecdotal evidence suggested that the reason for this lack of integration was that fund managers were measured and remunerated using pre-tax performance benchmarks, not post-tax benchmarks. In the fund managers' favour was the fact that there were simply no post-tax benchmarks against which their performance and remuneration could be measured.

We also found that there are other things that impinge on managing a fund for after-tax performance. There is a perception that managing a portfolio for after-tax returns can be difficult and expensive, primarily because financial accounting is different to tax accounting in Australia, and fund managers need expensive systems to integrate tax with financial accounting to properly manage the portfolio on an after-tax basis. Other reasons given for not managing funds on an after-tax basis are that fund managers do not know the tax status of members and, in any case, their investors can be zero-taxed pension funds.

GORDON D MACKENZIE F Fin is Convenor of the Master of Tax and Financial Planning at the Australian School of Taxation (ATax) at the University of New South Wales.

gordon.mackenzie@unsw.edu

المنارة للاستشارات

www.manaraa.com

There is a perception that managing a portfolio for after-tax returns can be difficult and expensive, primarily because financial accounting is different to tax accounting in Australia, and fund managers need expensive systems to integrate tax with financial accounting to properly manage the portfolio on an after-tax basis.

However, the evidence in support of after-tax management is clear with US research showing that after-tax measurement can outperform pre-tax management by up to 200 basis points.

In the United States, mutual funds (managed investment trusts (MITs) in the Australian environment) are required to report their performance in both before-tax and after-tax terms. Investigations that were completed prior to introduction of that obligation showed that investors considered that the tax position of a portfolio was important, after-tax reporting helped them make better-informed decisions, and that there was, generally, a growing demand from investors to be provided with after-tax returns.

As a matter of practice, after-tax management usually focuses on the rate of turnover of stock in the portfolio because that is considered to be the most significant issue with respect to managing a portfolio on an after-tax basis. Generally, increased turnover means less unrealised gains in the fund and unrealised gains are valuable because they defer actual tax payment. Yet, there are other practices that can be used to manage a fund on an after-tax basis including loss harvesting (which is where a fund disposes of assets that have a gain so that they can use any losses straight away), taking tax into account prior to trading stock, changing weightings in portfolios using derivatives, and changing the source of income. Another practice that is relevant to Australia is efficiently managing the imputation credit position of the portfolio, where it is invested in equities.

Reporting after-tax returns

While managing a fund for after-tax performance and how that can be achieved are two key aspects of this issue, probably the most important is how that after-tax performance should be reported to investors, both existing and potential. There are a number of methods by which after-tax returns can be reported but, to a large degree, which method is used will depend on what you want to inform current and potential investors about.

If, for example, the objective is to inform members about the tax efficiency of a fund, there are methods that use aggregate after-tax investment rates of return. On the other hand, there is the methodology used in the United States, and a similar method recommended by the funds management industry in Australia for MITs, both of which translate the pre-tax return from the fund into an after-tax return.

Interestingly, one area of this whole issue that is still not well understood is how investors and financial planners factor tax efficiency of a fund into the buying process. This will be our next area of research. ●

In the United States, mutual funds (MITs in the Australian environment) are required to report their performance in both before-tax and after-tax terms. Investigations that were completed prior to introduction of that obligation showed that investors considered that the tax position of a portfolio was important, after-tax reporting helped them make better-informed decisions, and that there was, generally, a growing demand from investors to be provided with after-tax returns.

للاستشارات المنارة

www.manaraa.com

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات

www.manaraa.com