

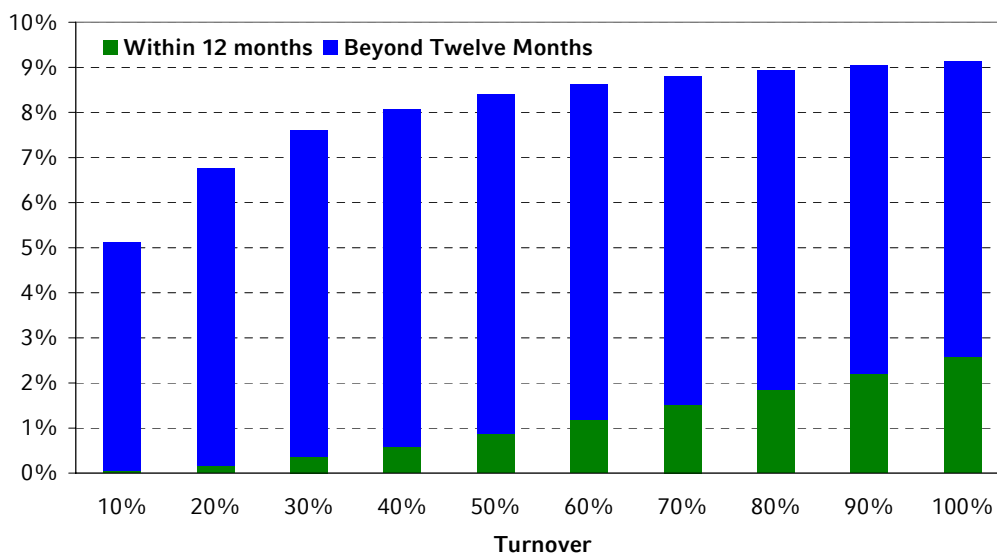
How Taxing is Turnover?

There has been intense recent focus on turnover and its effect on taxation. The debate has been distorted because the retail sector tends to ignore the consequences of unrealised portfolio gains. Below we investigate the real impact of turnover and suggest a simple pragmatic approach to emphasising dividend franking credits.

What does turnover do?

A common theme in the tax debate is that turnover hurts after-tax performance. In very early work on tax aware investing¹ it was realised that initial levels of turnover matter but the incremental effects of turnover diminish and are marginal in the zone of typical active turnover. This is an important principle that recurs in tax research². If a manager is turning over at 100%, shrinking that back to 50% is of little benefit. But even this analysis is blurred by how we recognise tax on unrealised gains. Using a simple mathematical model of turnover and capital gain³, the chart below illustrates the annual level of realised gains as a proportion of portfolio value, divided between short-term and long-term, for different levels of turnover in a constantly trending market gaining 10%pa.

Realised Gains by Turnover



Although the frequency of gains realised at 10% turnover is low, the size of those gains is large because they have been incubating for some time. At 10% turnover, this simple model suggests on average 49% of portfolio value would be unrealised gain. This compares to 9% at 100% turnover. At high levels of turnover the cost base of a portfolio is typically much closer to market value. So, although there is a higher frequency of gain realisation, the size of those gains is typically much smaller. Also realised losses will, in practice, often provide an effective shelter for short-term gains so the short/long mix is less important than it seems.

¹ Jeffrey, Robert H., and Robert D. Arnott 1993 'Is Your Alpha Big Enough To Cover Its Taxes?', *Journal of Portfolio Management*, Spring

² Pinnuck, R., and John Nardi, February 2007 'After Tax Returns', Goldman Sachs JBWere

³ The density function of holding period across a portfolio is given by Te^{-Th} where T is turnover and h is holding period. Capital gain over the holding period as a proportion of current value is given by $1 - e^{-gh}$ where g is continuous gain.

How Taxing is Turnover?

Provisioning for tax on unrealised gains

In stark contrast to the retail sector, institutional superannuation funds typically make provision for tax on unrealised gains. How the potential tax on unrealised gains is recognised in performance measurement has a large bearing on how we perceive the consequences of realised gains and turnover. At one extreme, if tax on unrealised gains is ignored, the impact of realisation is artificially severe. It is viewed as incurring tax that otherwise would have been avoided. Various events including manager redistributions and asset allocation changes can impose trading activity, even on passively managed portfolios, so it is unrealistic to assume all unrealised gains will never be disturbed. Alternatively, to view realisation as nothing more than an accounting shuffle, on the basis that tax would have been eventually payable anyway, ignores the lost benefit of tax deferral. Performance standards exist for both approaches⁴, but the true economic effect sits somewhere in between⁵. The profile of realised gains shown above can be sensibly converted to effective tax costs by taking this middle course. Bear in mind this is all calibrated on market gains of 10%pa.

On this basis we estimate the incremental impact of high turnover (100% relative to 10%) in terms of effective tax cost is around 0.33%. At a moderate turnover level of 50%, the incremental impact is already 0.21%. These estimates take no account of capital loss offsets or parcel selection which should reduce tax outcomes. The impact of capital gains realisation can be managed through intelligent parcel selection and regular loss harvesting which can be incorporated into portfolio optimisation.

Off-market share buybacks

The Board of Taxation is soon to report to the Government on the review of the tax treatment of off-market share buybacks. This follows the release of a discussion paper in July and submissions made in response. A concern about these transactions is that they advantage superannuation funds and low tax payers over others. While the outcome of this review is uncertain, to date off-market share buybacks have been one of the most effective avenues for enhancing post-tax results. They offer an opportunity to significantly enhance franking credits, although not without some market risk. Enhancing franking credits in other ways, for example by biasing towards high franking credit stocks can be problematic. The market price of franking credits from a superannuation perspective, reflected in ex-dividend price behavior, is reasonably efficient, and the alpha leakage and risk implications of chasing franking credits can outweigh the benefits. At the very least cognisance of the 45-day rule, where applicable⁶, is good practice.

A pragmatic first step

A basic hurdle in managing capital gains is that in a multi-manager context, the manager's own portfolio history and holding inventory is not the appropriate reference. Ideally, the combined fund holdings should be taken into account. But custody arrangements rarely facilitate adequate data flow for this to happen. Behind the scenes at the custodian there is great scope to impact on capital gains through intelligent parcel selection. To properly assess capital gains tax management, it is also necessary to build a bespoke benchmark with similar cash flow history. A pragmatic alternative to all this is to set a benchmark of gross index performance including franking credits and thereby focus solely on the franking issue. WestLB Mellon Asset Management has been managing a live discrete portfolio benchmarked in this way for two years:

Performance to 31 December 2007

	1 Month	Quarter	Fin. YTD	1 Year	2 Years
Fund	-2.26%	0.65%	9.07%	28.09%	26.54%
Benchmark	-2.63%	-2.47%	3.51%	17.56%	21.78%
Relative	0.37%	3.12%	5.56%	10.53%	4.76%

* Inception 1 January 2006

The benchmark used is the ASX300 Accumulation Index, grossed up for franking credits calculated by ITG Australia Ltd. Portfolio performance is calculated similarly and incorporates the franking credits associated with off-market buybacks along with disadvantage of the price discount on tendered buyback stock.

⁴ AIMR-PPS Pre-Liquidation and mark-to-liquidation approaches. The latter is reflected in the IFSA standard.

⁵ The 'half-way' tax cost is based on the difference between the tax rate incurred (15% short-term gains, 10% long-term gains) and half of the long-term rate of 10%. This is equivalent to a deferral assumption of circa 12 years.

⁶ Funds may choose to be assessed on average franking level thereby avoiding strict adherence to the 45 day rule.

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