After-Tax Performance – interactive discussion

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The Pre-Tax Return, single period

Manager value added

$$PreTaxReturn = \frac{V_E - VB - \sum F_i}{V_B + \sum w_i * Fi}$$

Capital at work

- V_E is ending value; V_B is beginning value
- F_i are client effect (external cash flows)
- w_i are weights corresponding to fraction of period remaining at time of external cash flow (0 for end, 1 for beginning, ½ for middle, (CD-D)/CD for Modified Dietz, etc.)

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The Pre-Tax Return, single period (restated)

Manager value added

$$PreTaxReturn = \frac{Income\&Expense + Gain\&Loss}{V_B + \sum w_i * Fi}$$

Capital at work

- Income and expense can be paid/received or accrued
- Gains and losses can be unrealized or realized

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The After-Tax Return, single period

Manager value added minus taxes

$$AfterTaxReturn = \frac{Income\&Expense + Gain\&Loss - Taxes}{V_B + \sum w_i * Fi}$$

Capital at work

- After-tax return is simply pre-tax return minus return lost/credited due to taxes

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What components of returns are taxable?

Taxable amounts

- Short-term realized gain/loss
- long-term realized gain/loss
- 5 year realized gain/loss
- interest/expense & amortization on U.S. Government bonds
- resident interest/expense & amortization on muni bonds
- non-resident interest/expense & amortization on muni bonds
- domestic corporate dividends on securities held more than 44 days
- all other interest, dividend & amortization income/expense
- change in unrealized gain/loss (depending on return methodology)
- Section 1256 contracts (60/40 percent rule) – futures and options
- Section 998 contracts – currency gain/loss

Based on US Tax Code, list not exhaustive

After-tax performance requires more detailed data than pre-tax performance

- Taxlot accounting is needed
  - Position entry: distinguish long- vs. short-term gain/loss
  - Position exit: basis adjustments due to bond amortization/accretion, corporate actions, return of capital
- Tax rates that apply to investors historically are needed
- Tax code varies by country

Benchmarking is difficult in after-tax reporting

- First, recall the properties of a valid benchmark:
  - Unambiguous
  - Investable
  - Measurable
  - Appropriate
  - Reflective of current investment opinions
  - Specified in advance
  - Owned
- An additional criterion is required of after-tax benchmarks:
  - Should reflect client's tax status

Pre-liquidation after-tax return

- Uses pre-tax market values at the start and end of period
- Subtracts taxes for the measurement period (income on accrual basis & realized gains)
- Does not reflect future taxes – may understate total tax burden

$$r = \frac{MV_E - MVB - CF - Treal}{MV_B + \sum(CF_i * w_i)}$$

What tax rates should be applied?

- Best practice is to use consistent tax rate methodology use over time and within each composite of either anticipated tax rates or maximum tax rates
- Usage of client's anticipated tax rates for income and capital gains is recommended
- Rates should be determined in advance and be manager's expectation of rates client will face
- May differ from rates client actually pays taxes on but are appropriate for performance since they guided the tax-aware investment decisions

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Composite construction

- Firms presenting after-tax performance must include all actual, fee-paying, discretionary portfolios that are managed on a tax-aware basis (in at least one of the firm's after-tax composites
- An after-tax composite is conceptually a sub-set of portfolios from a before-tax composite that is created to represent a specific tax-efficient investment mandate
- The firm may need to separate portfolios within a pre-tax composite (representing a broad investment mandate) into one or more smaller after-tax composites in order to best reflect clients' different tax structures and risk tolerances
- Alternatively, a pre-tax composite may already be constructed to take into account the different tax-related issues; thus the after-tax composite will consist of the same member portfolios

