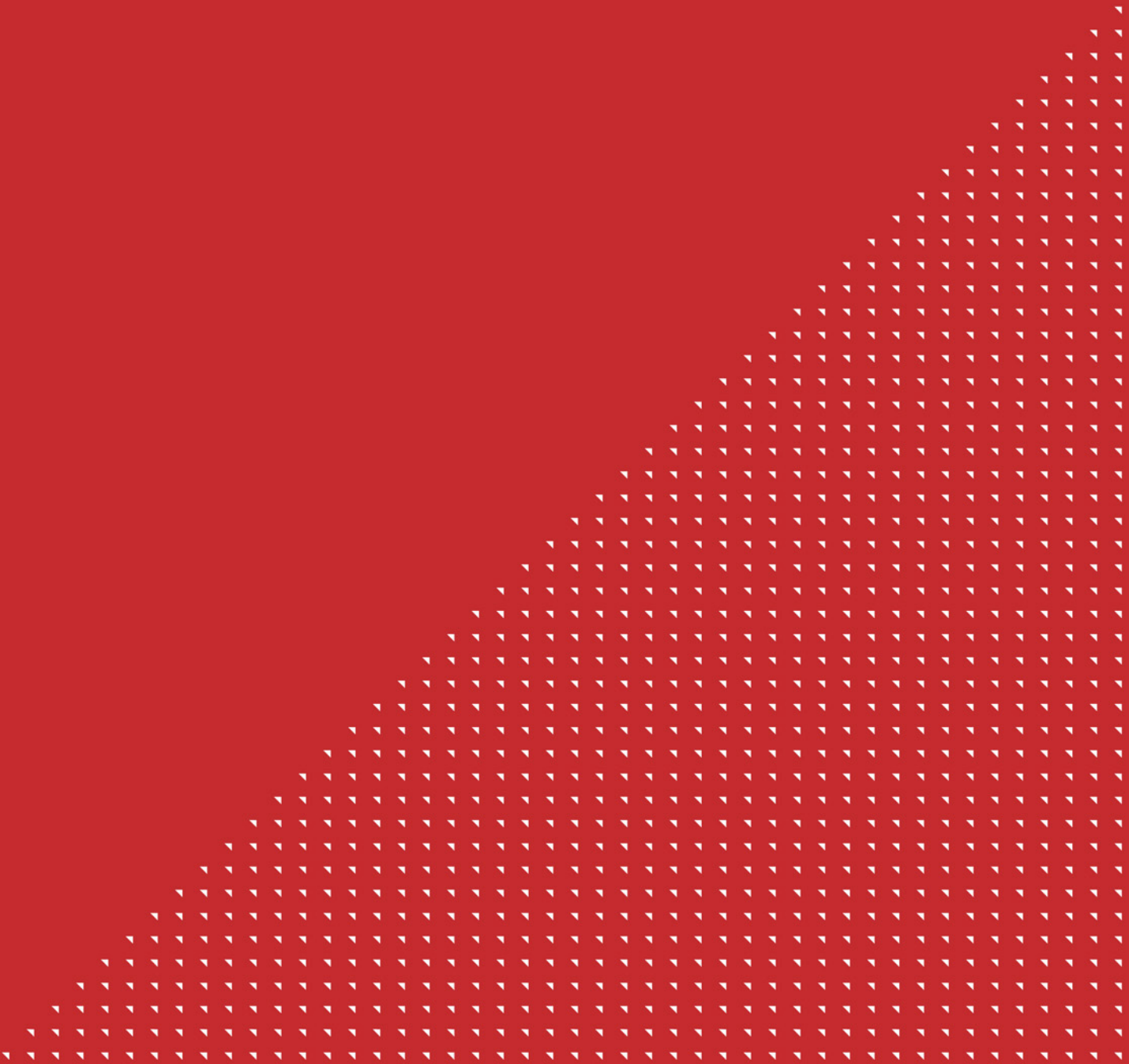


**Red Paper – After-tax investing
theory and practice**
Navigating the great divide

November 2009



Snapshot

- After-tax investing (ATI) requires investment managers to consider tax as part of their investment decision-making. This is attractive in theory, but can be difficult to implement in practice.
- A small number of ATI managers, including QIC, report large benefits (up to 100 basis points per year), which suggests that it may be in your members' interests to navigate the challenges of implementing ATI.
- ATI is not a 'one size fits all' investment solution. Your fund will need a 'best fit' ATI design that meets its particular cost requirements, benchmarking needs, portfolio structure, etc.
- Superannuation funds should be wary of overly simplified approaches to managing tax, which are not really true ATI solutions.
- The implementation of ATI is a collaborative effort and will be particularly challenging if your fund's investment managers have an embedded pre-tax focus.
- Managers and advisers can help your fund determine whether a move to ATI will create better investment outcomes for members.

