

Investment performance: publication of 'gross' returns should be banned

Michael Chamberlain¹

Michael Littlewood²

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There is much current discussion about regulatory and reporting regimes for all financial service providers, including the collective investment vehicles used in KiwiSaver schemes: 'managed funds'. Because of tax treatment, reporting of returns is complex and providers naturally pick results and comparisons that favour their particular offerings. So-called 'pre-tax' returns are sometimes 'derived' from net returns, but are often guesses.

The current organisation of the income tax system makes comparison of gross (pre-tax) returns mostly meaningless. Yet some fund managers quote just these gross (pre-tax; pre-fees) returns either to clients or to the public. Because gross returns are so misleading, the government's 2012 Budget announcement requiring the publication of those returns for KiwiSaver schemes is unhelpful. If New Zealand is to have open, transparent markets, providers should not be able to advertise their own versions of investment returns. As the government itself acknowledges, the only return that matters is what's left after tax and fees.

1. Introduction

'Managed funds' (or 'pooled investment funds') are potentially a low-cost, transparent way for savers with small amounts to join with others in flexible investment vehicles run by professional managers. For example, there are now nearly 2 million New Zealanders in KiwiSaver and, although they may not realise it, many are participating for the first time in managed funds that are part of a wider group of 'collective investment vehicles' (CIVs). These include superannuation schemes (that may be a 'portfolio investment entity' or PIE), unit trusts, family trusts, bank accounts, listed companies and even unregistered superannuation schemes. Each has its own tax treatment.

In other countries, CIVs for retirement savings typically attract no tax on their investment returns so, in a 'defined contribution' retirement savings scheme like

¹ Michael Chamberlain is principal of MCA NZ Limited, actuaries and consultants. He is also part-owner of Aventine Limited that, among other things, administers the SuperLife superannuation scheme and the SuperLife KiwiSaver scheme.

² Michael Littlewood is Co-director of the RPRC and is an independent director of SuperLife Trustee Limited, the trustee of both the SuperLife superannuation and SuperLife KiwiSaver schemes.

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KiwiSaver, the gross return, less fees, is what the member actually receives. In such cases, pre-tax comparisons of investment returns are therefore valid.

2. 2012 Budget announcements on KiwiSaver schemes

The government recognises that members of KiwiSaver schemes need better information on the investment returns from their savings.

“New disclosure rules, to take effect from April 2013, will allow people in KiwiSaver to evaluate and compare the performance of different funds. Fund managers will be required to report their performance and returns, fees and costs, assets and portfolio holdings, and liquidity and liabilities.” (English 2010, p. 7)

A related Cabinet paper gave more detail on proposed regulations that will require disclosure of, amongst other things:

“Performance and returns – a prescribed table disclosing the returns gross of fees and tax, the total net fees and tax; an example of a hypothetical investor demonstrating the impact of fees and taxes on the return; and, two graphs depicting the historical annual returns and fees;” (Minister of Commerce 2012, p. 2)

For the reasons discussed below, more thought needs to be given to the proposed requirement on publication of “returns gross of fees and tax”.

3. Currently complex tax environment

As a result of changes over the years to the income tax treatment of CIVs, calculating the correct amount of tax is now a complex and, in some cases, an impossible task. In 2010, we concluded in *Towards a more rational tax treatment of collective investment vehicles and their investors*:

“The income tax treatment in New Zealand of different forms of saving is somewhat removed from the relatively simple arrangements in the 1990s. It is now complex, costly, distortionary, expensive to regulate and has not been subjected to appropriate policy analysis. The total tax paid by savers directly and indirectly can now bear little relationship to the tax that would have been payable had all income been earned directly.” (Chamberlain and Littlewood, 2010, p. 2)

That report illustrated the different ways in which a New Zealand saver might invest in a particular listed Australian share or an overseas bond. It concluded that, with respect to:

- **an Australian share**, there were 11 different possibilities with seven potentially different amounts of tax from the same ultimate investment (the share);
- **an overseas bond**, there were 13 possibilities with nine potentially different tax treatments. (Chamberlain and Littlewood, 2010, p.p.16 & 20)

These examples explain the present position with regard to the ‘supply side’, starting with the same pre-tax returns. Turning to the ‘demand side’ of those same examples, for a given net amount of returns credited to a saver, what might we be able to tell about the original, pre-tax return from the underlying investments? The answer, in short, is not very much because of the complexities summarised. However, what matters is only the net return, actually received, and it is net returns that should be compared if the comparison is to be genuinely useful to investors.

