

After-tax Perspectives: 2011 Long-Term Investing Report

In this article, Raewyn Williams, Director, After-Tax Investment Strategies for Russell Investments discusses the importance of after-tax considerations for long-term investments.

Pre-tax versus after-tax: which is the best return measure?

One feature of the ASX-Russell Long-Term Investing Report is that returns are calculated and compared on both a pre-tax and an after-tax basis. The after-tax calculations reflect the tax profiles of a range of investors, from low marginal tax rate investors and concessional-tax superannuation investors through to investors on the highest marginal tax rate of 46.5% (including Medicare levy).

Analyses of investment returns over both shorter and longer time periods typically only focus on pre-tax outcomes for investors. This is because the measurement of the tax impact on investment outcomes depends on who the investor is, how long the investment is held for and other factors. Tax rules differ between asset classes. Tax adds complexity to the calculation and comparison of investment returns.

However, it is worth the added complexity: by including after-tax returns, the Report gives investors a more meaningful and 'real' measure of their net increase (or decrease) in wealth for different asset classes across the range of time periods measured. The after-tax numbers also give investors a truer sense of the relative attractions of different asset classes competing for investors' capital.

How has tax impacted long-term investment outcomes?

The Report highlights four significant areas where an after-tax perspective is especially important.

Australian equities

For lower tax rate investors (including superannuation funds), the combined effect of franking credits and capital gains tax is to improve – that is, add to – the pre-tax return by between 0.2%-0.5%. This challenges traditional investment thinking which assumes that tax will always be a detractor from investment performance. For these investors, to assess the value of Australian equities only in pre-tax terms means ignoring a potential half-a-percent pick up in after-tax investment returns from these asset classes.

It could in fact be higher than this. Some investors may also have direct international shares in their portfolio to diversify away from Australian shares. Given international shares have had negative returns over the last ten years, any capital losses realised on international shares can be used by these investors to offset capital gains made on their Australian shares. For these investors, then, the only impact of tax on Australian equity returns will be the extra return generated by franking credits.

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Raewyn Williams
Director, After-Tax
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Higher tax rate investors

The Report confirms what highly taxed investors know: tax can significantly reduce investment returns, particularly for the cash and fixed income asset classes where there are little or no tax deferral opportunities or capital gains tax discounting relief. Twenty-five year fixed income returns illustrate this harsh reality, where approximately half of the 9.8% pre-tax return was eroded by tax. This reflects Australia's high top marginal tax rate, including Medicare levy – it is currently 46.5% (and has been higher at times during the twenty-five year performance period), which is relatively high compared to other OECD countries.

The Report notes that other asset classes offer some in-built tax concessions and therefore lower effective tax rates for top-rate investors, from 18% on Australian shares through to 34% for global REITs. This should remind highly-taxed investors that there will normally be a tax detriment suffered when there is a 'flight to cash' or other change in asset allocation strategy which shifts an investor's assets from a lower-taxed asset class into a higher-taxed asset class. While such a shift can be warranted, it will be important for the investor to be fully aware of the consequences, in after-tax terms, of the change.

Superannuation

The ability of investors to choose between investing via a superannuation vehicle versus outside superannuation is an important feature of the Australian investment landscape. As the Report illustrates, for higher tax rate investors, investing via superannuation provides an opportunity to increase after-tax returns in all asset classes. The greatest opportunity is in respect of the fully-taxed asset classes where investment returns can be increased by 1.2%-2.4% (cash) and 1.9%-3.6% (fixed income).

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Investors will also find it useful to note that the tax advantage of holding these assets inside superannuation grows the longer the assets remain held by the investor via his/her superannuation vehicle.

Gearing

Assessing the benefits of gearing is best done using an after-tax focus because of the tax benefits of deductions for borrowing costs (gearing).

The Report compares the ungeared and 50%-geared returns of Australian shares and residential property on an after-tax basis. These are the most commonly geared asset classes. For all time periods measured, and especially over the mid-range twenty year measurement period, gearing has increased the after-tax returns of these asset classes relative to an ungeared strategy. Gearing benefited investors at all tax rates, but especially higher-taxed investors, which is logical.

This article is intended to be read alongside the 2011 Long-Term Investing Report. Please access the full Report from:

» www.russell.com.au

» www.asx.com.au

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