



Tax-effective investing – a year round affair

Amazingly, every year that magical date, 30 June, generates an increased number of media attention and queries as investors and advisers seek the latest “tax-effective” investment. Ranging from emu farms, almond growing, wine estates, capital guaranteed equity products, to even the traditional imputation funds, the industry is abuzz with “tax-effectiveness” as a key goal.

What is most amazing about these times is how much people can focus on tax as that magical date approaches, but how little they focus on it throughout the rest of the year.

While many researchers, advisers and clients acknowledge tax as a cost of investing, and something to be minimised where possible, it is often quickly forgotten when a manager’s return drops 50-100 basis points below an index. During these times, those same people begin to question if the manager has ‘lost their competitive edge’.

What many people fail to realise is that tax is generally the single largest cost an investor faces when investing. In fact, tax can have a significantly higher impact than fees, a manager’s short-term underperformance, or even slightly altering a fund’s asset allocation.

So how important is tax?

The after-tax return that investors actually receive in their pocket is dramatically impacted by two factors – franking levels and turnover. These two factors can cause a dramatic difference in the after-tax return to investors in funds, which deliver the same headline rate.

To illustrate this point, consider a fund that has generated a 1 year return of 10%, made up of 3% distribution and 7% capital growth. The table below shows the after-tax return investors on different marginal tax rates would actually receive in their pocket, depending on whether that fund has a low (50%) or high (130%) franking level.

Franking \ MTR	0%	15%	31.50%	48.50%
Low (50%)	10.6%	10.1%	9.5%	8.9%
High (130%)	11.7%	11.0%	10.2%	9.4%

Assumptions: The distribution component consists entirely of ordinary income (ie. there are no realised capital gains), and the investor continues to hold the investment throughout and beyond the period.

As you can see, for an investor on the top marginal rate of tax (including Medicare Levy), the variation between a high and low franking level can cause around a 0.5% difference in the amount the client actually receives in their pocket.

But even more concerning is the impact turnover can have on the amount an investor actually takes home in their pocket. The table below considers the same fund, but takes into account the impact that a very high, high, low and very low turnover strategy can have on your clients' returns on an after-tax basis over a year.

Turnover \ MTR	0%	15%	31.5%	48.5%
Very Low (10%)	10.0%	9.5%	8.9%	8.4%
Low (50%)	10.0%	9.3%	8.5%	7.7%
High (100%)	10.0%	8.5%	6.9%	5.2%
Very High (150%)	10.0%	8.0%	5.7%	3.5%

Assumptions: The distribution component consists entirely of ordinary income (ie there is no distributed capital gains), but has a nil franking level; the investor continues to hold the investment throughout and beyond the period; the high and very high strategies only generate non-discount capital gains, and the very low and low strategies only generate discount capital gains; and there are no losses available to offset any capital gains.

For an investor on the top marginal tax rate, the variation between a very low and very high turnover manager could be almost 5% in the difference that investors actually take home.

When you put these two factors together, the range of possible outcomes for an investor on the top marginal rate of tax (including Medicare Levy) for a fund that delivers the same 10% headline rate, depending on franking and turnover strategies is:

Franking \ Turnover	Very Low (10%)	Low (50%)	High (100%)	Very High (150%)
Low (50%)	8.7%	8.0%	5.5%	3.8%
High (130%)	9.2%	8.6%	6.0%	4.3%

Assumptions: The distribution component consists entirely of ordinary income (ie. there is no distributed capital gains); the investor continues to hold the investment throughout and beyond the period; the high and very high strategies only generate non-discount capital gains, and the very low and low strategies only generate discount capital gains; and there are no losses available to offset any capital gains.

As you can see, for an investor (in the top marginal rate of tax), the variation between a low franking, very high turnover (blue box) and a high franking, very low turnover (pink box) could be as much as 5% over 1 year! This is a lot more than the underperformance many advisers would tolerate before changing managers.

And of course, this is before you start to think about the extra impact that arises once you begin to compound this difference each year within investors' portfolios.

MLC IncomeBuilder™ delivers high franking and low turnover over 10 years

Recently, MLC celebrated the 10 year anniversary of MLC IncomeBuilder™. While many funds have struggled over this time to deliver consistent tax-effective returns for investors, over its history, MLC IncomeBuilder™ delivered an average of almost 130% franking, and less than 1% distributed capital gains due to its low turnover of stocks (averaging less than 15% per annum over the last 5 years) each year. Since inception, MLC MasterKey Unit Trust IncomeBuilder™ has delivered a return of 11.8% p.a.



Celebrating 10 years

MLC INCOMEBUILDER™

Tax is not a one-off concern within a portfolio to be considered once that magical date of 30 June draws near. Rather, to get the best for your clients, you need to be aware of how tax-aware your managers are in generating returns for your clients. While excess returns can look good on paper, if your clients' accountant tells them because of your recommendation, they have to pay a tax bill which almost wipes out their whole return (over and above their excess return), there's no guarantee they'll be satisfied with investing in that 'good performing' fund.

When you select the next investment for your clients, perhaps you should consider how tax-aware the manager is in generating returns – otherwise your client could well be getting less than their expectations.