4. The problem of comparisons

It is not possible, based solely on the gross returns, to work out whether a manager is relatively good or bad, nor whether the return will result in a higher or lower amount being paid to the investor. This exacerbates the normal uncertainties surrounding past returns which are covered usually by a general warning such as ‘past returns are not a good guide to the future’.

Publishing gross returns without additional information on the investment structure, the tax basis and fees, does not help an investor. Even with that additional information, only a sophisticated investor could understand what the implications are to the returns they receive.

The problem is largely caused by the complexities of the tax regime. New Zealand now has three different tax regimes for the investment income: accruals⁴, FDR⁵ and Australasian shares⁶. These different tax regimes are then combined with the complications of PIE⁷ and non-PIE vehicles. A provider can ‘construct’ the gross return required to win a before-tax performance comparison with another provider, without, in the process, improving the net return to the investor. In fact, in many cases, the investor ends up with a lower comparable return because of higher fees and costs.

5. A simplified example illustrates the problem

A simplified example shows why quoting or comparing just gross returns should be outlawed.

Take two managers: Manager A and Manager B. In both cases, the New Zealand CIV is a PIE (as is the case with all publicly available KiwiSaver schemes). Assume both are successful index managers⁸ and so achieve the return of the market index less fees. Each invests in overseas shares and has funds that follow the MSCI index on a fully hedged basis, i.e. they both fully remove the risks associated with currency movements.

- **Manager A** buys units in an overseas-based, overseas share fund and separately buys hedging contracts to remove the currency risk against changes in the New Zealand dollar. In this case, the hedging contracts are taken out *separately* to the units in the overseas share fund. Manager A charges 1% of assets after tax as its fee.
- **Manager B** also buys units in an overseas-based, overseas share fund but one where the hedging contracts are bought and held by the overseas manager *within* the overseas fund itself. Manager B therefore just owns units in the overseas share fund. Manager B charges 0.25% of assets after tax as its fee.

⁴ The accruals regime, amongst other things, deems income as earned if the ‘mark to market’ value of an asset has changed since the start of the measurement period. It also records losses in a similar way.

⁵ ‘FDR’ is the ‘fair dividend return’ method that assumes a share, or group of shares, will earn 5% in the coming year, based on the asset’s opening value at the beginning of the year. The actual return earned is irrelevant and is not directly taxed. Likewise, any loss is not deductible.

⁶ Listed New Zealand shares and some listed Australian shares qualify for an exemption from the normal rules that apply to capital gains earned from trading those shares.

⁷ A PIE (or ‘portfolio investment entity’) has special tax treatment. It pays no tax as an issuer in its own right but rather pays tax on behalf of individual members on a basis that reflects (but is never the same as) the individual’s own marginal tax rate. This proxy tax treatment requires much complexity and will usually see the member pay less tax than had the investment income been earned directly.

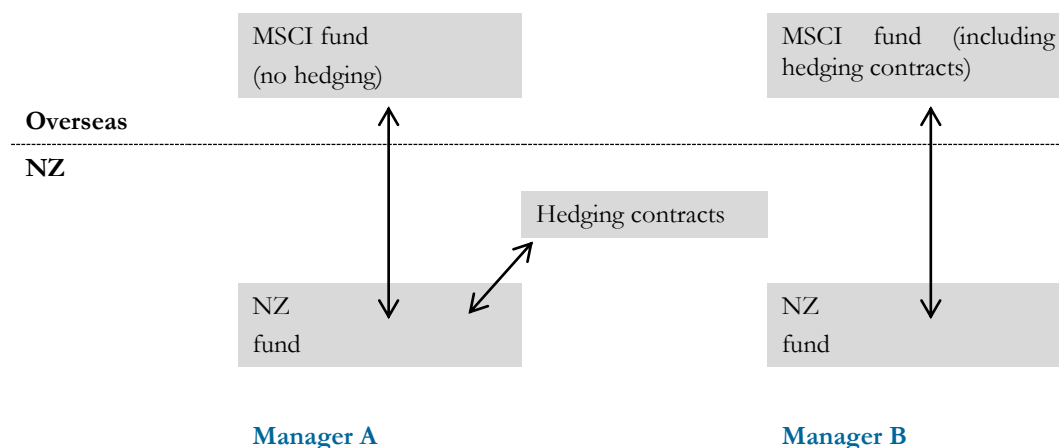
⁸ An ‘index manager’ deliberately emulates the investment returns from a particular index. The case used in the example is the ‘Morgan Stanley Capital Index’ of over 6,000 of the largest listed companies throughout the world (the MSCI).

