FY22 highlights the benefits of managing portfolios on an after-tax basis

Plato
INVESTMENT MANAGEMENT

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Are you missing out on after-tax alpha?

In its 2018 report, the productivity commission mentions that there is a significant deficit in after-tax management in the accounts of superannuation members. Based on our experience, we haven't witnessed a significant change in industry behaviour over the following 4yrs since the review was released, potentially due to the increased level of merger activity in the industry adding complexity for funds. This observation was never more relevant than in FY2021/22 which was an extraordinary year for investors with regards to the hugely profitable distribution of franking credits by Australian companies, with the Plato Australian Shares Tax Exempt Fund generating 4.83% return from franking credits, approximately twice what it normally generates and around three and a half times the normal index level of franking. There were a number of drivers of this massive level of franking, including record dividends from iron miners RIO, BHP and Fortescue, tax-effective buy-backs from Metcash, Commonwealth Bank, Woolworths, Westpac, JB Hi-fi and Qube, plus the spinoff of BHP's oil and gas assets to Woodside which was distributed to BHP shareholders in the form of a fully-franked dividend.

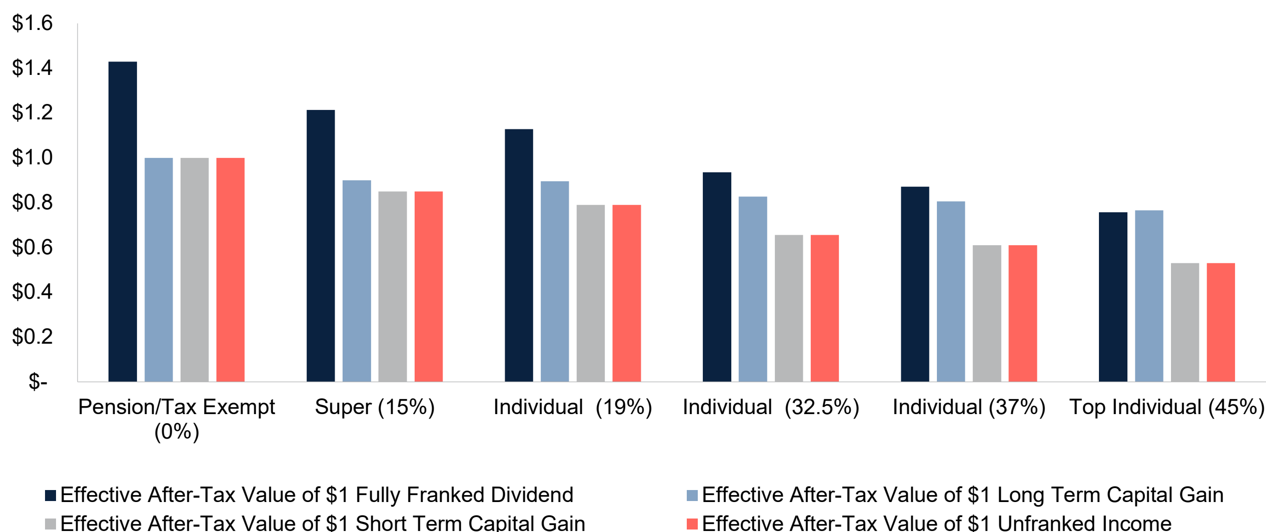
This period has highlighted the benefits to low-tax investors of managing their portfolios on an after-tax basis. However, despite their large contribution to returns, most investment performance surveys don't include franking credits which makes the alpha generated by after-tax management largely invisible to investors. This is particularly relevant in a year when certain segments of the active management industry have struggled in Australia.

Starting with the basics, in Figure 1 we show the current after-tax value of one dollar of pre-tax return for four types of investment returns;

1. Fully franked dividends (30% corporate tax rate)
2. Long-term capital gains
3. Short-term capital gains; and
4. Unfranked income in the hands of various taxpayers.

