

Q&A – After-Tax Benchmarking and Analytics in Global Equities

More funds are beginning the process of measuring the investment performance of their global equity managers and strategies on an after-tax, not just pre-tax, basis in addition to benchmarking their Australian equity managers. In this paper we answer some of the frequently asked questions when it comes to measuring and benchmarking after-tax returns for global equities.

Introduction

With ever-increasing competition in global markets and lower return expectations from equities going forward, implementation efficiency is of paramount importance to investors.

Incorporating tax awareness into a global equity portfolio management process involves some logistical challenges, however portfolios that are accurately valued against absolute returns and managers that can be evaluated on consistent performance criteria, level the playing field and drive better investor outcomes.

What is best practice of after-tax measurement and benchmarking?

When looking to evaluate manager performance, we believe the following forms best practice and should be considered fundamental in any methodology:

1. Evaluating performance should be based on after-tax alpha.
2. Manager mandates should have a customised benchmark that reflects the Capital Gains Tax positions in the portfolio.
3. Both manager and benchmark performance should be adjusted for:
 - a. Cash flows; &
 - b. In-specie transfer of stocks.
4. Tax parcel selection methodology applied to the portfolio should also be applied to the benchmark.
5. Clients typically use the post-liquidation approach where unrealised tax parcels gains/losses are taxed at the discounted capital gains tax rate.

How is after-tax performance calculated?

At its core, after-tax performance measurement is simple - adjust your starting and ending values by the tax liability in your standard return formula:

$$\text{Before-tax Return} = \frac{V_1}{V_0} - 1$$

$$\text{After-tax Return} = \frac{V_1 - \text{Tax Liability}}{V_0 - \text{Tax Liability}} - 1$$

It is the calculation of the tax liability that has significant complexity.

Why are customized after-tax benchmarks important?

There can often be variation between the same after-tax benchmarks, due to the different level of unrealised gains/losses of each benchmark (which is based on its portfolio unrealised gains/losses at inception of after-tax measurement).

We can expect the level of variation to range between 0.1% to 0.7% per annum. When evaluating manager after-tax alpha, this variation is significant and must be considered.

What is involved in creating a customised after-tax benchmark?

At Initialisation

- Matching the unrealised capital gains/losses tax position of the portfolio, so the benchmark has the same level of tax liability/credit as the portfolio.

- Applying the relevant tax parcel selection methodology.

Ongoing

- Matching cashflow to the benchmark as what occurs at the portfolio level.
- Matching in-specie unrealised capital gains/losses of stocks transferred into a portfolio for the benchmark.

Why is a customised approach to global after-tax analysis and measurement to benchmark after-tax returns superior to using the standard MSCI Net Returns benchmarks?

- Overcomes the weakness of using Net Returns benchmarks as there is a 'freekick' to the portfolio where Withholding Tax Credits are included at the portfolio level, but these credits are not reflected in the Net Returns benchmarks.
- Includes capturing income tax for countries where the withholding tax rate is 0%; where this does not capture Australian income tax that is paid at the superannuation income tax rate of 15%.
- Includes taxation impact on capital gains.

Why should the Gross Returns Benchmark be used as the starting point?

Using the MSCI Gross Index as the starting point will result in a 15% tax rate applied on all income. Essentially, this results in all gross income being taxed at the superannuation income tax rate of 15%.

If using the MSCI Net Index as the starting point:

- for countries where the withholding tax rate is 0%, an income tax rate of 15% will be applied;
- for countries where the withholding tax rate is above 0% but less than 15%, an additional tax will be applied to reach the income tax rate of 15%; and
- for countries where the withholding tax rate is above 15%, withholding tax credits and/or FITO will be added back for a net result of an applied income tax rate of 15%.

By using gross returns as a starting point, we can simplify our approach and yield the same result as using MSCI Net Indexes as the starting point and applying the respective withholding tax credits and FITO's (which would be much more complicated).

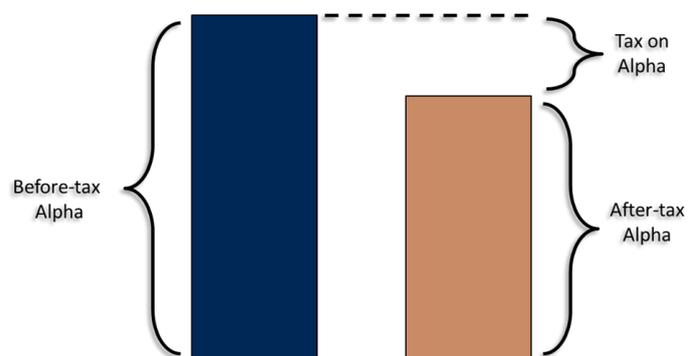
Warakirri's proprietary after-tax benchmarking methodology

- ❖ Available for all standard MSCI benchmarks
- ❖ Each benchmark is fully customized
- ❖ Utilises the standard MSCI Gross Returns Benchmark as the starting point for Before-Tax measurement
- ❖ Superannuation income tax rate of 15% applied on all gross income
- ❖ Capital gains tax applied in accordance with:
 - Nominal (short term, held less than 12 months) realised gains at 15% tax rate;
 - Discounted (held more than 12 months) realised gains at 10% tax rate
- ❖ Post-liquidation methodology used to treat unrealised capital gains/losses at the discounted capital gains tax rate of 10%

How will alpha compare when moving from pre-tax measurement to after-tax measurement?

