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Do active fund managers care about capital gains tax efficiency?

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ABSTRACT

This study investigates the tax efficiency of actively managed equity funds by conducting a previously unaddressed natural experiment. Specifically, we examine whether asset sales were timed to take advantage of the introduction of a substantial discount to realized capital gains when the holding period was at least 1 year. Institutional equity fund management in Australia is principally focused on the pre-fee and pre-tax performance surveys of leading asset consultants. Given this industry setting, our study is important because tax efficiency is not accounted for directly in the reported performance numbers, and is thus opaque. We find that active fund managers overall have significantly increased the proportion of long-term capital gains realized after the change in taxation code, although there are significant variations across funds. We also find that active fund managers realize more long-term gains on both large capitalization and low volatility stocks.

1. Introduction

This study investigates actively managed equity funds' tax efficiency by conducting a previously unaddressed natural experiment — an examination of whether stock sales were timed in order to take advantage of a 50% discount in taxable capital gains for assets with a holding period of at least 12 months. The capital gains tax discount was introduced in 1999 through an amendment to the Income Tax Assessment Act. Applying the popular First-In-First-Out (FIFO) principle to our sample of the daily trades of twenty-six institutional equity funds from 1994 to 2002, we find the proportion of short-term capital gains

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realized decreased in a statistically significant manner after the change in taxation code. The overall decrease in the proportion of short-term capital gains is not evident when capital gains are computed using the Last-In-First-Out (LIFO) methodology. However, the LIFO approach is inherently insensitive to fund managers' tax management.[2]

Commonly used investment funds (i.e., unit trusts) are not liable for taxation themselves, however, fund income and realized capital gains are 'passed through' to unit holders, where income tax is assessed at the individual investor level.[3] The U.S. Securities and Exchange Commission (SEC) mandate that mutual funds disclose the impact of tax liabilities in mutual fund advertising and marketing materials.[4] However there are no corresponding legal requirements in Australia. While fund performance is published and monitored through the surveys of asset consultants and fund ratings houses as well as contained in databases, the principal focus of the fund management industry has been on the collection and dissemination of pre-tax performance.[5] Our findings are important in relation to public policy concerns within the current fund manager reporting and performance survey assessment regime. Arnott and Jeffrey (1993) and Arnott et al. (2000) highlight the differences between before-tax and after-tax returns. Dickson and Shoven (1993) and Mawani et al. (2003) argue that the relative rankings of funds can differ significantly between before-tax and after-tax assessment criteria. Opponents of after-tax reporting argue that differences in individual investors' tax rates would lead to inconsistent reporting; including the assertion that investors will not understand the impact of tax on total returns; and that after-tax computations increases administration costs.[6] While active fund managers argue that it has been the norm over the past 3 years for Australian equity managers to carefully monitor turnover, with respect to tax considerations,[7] index fund managers argue that taxes are neglected because active fund managers are not measured with respect to after-tax returns.[8] A potential conflict of interest exists when only pre-tax returns are published because investors do not have an opportunity to compare the net returns among a peer group. Fund managers may be executing "rash trades"[9] to increase their pre-tax returns marginally, but such activity may not necessarily maximize after-tax returns, nor be in the interests of unit holders. Our findings suggest that not all Australian active fund managers are operating in a way that optimizes the after-tax returns for fund investors.

This study makes contributions to the literature that examines whether, and to what extent, investors respond to tax incentives. Stiglitz (1983) and Constantinides (1983, 1984) analyze the effect of taxes on investment decisions. They suggest that investors should realize losses immediately and defer the realization of gains until a forced liquidation arises, in order to maximize the present value of tax shields and to minimize the present value of tax liabilities. Gibson et al. (2000), Poterba and Weisbenner (2001), and Grinblatt and Keloharju (2004) find evidence that individual and institutional investors increase the selling of loss-making stocks prior to the tax year end. However, there are competing theories to this tax loss selling hypothesis that could explain fund manager tax year end selling for loss-making stocks, such as the window dressing and seasonality (see Grinblatt and Keloharju, 2004; Sias, 2007). Our study of the capital gains tax discount provides a unique and unambiguous event to test whether delegated fund trading is responsive to the tax incentives of the principals–investors.

U.S. evidence suggests that investors are tax-aware and adjust their investment flows to tax incentives, even before the SEC's mandatory disclosure requirement. Bergstresser and Poterba (2002) study the performance-flow relation with respect to after-tax returns, and document that fund inflows are more

[2] The method also results in undesirably large unrealized capital gains being accumulated and distributed to future fund investors.

[3] There are taxable investment vehicles, which do pay tax as a collective investment scheme, such as pooled superannuation trusts and life office funds. However, the most commonly available investment scheme is that of a unit trust, which distributes income and capital gains to individual unit holders.

[4] Rule 482 under the Securities Act of 1933 and rule 34b-1 under the Investment Company Act of 1940 which require certain funds to include standardized after-tax returns in advertisements and other sales material. These rules are effective from April 16, 2001 but the compliance date has been extended to December 1, 2001.

[5] Dunstan (2006a,b). Index fund provider, Vanguard, and multi-manager MLC are the notable exceptions.

[6] Barrett (2006b).

[7] Wright (2006).

[8] Dunstan (2006a).

[9] Barrett (2006b).