We calculate after tax values for various marginal tax rates, including the 2% Medicare Levy for individuals. Fully franked dividends are currently the most valuable form of return for all Australian investors bar those investors on the very highest 45% tax rate, where the 50% CGT discount makes a long-term capital gain the most valuable. Tax-exempt investors like charities and pensions phase superannuation don't pay capital gains tax, but other taxed investors do. Taxed investors have a particular aversion to realising short term capital gains, which is often why low turnover strategies are considered tax effective. If investments are being managed in a commingled pool, then those assets will likely be managed on a before tax basis as it is not possible to optimise an after-tax outcome for multiple investor tax rates at the same time. This may leave after-tax alpha "on the table" for those investors who don't manage for targeted tax brackets.

Figure 1. The current after-tax value of one dollar of pre-tax income



Source: Plato

In addition to the changes investment managers can make to their portfolio (detailed below), superannuation funds can also structure their funds in better ways in order to make the generation of after-tax alpha possible. This includes segregating the assets of their 15% tax rate accumulation and 0% tax rate pension pools so that these assets can be managed optimally. As more Australians move into retirement, the percentage of assets in pension phase will likely increase for most if not all large superannuation funds making the segregation of these assets more practical as well as being more important. It is common for Australians to start actively engaging with their superannuation fund as they approach retirement so it is important that these superannuation funds can show that they specifically tailor their portfolios for pension phase investors.

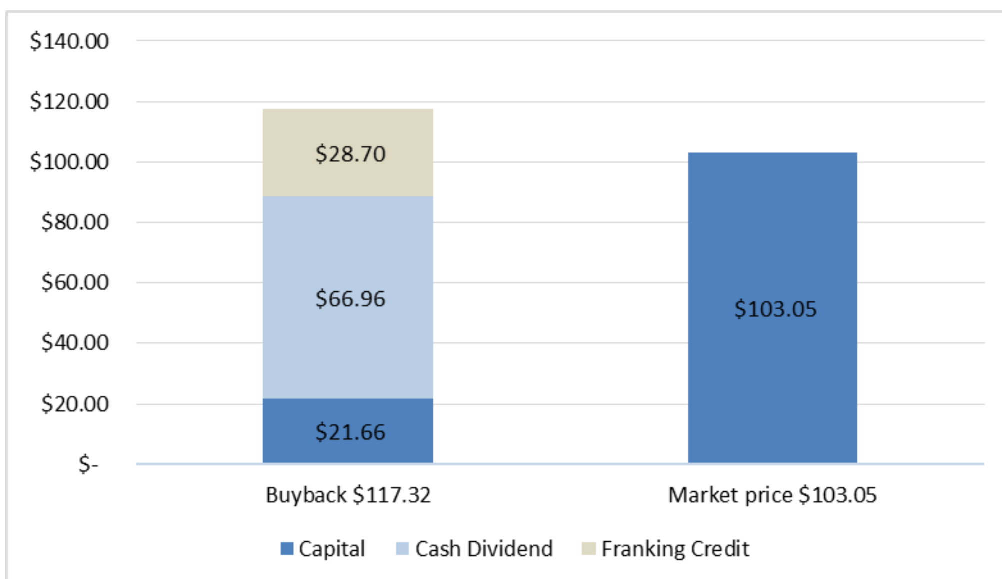
Off-Market Buybacks

Tax-effective off-market buy-backs highlight the benefits of managing investments from the after-tax perspective of the client rather than on a before tax basis. Tax-effective buy-backs always lose money on a before tax basis[i][1], but add value after tax for tax-exempt investors, and usually, but not always, for low taxed investors (15%/19% tax rates). However, these buy-backs often lose money for highest taxed individuals.