The differences between the two New Zealand funds are:

- (a) the managers' fees (1% a year vs. 0.25%) and
- (b) the structure of the hedging contracts (outside the overseas share fund vs. within the fund).

The arrangements are shown in Figure 1.

Figure 1



We shall next assume that the return from overseas shares for the year was 5% and that the movement in the currency (the NZ dollar) was 10%. As the NZ dollar strengthened by 10%, the hedging contracts would pay out an amount to offset the loss caused by the 10% rise in the NZ dollar plus any tax effect.

Investments in the overseas share funds are taxed on a deemed 5% dividend income, under New Zealand's FDR regime. They are not taxed on the actual return. For a top rate taxpayer (i.e. one on a PIR⁹ of 28%), this reduces the actual return by 1.4% whether the actual return is positive or negative. The 1.4% is 28% of the 5% deemed dividend (for those wanting the mathematical formula).

Gains from currency contract investments in the overseas fund (Manager B) are not taxed as they are within the fund and therefore are included under the FDR regime calculation.

In contrast, the gains from the separate currency contracts (Manager A) are taxed during the year under the accruals regime on the actual return. Therefore, for Manager A to ensure that it receives an after-tax return to offset the currency movement, it must take out (buy) currency contracts of 1.39 times the assets it has invested. The extra 0.39 pays the tax so that after paying the tax on any gain it eliminates the currency risk:

$$\text{i.e. } (100\% - 28\% \text{ tax}) \times 1.39 \times \text{currency movement} = 1.0 \times \text{the currency movement.}$$

⁹ The PIR is the 'prescribed investor rate' that applies to investors in a PIE. It is a deemed rate, as a proxy for the investor's marginal tax rate and is used by the PIE to tax the share of investment income attributable to the PIE's investor.

The net returns (after-tax and then after-fees)

The net-of-tax but pre-fees return, for each manager, is 13.6% for the year. This is made up of:

Table 1

Movement in share market	5.00%
FDR tax	-1.40%
Currency movement	<u>10.00%</u>
Net return	13.60%

Therefore the net of tax and fees return of the managers is the 13.6% less fees.

Table 2

	Net of tax and fees return	
Manager A	12.60%	(13.6% – 1% (fees) = 12.6%)
Manager B	13.35%	(13.6% – 0.25% (fees) = 13.35%)

Clearly Manager B is better for the investor as 13.35% is higher than 12.6%. This variation in percentage returns will make a large difference to the investor's accumulated wealth at retirement.

This example highlights the importance of low fees, all else being equal.

6. What actually is the 'gross return'?

Financial service providers normally do not quote net returns but rather the before-tax returns, probably because they are bigger numbers. In this case, Manager A has an apparent advantage, as the currency contracts are outside the product, are taxed separately and the tax that is paid adds to the gross return, and thus increases the 'apparent' return to the investor.

- The gross return of **Manager A** is the 5% (from shares) plus 1.39 x 10% (from currency) = 18.9%.
- The gross return for **Manager B** is the 5% (from shares) plus 10% (from currency) = 15%.

On a gross basis, Manager A has a higher return and looks better than Manager B.

Even if the gross returns were adjusted for fees¹⁰ as is done in some performance surveys, Manager A (at 17.9% after fees) still looks better than Manager B (14.75%), despite charging much higher fees than Manager B.

However, Manager B is still better because the investor has a higher return in the hand. It is the return to the investor that is important: the return in the hand. As Table 3 overleaf shows, Manager A pays a lot more tax but that doesn't help the investor.

¹⁰ Note: for simplicity, the fees were taken as being after-tax fees. In practice, fees would be tax deductible and therefore the gap between Manager A and Manager B after-fees but before tax, would not be as great.

Table 3

	Manager A	Manager B
Gross return	18.9%	15.00%
Tax	<u>6.3%</u>	<u>1.40%</u>
Net return	13.6%	13.60%
Fees	<u>1.0%</u>	<u>0.25%</u>
Net of tax and net of fees return	12.6%	13.35%

In this simple example, the differences in gross and net returns to the investor are affected by three factors: the treatment of tax on currency, how the currency contracts are managed and structured, and the differing fee structures.

