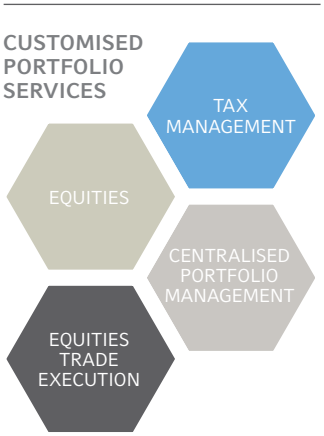
Russell Investments

Centralised Portfolio Management improves global shares efficiency and after-tax outcomes

A multi-billion dollar Australian multi-asset portfolio manager wanted to invest in a diversified global shares portfolio with a focus on investor's after-tax outcomes. The asset manager partnered with Russell Investments to use a Centralised Portfolio Management (CPM) approach designed to improve the portfolio's after-tax performance and create a customised after-tax benchmark for global shares.



Situation

Since the 2010 Cooper Review and the Australian Government's 2013 Stronger Super Reform, which observed that trustees of Australian superannuation funds need to take into account after-tax investment returns, there has been a number of providers in the Australian marketplace offering different types of after-tax Australian shares solutions.

However, while global shares forms a significant proportion (20-40%) of a typical Australian superannuation fund's asset allocation, very few providers manage global shares portfolios with an explicit focus on after-tax outcomes from an Australian investor's perspective.

There were also no appropriate after-tax benchmarks available in the market to accurately assess after-tax performance on an apples to apples basis.

Solution

In October 2014, Russell Investments used a Centralised Portfolio Management (CPM) approach to incorporate:

- Active manager insights from multiple global shares managers;
- A large cap value (smart beta) factor exposure; and
- A consideration of tax-aware factors to mitigate inefficient after-tax outcomes.

To achieve this, we drew on our five core capabilities - capital markets research, asset allocation, manager research, factor exposures and implementation.

Russell Investments firstly researched the world to identify a buy-list of leading global shares managers. We then analysed these managers to examine the relative inherent tax-effectiveness of each manager's investment process. The managers selected were capable of generating excess returns through strategies that have a long-term investment horizon with relatively low portfolio turnover – which means they are naturally tax efficient. In addition, Russell Investments identified an opportunity to enhance the aggregate portfoliowith an allocation to a systematic large cap value factor exposure.

We then implemented the manager insights and factor exposures through a CPM approach that's designed to further improve the portfolio's after-tax performance by reducing portfolio turnover, thereby lowering the frequency of disposals for investments and therefore transaction costs.

This was supplemented with specific tax lot selection and security holding period management to mitigate inefficient after-tax outcomes. The former generally involved selecting share 'lots' sold with a higher cost basis with lower gains realisation and to maximise the level of assets invested. The latter involved monitoring when assets have been held for more than a year and may qualify for the statutory capital gains tax discount concession. The portfolio also claims franking (imputation) credits and withholding tax credits on securities where available.

Russell Investments was also first in the industry to create a customised after-tax benchmark for global shares to allow an accurate like-for-like assessment of the performance of the tax aware portfolio on an after-tax basis. Drawing on our thought leadership and years of experience in after-tax management, we worked with GBST, an innovative technology and software provider to the global financial services industry, to create a benchmark that addressed the great degree of complexity and customisation required for after-tax performance measurement.

Results

Russell Investments' CPM approach delivered strong after-tax returns and cost savings benefits:

- **Preserved active manager insights.**
  The key goal in managing an active multi-manager portfolio with a focus on after-tax outcomes is to capture excess returns from active manager insights while mitigating inefficient tax outcomes. This is challenging because active management strategies by nature tend to incur higher turnover than the underlying benchmark, thereby tending to increase gains realisation which impacts on the after-tax return. The portfolio successfully captured pre-tax excess returns by carefully selecting and combining managers, using a centralised portfolio management technique and applying tax aware strategies, including conscious selection of tax lots on share sales.

- **Strong excess returns before and after tax.**
  By centralising all trades in the portfolio, the CPM approach means that there is a lower level of disposals for investments within one total portfolio, unlike a traditional approach where gains are realised by each individual manager. These strategies employed by Russell Investments, together with combining the active manager insights into one aggregate portfolio, added 3.4% p.a. since inception to date[1].

- **Reduced turnover generating cost savings.**
  By centralising all trades through CPM, we significantly reduced turnover in the aggregate portfolio by more than 50% since inception to date[2]. This in turn reduced commissions by 0.14% p.a. and spreads and other transactions costs by 0.2%[3] p.a.

1. Since inception (October 2014) to 31 December 2015, comparing gross of fees to custom after-tax series off Russell Global Large Cap Net Index calculated by GBST assuming 15% tax rate applicable to superannuation investors.
2. Stock turnover reduced by 72% in the period since inception (October 2014) to 31 December 2015, compared to traditional active multi-manager structure. Going forward, Russell expects turnover to continue to be at least 50% lower.
3. Since inception (October 2014) to 31 December 2015, compared to a traditional active multi-manager structure.

For more information speak to:

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