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Why tax matters in portfolios

The case is clear – tax is the largest single cost to investors, and tax matters. Investors should seek to achieve the best possible after-tax return. After all, our future consumption needs can only be met with the after-tax proceeds of our investments.

A focus on after-tax returns is not only of benefit to investors but is increasingly becoming an important government policy consideration. The Productivity Commission, when reviewing public offer superannuation funds, noted that "how [super] funds manage tax is important because it can make considerable differences to the net returns credited to a member's account". The report only related to public offer superannuation funds, but for investors at higher tax rates, the stakes are much higher.

Equity investment management, by its very nature, involves a complex trade-off between uncertain information: forecasts of stock return, risk and cost of trading. Thus, it makes clear investment sense that tax information also be considered in any investment approach.

A tax aware approach should consider how each action in a portfolio will impact the tax position of the portfolio. Often there will be simple decisions that can make a material difference to the after-tax return of the portfolio.

In many cases, slightly different trading decisions will make negligible difference to the overall portfolio positioning or approach but the after-tax implications can be quite different. Leaking unintended tax cost out of a portfolio ultimately leaves less capital for compounding over the long term and delivers an overall small after-tax return.

Investment process challenges

When considering a tax aware investment approach, there are a range of simple measures which can be employed.

The sale of securities gives rise to either a gain, or loss, depending on the cost base of the specific share lots sold. A tax aware approach will be cognisant of the vintage of each tax lot and may hold off realising a gain until it has been held for more than 12 months. This will be important to individuals and super funds who pay less tax on long term gains.

Similarly, new inflows to a portfolio can be invested in a subset of portfolio holdings. Not investing new capital into some stock acts to reduce their portfolio of weight. This can be a preferable way to trim a position without realising a taxable gain via selling some of the shares, allowing for new stock selection information to be embedded in the portfolio in a more a tax effective way.

Tax credits associated with dividends are certainly valuable to domestic investors. Any investor will want to ensure that they do not contravene the 45-day rule to ensure the franking credits on relevant dividends are not lost. Off market share buybacks usually contain a high franked income component and a low capital price, therefore such transactions can be extremely attractive when assessed on a post-tax basis but detrimental to pre-tax performance.

These measures are not necessarily to be set as hard and fast rules but as additional inputs into the portfolio construction process. Being able to consider more information: the uncertain and the certain, will mean that a better trade off can be achieved.

After holding a position for eleven months is it preferable to sell in favour of another, more attractive, security or what are the implications of holding that trade for another month?

Do other trading opportunities exist in the portfolio which better reflect my stock selection views and at the same time realise some positions currently in a loss position to match off against other gains?

Having a stock selection perspective on every stock in one's investible universe also allows for a more considered investment trade-off between risk, return and after-tax outcomes. Combining this knowledge with the tax position of the portfolio provides an information edge which can deliver better long-term outcomes.

Within a passive investing approach, the benefits of being tax aware are limited but still evident. Indexed portfolios incur turnover when implemented in the real world and this has tax implications. At the same time a passive approach has limited scope to make the necessary trade-offs to be truly tax aware in its implementation.

Adding tax awareness to an active equity approach can certainly add value (versus an after-tax benchmark). Importantly, this additional benefit is uncorrelated with the traditional stock selection approaches and does not necessarily increase active risk.

Performance measurement

Calculating manager and relevant benchmark performance on an after-tax basis is often cited as a key reason for why tax awareness is failing to become a mainstream concern. Such concerns are increasingly unfounded due to service provider and index vendor innovation.

Calculation of a manager-specific benchmark return will directly incorporate the tax events of the benchmark in the similar way in which they are considered in the manager's own portfolio.

Changes in the positions of the underlying index need to be reflected as buys and sells resulting in taxable gains/losses. Capital flows (due to investor applications and redemptions) also need to be reflected as buys and sells. There are no trades necessary for the after-tax benchmark when a manager makes changes to their portfolio for stock selection reasons; those trades are the decision of the manager and only impact their portfolio's after-tax performance.

The quote

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Aggregate portfolio structure

It is common practice, especially for institutional asset owners, to construct equity portfolios consisting of individual accounts with a range of investment managers.

Even the appointment of two managers is likely to greatly impact the tax efficiency of the aggregate portfolio if not done with due care and consideration of tax. Neither manager knows the positions, intentions or trades of the other manager(s) and is not expected to take that information into account. Each manager could be very tax efficient individually, but when aggregated with the actions of other managers, franking credits may be lost, long term gains can become short term gains.

However, there are ways to mitigate this problem, including the use of a Centralised Portfolio Management (CPM) system, whereby instead of each underlying manager executing trades based on their view of optimality for their slice of the total account they manage, each underlying manager hands their optimal view to another independent firm (the CPM), who will do the trading.

Another approach is the adoption of a Tax Efficient Multi-Strategy Core, which involves the appointment of a single manager who can blend several investment styles and integrate the relevant tax management features.

Of the two, the CPM approach is the most holistic approach. Unfortunately, however, it can be complex to implement and requires the coordination of many participants: investment managers, custodians, executing brokers.

Are we doing all we can?

Incorporating considerations of tax into an equity investment process is thought to be complex and technically difficult. Such thinking should be relegated to the past since none of these barriers are insurmountable. There is scope for improved outcomes for all tax paying investors notwithstanding that different investors and investment structures will be better placed to embrace a more tax-aware approach.

Being tax aware is a natural extension of a cost reducing mind-set. Tax awareness will lead to better management resulting in improved investment outcomes for the long term. At the end of the day, the after-tax outcome is the only outcome of true relevance to investors. **FS**