Unfortunately, no matter what warnings are given, investors will focus on the headline returns cited in advertisements and used in surveys. They will assume, wrongly, that they are fair, reliable and the best information available.

Currency management is important

In the example, the biggest difference in gross returns is caused by the 10% movement in currency. While 10% sounds high, movements at this level are common. Experience shows that currency moves +/- 10% in a year about half the time so it is common to get variations of this level. If an investor really wanted a higher gross return:

- When the NZ dollar strengthens, it pays to have the currency outside the product.
- If the NZ dollar weakens, it pays to have the currency within the overseas product.

If the focus is instead on the return to the investor, lower fees are always better.

7. Disclosure of returns – the simplified case

We suggest that regulators have a choice. They can regulate to ensure disclosure of:

- (a) **'correct' gross returns:** consistency in quoted gross returns (knowing that investors will usually be misled and therefore make poor decisions), or
- (b) **complete disclosure:** consistency in the gross returns but require disclosure of the tax treatment and structure (knowing that investors will be confused by the additional material and instead focus on the high level gross returns and be misled), or
- (c) **actual net returns:** disclosure of the return to the investor in the hand i.e. the net returns after both tax and fees. Information should also be provided on structure and tax but if the investor does not read it, the disclosed relative returns will not be misleading due to the tax treatment.

Even if the provider knew the correct gross returns (which is not always possible), publishing them as in Option (a) would not help as they will reflect, in part, the way the CIV is structured without necessarily benefiting the investors.

While complete disclosure as in Option (b) may help the expert commentator, it will not help the people who matter: the investors.

The answer is that regulators should adopt a principled approach and require managers to disclose performance in a way that is not misleading and that is understood by the average, non-expert investor. Option (c), the after-tax, after-fees return is all that matters.

Under this principled approach, if Manager A disclosed either the 18.9% or the 17.9% it would breach the principle even if technically accurate, because the expected net returns to the investor are lower than other managers and so the investor would be clearly misled.

8. Active management complications

The very simple example used index managers to eliminate a further source of confusion. 'Active management'¹¹ introduces a further level of volatility and potentially misleading returns that also requires additional disclosure and explanation.

In any given period, certain styles of active managers work better than others and they will generate above market returns for that period. However, the international evidence is that active managers cannot consistently generate those 'excess' returns in all periods and at some point there will be a period not suited to that manager's style: see, for example, Ferri (2010)¹².

Where a manager performs above or below the market index, the difference should be explained so the investor understands whether it is a temporary or a permanent return advantage. An active manager should not be allowed to disclose above market returns that relate to style or philosophy, unless it is a permanent advantage based on demonstrable skill that is likely to be persistent across all market conditions.

This can be illustrated by two simple examples.

Let's say a global share manager has a style bias that favours 'growth' shares (i.e. shares that are expected to give above average returns because of their future above-average growth prospects: they typically have a high current price earnings (or PE) ratio. In the last three years, such a manager will have done comparatively well because growth shares did better than the market as a whole. Note that a 'value' manager, which is the opposite of a growth manager, would have done the reverse by favouring shares with relatively lower PE ratios.

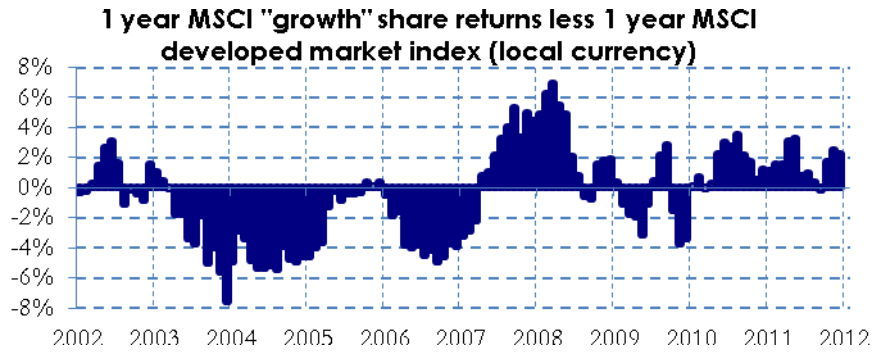
However, in 2003/2007 the 'growth' manager will have done significantly worse than average, and worse than the 'value' manager.