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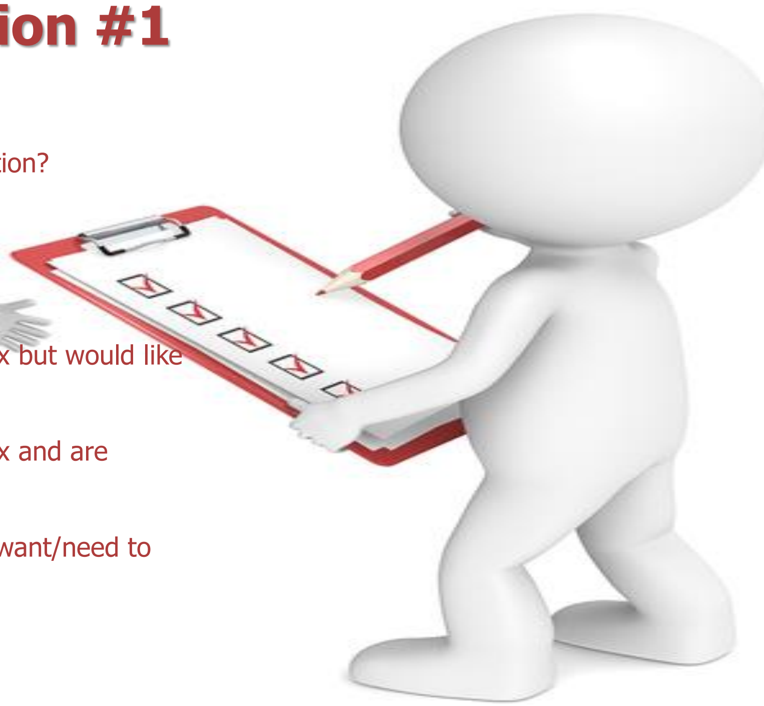
Poll Question #1

Which best describes your situation?

A. We calculate after-tax
B. We do not calculate after-tax but would like to
C. We do not calculate after-tax and are unlikely to
D. We are unsure whether we want/need to



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Poll Question #2

Which best describes your situation?

A. We calculate for individual portfolios (client reporting)
B. We calculate after-tax for composites or models (prospects or clients)
C. We calculate after-tax for individual portfolios and composites/models

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Poll Question #3

How do you calculate after-tax returns?

A. We use spreadsheets

B. We use a proprietary system

C. We use a third-party vendor system

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Poll Question #4

Which best describes your situation?

A. We have a performance verification done for our after-tax reporting

B. We do not have a performance verification done for our after-tax but would like to or are considering it

C. We are not interested in after-tax verification

D. Other (please explain)?

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Discussion Topics

- For those with no plans for after-tax: what reasons?
- For those that do not calculate after-tax but do not, or are weighing whether to:
  - What are the obstacles?
  - What are the drivers causing you to consider?
  - What is the hesitancy?
- For those that do calculate after-tax:
  - What types of strategies? (Asset classes? Tax-efficient?)
  - Has it been successful?
  - What were the major challenges?
  - Do you use after-tax benchmarks?

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Discussion Topics

- For those that do calculate after-tax:
  - What types of strategies? (Asset classes? Tax-efficient?)
  - Do you use after-tax benchmarks?
  - Do you follow/claim USIPC after-tax compliance?
  - Has it been successful?
  - What were the major challenges?
- For the vendors:
  - Do you calculate after-tax? If so, for accounts, models, composites?
  - Major challenges?

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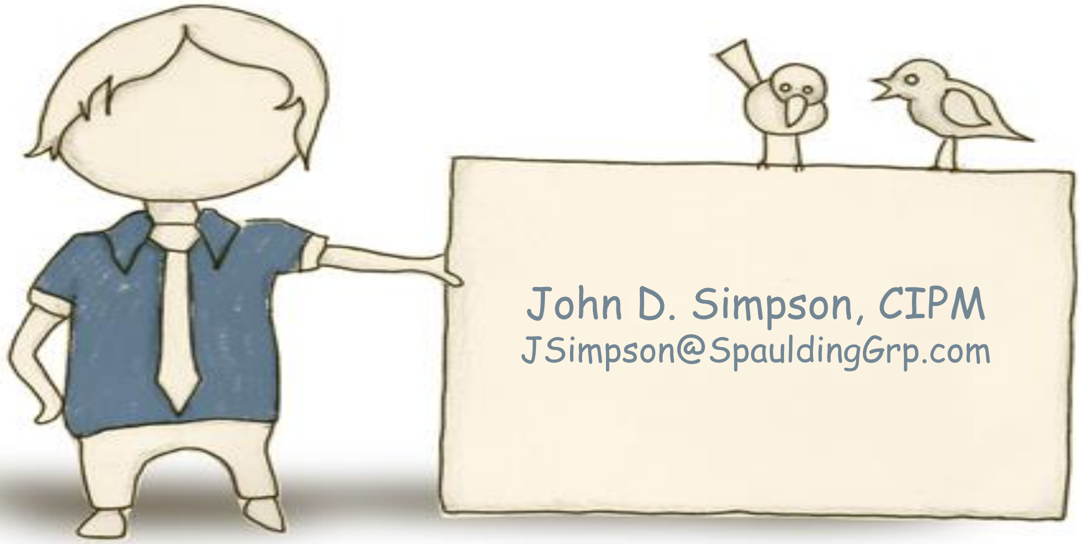

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