

You can't eat pre-tax performance



While investment managers are typically evaluated on their pre-tax performance, MLC recognises that after-tax returns matter most to investors.

As investment managers are usually assessed on their pre-tax returns relative to a 'peer group' or market benchmark, many employ investment strategies that have little or no regard for tax.

The problem is that tax is generally the single biggest 'cost' for investors. In fact, tax can have a considerably greater impact than fees, a manager's short-term underperformance (eg due to a style bias) or subtle changes to the asset allocation. This is particularly true with fully taxable portfolios (eg unit trusts) where individuals pay tax at marginal rates of up to 46.5%*.

But even when the tax rate is considerably less, tax can still have a significant impact on what investors actually receive. If you refer to the table above right we compare the impact that different after-tax returns have on the performance of a \$10,000 investment, when compounded over a 20 year period.

When you consider the tax 'drag', it's what's left in the investor's hands (on an after-tax basis) that determines their quality of life, now and in the future.

Hypothetical pre-tax return	Hypothetical after-tax return	After-tax value of \$10,000 invested after 20 years
8%	8%	\$46,610
8%	7%	\$38,697
8%	6%	\$32,071
8%	5%	\$26,533

* Includes a Medicare Levy of 1.5%.

Tax-aware versus tax-efficient investing

Delivering strong returns on an after-tax basis is not just about making the portfolio as tax-efficient as possible.

The key is to build portfolios that aim to achieve particular risk/return objectives, while being fully aware of the tax implications. Consider these three hypothetical examples.

- Portfolio A is very tax-efficient, but the after-tax return is the lowest.
- Portfolio B has generated the highest pre-tax return, but has done so in a tax-inefficient manner.
- Portfolio C has also delivered a strong pre-tax return, but by being tax-aware, has generated the best after-tax result.

Portfolio	Pre-tax return	After-tax return
A	6%	5.5%
B	13%	7.5%
C	10%	8%



How is MLC tax aware?

MLC takes into account the tax impact of investment decisions at a number of different levels.

- **Asset allocation** – We consider after-tax return assumptions when deriving the strategic asset allocations for our multi-sector portfolios.
- **Manager appointments** – Since the late 1990s, the tax implications of a manager's investment process has been a part of our research criteria. For example, a manager with a lower turnover means investors can benefit from tax deferral and can take advantage of the 50% capital gains tax discount when assets are held by the fund for 12 months or more. This is one reason why our portfolios have a bias towards lower turnover managers[#]. We also encourage and actively work with our managers to include tax considerations in their decision making processes, particularly global managers who are often unfamiliar with Australian tax law.
- **Manager transitions** – When changing managers in a strategy, we transfer as much stock internally as possible between managers. We also hire expert transition managers to reduce market trading, hence reducing realised capital gains and transactions costs.
- **Emulation** – In the MLC Australian share strategy, we run an aggregate portfolio based on our investment managers' individual portfolios. As a result, when one manager is selling the same shares another manager is buying, we don't have to trade as they offset each other. This reduces unnecessary turnover and reduces realised capital gains.
- **Rebalancing** – We are able to do most of the rebalancing of portfolios using cashflow, rather than buying and selling assets. This also helps to reduce realised capital gains for investors.

While tax is clearly an important consideration, looking after the interests of investors requires some level of turnover and realisation of capital gains. Generally, the lower the level of turnover, the higher the unrealised capital gains within the fund is going to be. This means future investors may be left with a large capital gains distribution for gains accrued before they joined the fund.