Chart 1 overleaf plots the return from 'growth' global shares less the return from the wider market as measured by the MSCI index in each case.

¹¹ By contrast with index or passive management, the 'active manager' tries to produce returns that beat a chosen market index (or indices). It does this by deliberately weighting a portfolio in favour of shares and other securities to take advantage of what the manager sees as economic or market conditions.

¹² Ferri (2010) shows that a single, actively managed CIV in the US has a 42% chance of beating its comparable index over a single year. His research suggests that the chance worsens to only 12% over 25 years.

Chart 1

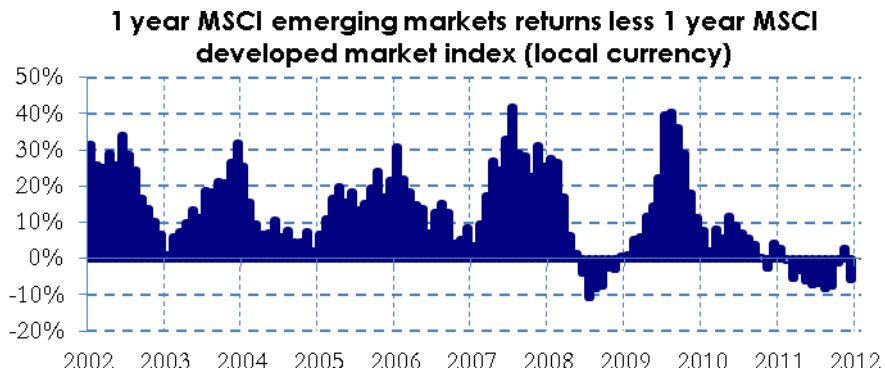


Source: MCA NZ, actuaries

Therefore quoting returns that favour the periods where the bars are above the line (from 2007 onwards or, say, for ‘the last five years’) ignores that fact that it is not skill but a style or philosophy that lead to the higher returns since, in this case, 2007.

Likewise, some managers invest in global shares but include a small exposure to emerging markets. As emerging markets generally (but not always) outperform the wider market (as illustrated in Chart 2), the manager will appear to do well but that is down to a natural bias or style and not skill i.e. the original decision to hold emerging market shares. The manager should in this case be compared to a benchmark that has an exposure to emerging markets.

Chart 2



Source: MCA NZ, actuaries

9. A suggested regulatory framework

When managers tell CIV members what returns they have achieved or advertise their achievements, the quoted returns need to always be after-tax and after-fees.

Also, showing returns in dollars highlights the significance that small differences in percentages make to the ultimate savings. Where a manager quotes investment returns in marketing material, they should be accompanied by a certificate or provider warranty that the returns are not misleading and that any quoted comparison with other funds is a fair (like with like) comparison.

At the same time, regulators should require the provision of financial data in a common format to a central body so that returns can be calculated by that body in a consistent

way. Also, a non-industry organisation, for example a professional body or tertiary institution, could be given a public contract to analyse the data and publish comparative tables on a timely basis.

In summary, we agree with the government that the current rules need changing, but we do not agree with the detail of the government's proposals on KiwiSaver schemes. Instead, we suggest that:

1. Publicity that emphasises just gross returns should not be allowed or, if published, they should be given a lesser prominence than net (after tax and fees) returns.
2. Quoted returns should be accompanied by a provider certificate saying they are not misleading.
3. All financial data that will allow a public issuer's performance data to be calculated should have to go to a central body.
4. Some suitably qualified organisation should be given a contract to analyse that data and publish combined results on a timely basis.

The Cabinet Paper that was released on Budget Day concerning just KiwiSaver scheme disclosure requirements stated:

“The net return of the fund is the single most important factor because net returns ultimately determine the benefit for individuals from employing a manager to manage their investment.” (Minister of Commerce 2012 p. 6)

We agree. Gross returns should not be the starting point for the disclosure of investment performance. The complexities of the tax system make gross returns meaningless for comparisons across funds and across managers.

For comments on this *PensionCommentary* and for further information please contact:

Michael Littlewood
Co-director, Retirement Policy and Research Centre
University of Auckland
Private Bag 92 019
Auckland 1142
New Zealand

E Michael.Littlewood@auckland.ac.nz
P +64 9 92 33 884 DDI
M +64 (21) 677 160
<http://www.rprc.auckland.ac.nz>

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