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Tax-managing a Responsible Investing Portfolio

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The rise of Responsible Investing – investments motivated by environmental, social and governance (ESG) concerns – has been well-documented. In Australia, many APRA-regulated superannuation funds proudly identify as activists on important issues like climate change, modern slavery and board diversity. Given the scale of the industry and its reach across the nation and beyond, the collective pursuit of Responsible Investing by funds has profound implications for the way society is being shaped for future generations.

One Responsible Investing principle – how companies practice 'good tax citizenship' – presents an interesting twist for Australian superannuation funds who are themselves taxpayers, unlike their global pension fund peers. Overlooking the tax implications of day-to-day investment decisions risks the fund breaching its legislative duty to manage taxes; but, of course, aggressive tax planning could 'out' a Responsible Investing fund as inauthentic and hypocritical if they are criticising companies for such acts. The dual objectives of *Responsible Investing* and *after-tax investing* are each compelling, but is it possible for funds to find ways to pursue them which are compatible; even complementary?

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This paper aims to answer this question and charts a course for superannuation funds to comfortably pursue the goals of both Responsible Investing and after-tax investing. With a sensible framework akin to the way 'responsible' companies think about tax, we easily reconcile the principles of 'good tax citizenship' and 'after-tax investing' for a responsible (and taxable) superannuation fund investor. Further, using an exemplar portfolio of global equities constructed by specialist ESG manager, Calvert, we show how a superannuation fund could implement this portfolio in an after-tax focused way, with relatively little impact on the fund's risks. We quantify a 25-60 basis points (bps) annual benefit to funds who implement our exemplar Responsible Investing portfolio with an explicit after-tax return focus.

Tax citizenship as a principle of Responsible Investing

A recent global survey of institutional asset owners by Morgan Stanley[1] reported on the ascendancy of Responsible Investing: 95% of respondents were currently integrating or considering integrating Responsible Investing, and 57% envisioned a time when they will only allocate to managers with a formal ESG approach. Consistent with these findings, Australia has seen a rise in new superannuation ESG products to meet member demand over the past few years. The current pandemic crisis may have helped the cause, with the trade press reporting that for the year ending 31 March 2020, superannuation fund members investing in a balanced or growth option would have been 1.5% better off in the ESG-focused option[2].

To explore this trend, we introduce (and will detail in our modelling later) our exemplar portfolio – an ESG-tilted MSCI World Ex-Australia index portfolio constructed for a hypothetical Australian superannuation fund by ESG specialist, Calvert. This portfolio applies Calvert's documented Principles for Responsible Investment[3] to the investible universe, focusing on:

- environmental sustainability and resource efficiency,
- equitable societies and respect for human rights, and
- accountable governance and transparent operations.

These reflect Calvert's philosophy that companies with strong sustainability profiles, collectively, have the potential to meet or exceed the performance of the common broad-market benchmarks.

Part of Calvert's stated beliefs (our italics) are that:

> "most corporations deliver benefits to society, through their products and services, creation of jobs, *payment of taxes*, and the sum of their behaviours."

This shows how the principle of good tax citizenship fits with an overall Responsible Investing mindset for a superannuation fund. The principle, part of the 'G' (governance) in ESG[4], motivates Calvert to exclude from its modified index portfolio companies in the MSCI universe fined for breaches of tax law or subject to public tax controversies which allege that the companies have engaged in aggressive tax planning. For example, 'FAANG' tech stocks[5] have flexibility over the sources of their profits (i.e. the ability to 'profit-shift') and, some argue, pay relatively little tax in high-corporate tax jurisdictions given the size of revenues attributable to that country. When the UK in December 2014 passed a 'diverted profits tax' to address this problem (with Australia following suit in 2017 and France last year), it was quickly dubbed the 'Google tax'.

[1] See Morgan Stanley's 'Sustainable Signals Asset Owners See Sustainability as Core to the Future of Investing', https://www.morganstanley.com/content/dam/msdotcom/

[2] Rachel Alembakis, 'ESG funds withstand economic turbulence from pandemic', Money, 13 May 2020, https://www.moneymag.com.au/coronavirus-esg-super-funds

[3] See https://www.calvert.com/media/34498.pdf

[4] See the OECD/G20 Principles of Corporate Governance, which cover corporate tax responsibility and aggressive tax planning.

[5] Facebook, Apple, Amazon, Netflix and Google (Alphabet) together comprise 'FAANG' tech(nology) stocks.

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A February 2020 Harvard Law School-sponsored on-line forum on corporate governance provided a rare foray into the intersection of tax and Responsible Investing[6]. It rationalised tax citizenship as an important governance principle because of:

1. *Direct financial impact* - Breaches of tax law can lead to material fines to be paid by the company
2. *Brand impact* – Breaches of tax law or community expectations about taxpayers can damage the company's brand and reputation (with indirect financial impact)
3. *Social license* – a bad corporate tax citizen can "deprive governments of funding needed to provide services to communities".[7]

The last of these seems particularly topical given countries' mounting fiscal burden to fight the pandemic. It frames companies' tax obligations as a contribution to the COVID-19 'war effort'. It aligns with the US Business Roundtable's profound reinterpretation of the purpose of a company in August 2019, to focus not just on the interests of shareholders, but of broader community *stakeholders*.