Firstly, it is important to note a few fundamentals:

- After-tax alpha will typically be less than before-tax alpha;
- The more a manager outperforms, the greater the tax drag; and
- Conversely, after-tax underperformance will typically be lower than before-tax underperformance.



Given the superannuation tax rules that apply to Australian Superannuation funds:

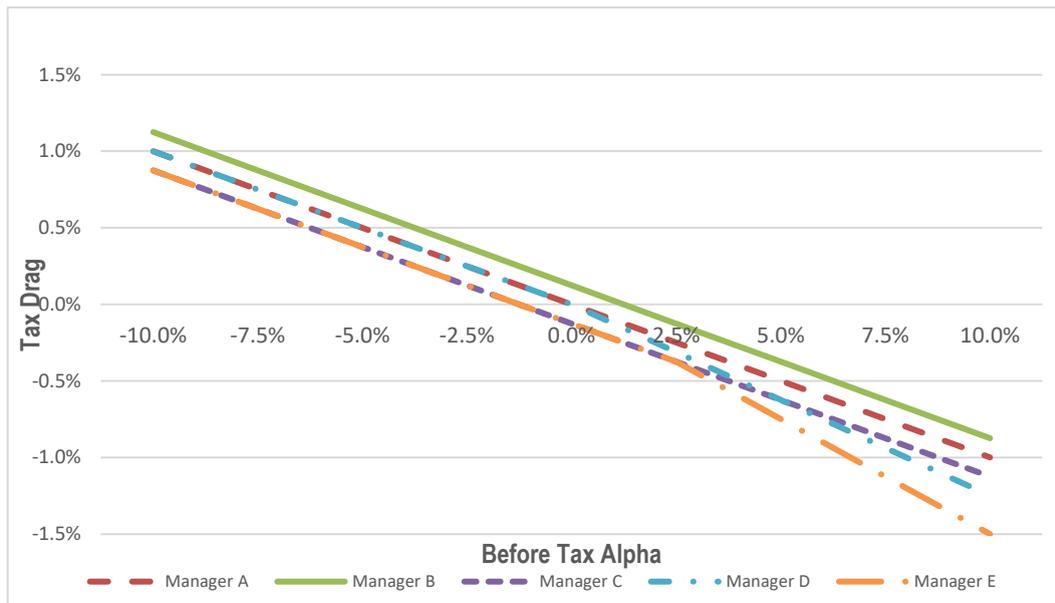
- The long-term discounted capital gains tax rate is 10%. This forms the basis of our expected tax drag at a given level of alpha.

- An efficient manager which earns less income and/or nominal realised capital gains than its after-tax benchmark can have a lower tax drag than 10%.
- A manager which earns more income and/or nominal realised capital gains than its after-tax benchmark will experience a higher tax drag than 10%.

What is the likely impact, in basis points, of moving from a before-tax alpha to an after-tax alpha approach?

The graph below illustrates the tax drag impact from after-tax measurement for a given level of before-tax alpha for a range of outcomes:

Manager Comparison
Before-Tax Alpha and Change in After-Tax Alpha



Source: Warakirri Asset Management

- **Manager A** – similar level of income and nominal gains as the benchmark = Tax Neutral Manager
- **Manager B** – lower level of income, similar level of nominal gains as the benchmark
- **Manager C** – higher level of income, similar level of nominal gains as the benchmark
- **Manager D** – similar level of income, higher level of nominal gains as the benchmark
- **Manager E** – higher level of income, higher level of nominal gains as the benchmark

The scenarios above show the following:

- At +2% level before-tax alpha, after-tax alpha is expected to range between +1.7% to +1.9%.
- At +5% before-tax alpha, after-tax alpha is expected to range between +4.3% to +4.6%.
- At +10% before-tax alpha, after-tax alpha is expected to range between +8.5% to +9.1%.

It was assumed that managers that did not deliver outperformance and would not generate nominal gains greater than available losses. Outcomes may vary from the above expectations due to a variety of factors, however we would expect most manager mandates to range between these levels.

Summary

Every taxable investor warrants a benchmark as unique as their tax-managed investment approach. There's no better gauge for measuring after-tax performance than a customised benchmark. Creating an appropriate after-tax benchmark allows an investor's portfolio performance to be put in proper perspective, making it possible to truly measure the success of active tax management.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au