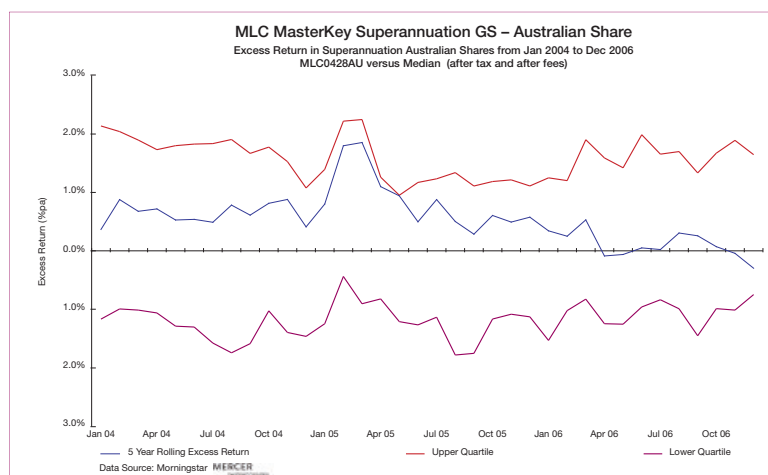
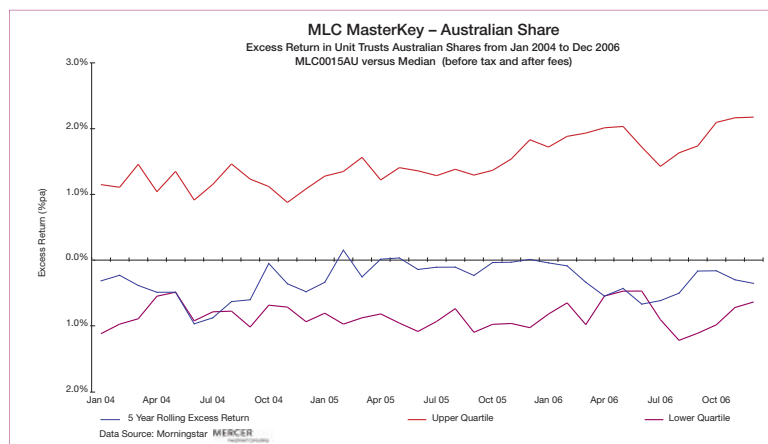
Other key reasons for preferring low turnover managers is that lower turnover generally results in lower transaction costs (eg brokerage and stamp duty) and more stable distributions.

How has MLC performed on an after-tax basis?

While MLC is constantly looking for ways to improve the tax-awareness of our investment funds, what we have done to date has had a positive impact for investors.

The graphs below show the pre and post-tax excess returns over rolling five year periods from the MLC MasterKey Australian Share Portfolio, versus the median, upper and lower quartile managers.

We have used the Unit Trust version (where tax is not withheld) as a proxy for pre-tax performance and the Superannuation version (where tax is withheld at up to 15%) as a proxy for after-tax performance.



As you can see, the pre-tax results have been somewhat similar to the median manager. However, the post-tax results have been consistently first and second quartile – proof MLC is delivering on its commitment to provide strong after-tax performance.

Note: While there are some differences in the peer group between the two universes, the commonality of managers is significant.

MLC is now providing after-tax performance figures

MLC believes so strongly in the importance of after-tax returns that, from the end of August 2006, we started to produce after-tax performance figures for our 'ordinary money' investments, including:

- MLC MasterKey Unit Trust
- MLC MasterKey Investment Service (including MLC MasterKey Investment Service Fundamentals)
- MLC Wholesale Funds.

These figures, which are produced in addition to the usual performance reporting, can be found in the adviser section of mlc.com.au. They are published within 20 business days of each month end. Early in 2007, after-tax returns will also be made available directly to clients.

There are two different ways of calculating after-tax performance:

- **After tax on distributions** – the return to investors after reinvesting distributions net of any tax payable or refunds receivable. This shows the tax-efficiency of a fund.
- **After tax on distributions and full redemption** – the return to investors after tax on distributions (as per above), as well as after any capital gains tax on disposal of the investment at the end of the period. These returns show the full impact of tax, after taking into account realised and unrealised capital gains, and shows a clients' total after-tax position by investing in a fund.

MLC calculates both these returns to provide advisers with full information on the impact that tax can have on an investor's final outcome.

MLC produces after-tax returns for the low (16.5%*), medium (31.5%*) and high (46.5%*) tax brackets, as well as the superannuation tax rate of 15% (given Self-Managed Superannuation Funds may invest in these 'ordinary money' portfolios).

All after-tax returns are 'hypothetical', given every investor's tax position is different and certain assumptions underline the calculation methodology. As with pre-tax performance, you should be cautious when making point-in-time comparisons and always take into account any style differences.

* Includes a Medicare Levy of 1.5%.

Where is the industry heading?

At this stage, only a few organisations in Australia are producing after-tax performance figures. However, MLC has been actively involved in discussions regarding the industry's position. For instance, we recently produced a research paper for the Investment and Financial Services Association (IFSA), where we argued that:

- tax really does matter, and
- the only way to ensure this mindset becomes part of our industry's DNA is to make it compulsory to report on an after-tax basis.

ASIC also recently stepped into the debate on after-tax returns at this year's Association of Superannuation Funds of Australia (ASFA) conference. They stated super funds were failing in their fiduciary duties by encouraging managers to produce pre-tax returns that may not necessarily be in members' best interests.

We will keep you updated of any developments in this area.

Note: In the US, the Securities and Exchange Commission has compelled managers to generate after-tax returns, but for the top tax rate only.

Tax is not a one-off concern to be addressed as 30 June approaches each year. When selecting the next investment for your clients you should consider whether the manager is tax-aware. While headline (pre-tax) returns can look good on paper, if your clients end up with a big tax bill, they may not be that pleased with your recommendation.

