Warakirri Asset Management Pty Ltd
ABN 33 057 529 370 AFSL No 246782

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Submission to 'Review the investment governance' by Warakirri Asset Management

Issue 2 – Managing after-tax returns

Question 2.1 What are the benefits to superannuation fund member and the industry if this recommendation is implemented?

The goal of after-tax management is to maximise the after-tax return for members. Managing after-tax returns will remove the disconnect that has historically existed whereby investment managers have been incentivised and remunerated based on before-tax returns but superannuation members only receive after-tax benefits.

The benefit to members has been estimated in a recent report by Towers Watson. The report focused on the Australian equities asset class, which is typically the largest asset class and the asset class where the largest opportunity for ongoing after-tax management exists. Towers Watson estimates that Manager Level Strategies can add 0.25% to 0.5% per annum for superannuation investors. In addition, Towers Watson estimates that the benefit from participation in off-market share buybacks is approximately 0.25% to 0.35% per annum. Monitoring managers on an after-tax basis will quantify the impact of tax on investment returns and highlight managers who have the adopted best practice in relation to tax management as part of their investment process.

Mandates will be allocated to managers on the basis of their after tax results which will create motivation to improve all managers' tax management skills and identify areas of improvement.

Based on results from the 2009/10 financial year Warakirri has seen dispersion of up to 1% in manager after-tax outperformance where the manager's had similar before-tax outperformance. Hence, before-tax performance does not provide a reliable estimate of after-tax performance.

Live example: 1 July 2009 to 30 June 2010

	Before-tax outperformance	After-tax outperformance
Manager A	2.92%	3.07%
Manager B	2.92%	2.53%
Variance	0.00%	+0.54%

Performance fees would be paid on actual after-tax outcomes. That is, from a member's perspective.

Warakirri Asset Management
Level 3, 53 Queen Street
Melbourne VIC 3000
Phone: (03) 8613 1111
Facsimile: (03) 8613 1190

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Question 2.2 What transition costs will trustees face in the implementation of this recommendation?

Transition costs should be minor. Different funds would likely adopt different models of after-tax management. Given the costs of after-tax management and measurement are typically “fixed” in nature (i.e. it does not cost significantly more to measure a portfolio of $1m vs. a portfolio of $100m), larger funds would likely take advantage of their scale and adopt more comprehensive after-tax measurement and management in order to obtain the most accurate and valuable information available. Smaller funds may be better off investing in investment vehicles that are managed in the appropriate manner.

There may be legal costs involved in updating investment management agreements to reflect the change from before tax to after-tax objectives. Based on our experience this hasn’t been a major obstacle.

Question 2.3 What ongoing costs will trustees face in the implementation of this recommendation?

Ongoing costs relate to the provision of the after-tax reporting and benchmarks.

Costs are typically “fixed” regardless of funds under management but the benefits are positively correlated with the size of the portfolio. Accordingly, the benefits of after- tax measurement will be greater for larger funds as the value (in dollar terms) of improved after-tax returns will be higher. For a large superannuation fund with at least $2/3 bn in Australian Equities, the cost of measuring Australian equities managers on an after-tax basis versus after-tax benchmarks would be the equivalent of less than 1bps (<0.01%). Estimated benefits are outlined in response to question 2.1.

Given the low cost for large funds there is an argument to be made that it should be legislated that large funds measure their Australian equities managers on an after-tax basis.

However, we believe that legislating or requiring prominent disclosure and an explanation of how funds are looking after their members’ best interests from an after-tax perspective would result in the desired action from Australian superannuation funds.

John Nolan
Managing Director

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Melbourne VIC 3000
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