After-tax investing theory and practice Navigating the great divide

Introduction

Imagine if your investment manager or adviser had an opportunity to increase your fund's returns by up to 1% every year without increasing your investment risk - and they ignored this opportunity. Or imagine if your investment manager offered you a fee rebate of 1% each year – and you turned them down.

You and your investment manager have, in fact, had these opportunities. The source of the increased return is not higher investment returns or lower fees, but rather lower tax liabilities (or higher tax refunds). Your members won't mind where the benefits come from, as long as their net returns are higher and their balances grow more rapidly as a result.

So, with such appealing outcomes, why haven't we seen more investment managers evolve their practices to manage and measure after-tax outcomes? And why haven't we seen more superannuation funds unhappy with this lost opportunity? The answer is that after-tax investing (ATI) is much simpler in theory than it is in practice.

While our industry has a broad appreciation of the benefits of ATI in theory, it continues to debate whether (and in what form) ATI can be delivered as a practical, meaningful, cost-effective and value-adding investment solution.

In this Red Paper, QIC draws on its experience in ATI to show how your fund can navigate the great divide between an acceptance of ATI in theory and its practical delivery.

Designing an ATI solution

There is no 'one size fits all' ATI solution for funds. Rather, to obtain a 'best fit' solution, funds need to understand three things:

1. What kind of value does your fund expect ATI to deliver? This will determine your fund's budget for an ATI solution (to ensure that the benefits outweigh the costs).
2. How would you like your investment managers to measure after-tax returns? The key to this will be agreeing on an appropriate benchmark with your managers.
3. Among the ATI options available, which is the best fit for your fund?

QIC's experience is that ATI strategies can generate additional return streams across all asset classes, and up to around 100 basis points (bps) or 1% per year for Australian equities strategies. Additional benefits can also be generated by employing ATI at a multi-sector overlay level, which can result in performance pick ups of between 11 to 45 bps per year. Your investment managers and advisers should be able to assist you in understanding the size of potential ATI benefits for your fund.

The lack of published benchmarks that calculate after-tax returns for funds has recently been addressed (at least for Australian equities) by the release of the ASFA-FTSE tax-adjusted Australian index series. There are some assumptions and constraints underlying the index calculation methodology that limit the accuracy of the benchmarks, but it is a simple, accessible benchmarking option for funds building an ATI solution.

The alternative is not necessarily an expensive, customised after-tax benchmark for each fund (although these are available). Having worked with a range of after-tax benchmarks, QIC believes the right benchmarking solution depends on what is meaningful for your fund. For example, QIC's seeded passive equity portfolios have start dates and cashflows that match our actively managed portfolios, allowing our clients to compare investment outcomes on an after-tax basis. This provides a simple, low-cost, after-tax benchmarking solution for these asset classes and has helped our clients identify outperformance of 13 bps and 11 bps (on an after-tax basis) in the first year of measurement. This level of transparency has also proved to be especially useful for the fund. The after-tax measures confirmed the fund was better off on an after-tax basis, whereas a reliance on gross benchmarks as a measure of performance would not have reflected the fund's true performance.

In July 2008, the Investment and Financial Services Association (IFSA) published a methodology for calculating pooled fund returns on an after-tax basis. This is another useful ATI measurement tool for funds that invest in pooled distributing trusts.

The risk of oversimplifying ATI

It is tempting for funds to turn to simple ATI solutions. However, funds should be wary of oversimplifying their ATI approach. For example, one approach is to equate tax with a turnover issue and simply move to a passive or low-turnover manager. While this is a low-cost alternative, it can hardly be called an ATI solution, as it ignores other cost-effective ATI approaches that can extract tax benefits from a much wider opportunity set.

With more than two year’s experience implementing a comprehensive ATI solution for a large superannuation fund, QIC has a thorough understanding of the traditional areas of ATI benefits, as well as market-leading expertise in generating material benefits from the less understood areas. For example, we have helped our clients determine which portfolios should hold currency hedging instruments, and whether physical or synthetic exposures should be used to generate year-on-year ATI return benefits.

It is important that your fund’s investment managers and advisers can help you understand the differences between emerging ATI approaches, rather than just suggesting one standard approach. An investment manager with experience in a wide range of ATI approaches is more likely to be able to help your fund find the right solution for its members. The right ATI solution doesn’t necessarily have to be complex or all-encompassing, but it should be ‘best fit’ in the context of your fund’s broader investment targets, size, operational structure, risk appetite, budget and other strategic factors. A ‘best fit’ ATI solution should complement these factors to deliver better investment outcomes for your members.

Potential ‘best fit’ approaches to ATI

The following table suggests different ATI approaches that a superannuation fund could apply within, and across, asset classes, with ratings of low value-add (✓), medium value-add (✓✓) and high value-add (✓✓✓).