Buy-backs added considerable after tax value for tax-exempt investors in FY22. Metcash, Commonwealth Bank, Woolworths, Westpac, JB Hi-fi and Qube all completed buy-backs in FY22, adding up to 20% to total returns including franking credits for each share successfully tendered for investors on a zero tax-rate, but note that buy-backs are usually subject to scale-backs. Commonwealth Bank undertook a $6B buyback which was worth 14% for zero-tax investors with a 79.4% scale back and added 0.32% in after-tax alpha to tax-exempt investors in our Plato Australian Shares Tax Exempt Fund. Figure 2 displays the value from participating for tax-exempt investors in the Commonwealth Bank buyback. Most managed funds do not participate in buy-backs, because they lose value pre-tax as the cash proceeds are less than the market price.

[1] By law these buy-backs must be done at up to a maximum discount of 14%.

Figure 2. The after-tax value from participating in the Commonwealth Bank Off-market Buyback in Aug/Oct 2021.



Source: Plato, Commonwealth Bank announcement 4/10/2021.*market price is average volume weighted price in the five trading days up to and including October 1, 2021

Plato manages the majority of its Funds Under Management on an after-tax basis, and in our Tax-Exempt strategy, off-market buybacks added 0.8% in after-tax alpha in FY22. Given the extraordinary nature of the last financial year, we think a more realistic annual after-tax alpha target by participating in off-market buybacks going forward would be 0.4% p.a.[2].

Other Decisions

Managing on an after-tax basis for clients doesn't just involve participating in off-market buybacks. Investors should be valuing franking credits, particularly tax-exempt investors who receive a full refund of franking, and for taxed investors they should be taking account of the impact of capital gains tax.

If one fails to account for franking on ordinary or special dividends, one may be missing out on significant after tax value. By fully valuing franking credits in our process, we are able to take advantage of franking credits not being fully priced by the market which has a large percentage of foreign owners which don't receive franking credits. For example, in Table 1, you can see five stocks that paid significant dividends in FY22. Plato was able to take advantage of the franking credits generated in all these stocks to deliver after-tax alpha for our tax-exempt clients. Based on its June 30, 2022 share price BHP is trading on a franking credit yield of 5% p.a. but delivered more than a 10% return to investors in franking credits alone in FY22 when you take into account the fully-franked special dividend they paid to investors in the form of Woodside Energy shares as part of its spinoff of its oil and gas assets.

Table 1. Stocks paying dividends with large Gross Dividend Yield.

[2] This after-tax alpha would be lower to superannuation investors in accumulation on a 15% tax rate.

Ticker	Name	Gross Income including franking	Franking Credit Income	ASX200 Index Weight
BHP[3]	BHP Group	16.61%	4.98%	10.96%
RIO	Rio Tinto	15.11%	4.53%	2.00%
SUL	Super Retail Group	13.80%	4.14%	0.07%
JBH	JB Hi-Fi	10.03%	3.01%	0.21%
ANZ	ANZ	9.34%	2.80%	3.20%
WDS	Woodside Energy	8.42%	2.53%	3.13%
SUN	Suncorp Group	8.20%	2.46%	0.71%

Source: Plato, Bloomberg, based on values on 30/6/2022.

As a final indication of the importance of after-tax management, we have estimated the difference between our active returns before-tax and after-tax for the Plato Australian Shares Tax Exempt Fund. Since inception in July 2017, Plato has added 1.6% p.a. more in after-tax alpha compared to pre-tax alpha for tax-exempt investors. Over the last financial year, however, the difference has blown out to a massive 3.4%, a huge difference to performance. We think Australian investors should be taking advantage of this potential after-tax alpha, particularly in an environment where future return expectations have been lowered.[4] The question investors should be asking is are their investment managers maximising after tax returns based on their specific tax circumstances and are their superannuation funds structured in such a way to make this possible.

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[3] This excludes the one off oil and gas assets spinoff which came in the form of a fully-franked dividend, where the cash dividend was replaced by the reception of Woodside Energy shares.

[4] See "Brace for 5pc super fund returns", by Joanna Mather in Australian Financial Review, 6th September 2019.

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