	Australian Equities	International Equities	Fixed income	REITs	Unlisted
Structuring opportunities	✓✓	✓✓	✓	✓	✓✓✓
Tax deferral opportunities	✓	✓	✓	✓	✓
Franking credit opportunities	✓✓✓			✓	
Withholding tax opportunities		✓	✓		✓
CGT discounting opportunities	✓✓	✓✓		✓✓	✓
Derivatives overlay opportunities	✓✓	✓✓			
Tax loss optimisation	✓✓	✓✓		✓	✓
Market tax arbitrage opportunities	✓✓	✓✓	✓✓	✓✓	
Multi-sector overlay optimisation	✓✓	✓✓	✓✓	✓✓	✓✓

Implementing an ATI solution

ATI is an enhancement to your fund’s existing processes that can deliver year-on-year benefits to your members. To get a ‘best fit’ ATI solution for your fund, it is important to understand where it can add value in the management of your investment portfolios. It should not be more costly and complex than is appropriate, but it should also not be so simple that opportunities to generate real value for members are ignored.

Realising your fund’s theoretical commitment to ATI as a clear design, and then practically implementing this design, has its own challenges, particularly if your investment manager and other key service providers (e.g. your custodian) are still firmly entrenched in the pre-tax world. It is important that you discuss with your investment managers and service providers what skills and experience they have in ATI. Be aware that creating and operating in an embedded ATI environment where the goalposts have moved from pre-tax to after-tax objectives is quite different from the occasional, opportunistic tax plays that the manager participates in (e.g. off-market share buybacks). It is easy for managers to underestimate the challenges associated with important aspects of ATI, such as:

- how to deliver real-time tax data to front-office staff before key decisions are made

- how (and if) to adjust after-tax performance measures for withdrawals, index changes and other taxable events outside of the portfolio manager's control
- how to embed real cultural change within the manager's teams to achieve a true after-tax focus.

It is also important that the investment manager understands the difference between minimising tax and maximising after-tax outcomes. The latter, which is QIC's focus, takes a more holistic view. This view is more closely aligned with what fund members really want, which is not necessarily lower tax, but better overall after-tax investment outcomes. To illustrate this simply, maximising after-tax outcomes allows for higher tax on investment strategies that take on tracking error (i.e. risk) to outperform market returns. The resulting after-tax return is better than that achieved via a buy-and-hold strategy, which involves lower tax but also delivers lower after-tax returns.

Investment managers should recognise your fund's focus on after-tax returns and should be prepared to engage with you to ensure that your approach to ATI can be implemented. You'll know that your fund is in the hands of a good ATI manager when your manager:

- can clearly articulate the aims of your ATI solution and key design aspects, such as scope, cost versus benefits and ownership of key decisions and deliverables
- can demonstrate an understanding of how your fund views key trade-offs, such as accuracy versus simplicity and tax benefits versus tax risks
- is willing to engage jointly in training and feedback loops to increase tax awareness in the new ATI environment.

For some superannuation funds and managers, this collaboration may deliver a high-end, best practice ATI solution to members. Having designed and successfully implemented a full-scale ATI solution, QIC can provide funds with practical insight into how ATI works and help them determine how they may approach ATI. Importantly, QIC's experience shows that the value generated for fund members from the move to ATI exceeds the cost of the move.

QIC's experience also provides insights for funds that seek a single sector form or other more tailored form of ATI. This is because QIC's approach to ATI is built on single-sector approaches with a multi-sector overlay. Where QIC has been engaged to provide an ATI solution, it benchmarks and reports its ATI results broken down into single sector (as well as option or multi-sector) outcomes. This level of transparency has helped QIC's clients (and QIC) gain an understanding not only of the value of ATI as a broad investment principle, but also the sources of ATI opportunities in different asset classes in different parts of the market cycle.

Where does your fund sit in the ATI debate?

ATI is not industry practice. Its value proposition is still emerging, and very few superannuation funds and investment managers are in a position to quantify the benefits of ATI. Even where those benefits have been quantified, the risk to your fund is that the benefits are not high enough to justify the costs and complexity of implementing ATI.

However, one thing is clear: no fund should be dismissing ATI as just a good idea that is too difficult to implement. The challenge for funds is to understand how well their tax outcomes are currently being managed, and whether they can achieve better overall member outcomes by challenging their manager's focus on pre-tax outcomes. The complexity of the challenge and the diversity of emerging approaches mean that different funds will reach different conclusions to the same ATI question. But QIC believes that the ATI question is one worth pursuing.

For more information or to find out more about QIC's ATI solutions, please contact Paul Murray, Senior Investment Specialist, QIC Australian Equities, on +61 2 9347 3320 or via email at p.murray@qic.com.

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