Clearly, superannuation funds that seek to hold companies to standards of tax citizenship as part their Responsible Investing programme would be prudent to hold themselves to these same standards.

Principles for marrying Responsible Investing and after-tax investing

Regulatory framework

Legislation and prudential guidance require APRA-regulated superannuation funds to consider tax when formulating investment strategy.[8] This is a fiduciary mechanism to align investment thinking to what actually builds retirement savings for fund members – after-tax returns on investment portfolios.

On the other hand, ESG considerations are a fund evolution that the regulatory guidance (particularly, SPG 530) caters to, without mandating. The onus on superannuation funds is simply to ensure that such Responsible Investing thinking is supported by the other broad considerations mandated by SPG 530 – risk, return, diversification, liquidity and valuation. This means, for instance, that funds must ensure members do not suffer from shortcomings such as a lack of diversification stemming from ESG-related industry exclusions. Interestingly, APRA, as regulator, seems to be emerging as a powerful supporter of Responsible Investing; for example, issuing a letter to funds (and others) in February this year on managing financial risks relating to climate change.[9] This seems to add regulatory impetus, if not imprimatur, for Responsible Investing by superannuation funds. What is notable is that the law and regulator see no inherent inconsistency with the idea of tax management and Responsible Investing, mandating the former and becoming increasingly supportive of the latter.

Stakeholder analysis

Companies viewed favourably through a holistic Responsible Investing lens pursue shareholder returns while managing the wider, longer-term consequences of their activities and the interests of broader stakeholders. The historic 'dividends and growth at all costs' mentality is subsumed by a 'widening of the lens' that contextualises, without diminishing, the interests of shareholders as the owners of the company. A new equilibrium is sought which does

[6] See https://corpgov.law.harvard.edu/2020/02/22/tax-and-esg/

[7] Ibid.

[8] See subsection 52(6) of the Superannuation Industry (Supervision) Act 1993 and paragraphs 6(e) and 31-33 of APRA Superannuation Prudential Practice Guide (SPG) 530, Investment Governance: https://www.apra.gov.au/sites/default/files/prudential-practice-guide-spg-530-investment-governance.pdf.

[9] See https://www.apra.gov.au/understanding-and-managing-financial-risks-of-climate-change. We recently remarked on this contrast with retrograde developments in the US in a published article: 'Opinion: Australian super funds could benefit from US ESG policy move', FS Sustainability, 24 September 2020, https://www.fssustainability.com.au/opinion-australian-super-funds-could-benefit-from-us-esg-policy-move?q=parametric

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not necessarily imply incompatibility, captured in the popular view that "if companies are transparent to shareholders about efforts to address stakeholder priorities, market value will likely increase over time as well"[10].

Returning to this paper's theme, Responsible Investing highlights the two-sided reality of a company's relationship with tax: companies should be paying what Australians would call their 'fair share' of tax, but – to honour their duties to owner-shareholders – should not be careless, cavalier or generous about how much tax is paid to the appropriate Tax Office, for what is not paid to the Tax Office becomes a return to shareholders. The new 'tax equilibrium' sought within a Responsible Investing mindset requires companies to manage the interests of both sets of stakeholders so that neither is exploited or neglected.

This paradigm also fits a 'responsible' Australian superannuation fund in balancing its obligations as a tax citizen. The fund members (like shareholders) have an important stake in how well or diligently the fund manages investment taxes, as their retirement outcomes are underpinned by after-tax investment returns. Yet the Tax Office's 'tax take' is key in underwriting the standards of living that Australian citizens enjoy. Thus, superannuation funds, like the 'responsible' companies in which they invest, need to reach for a tax equilibrium as part of their Responsible Investing mindset. Note that Responsible Investing is not a reason to reject the idea of after-tax investing, as this ignores the member's stake in the tax outcome – hardly 'responsible'. Rather, it endorses the 'responsible' management of investment taxes while ensuring that the after-tax investing solutions adopted do not veer to an extreme but tread a disciplined, moderate path which sits within the key boundaries of the law and the fund's own tax risk appetite. This tax equilibrium recognises both the members' and Tax Office's interests in the tax outcomes of the fund's investment decisions. It sits at the heart of our idea of tax-managed Responsible Investing, and comfortably reconciles the principles within.

Tax-managing a Responsible Investing portfolio

With potential philosophical differences dismissed, we now return to our exemplar portfolio to show how a tax-managed Responsible Investing approach can work in practice for a superannuation fund.

Methodology[11]

We begin with an MSCI World ex-Australia Index universe ('MSCI Index'), to which our ESG manager, Calvert, has applied its intensive, actively researched approach to Responsible Investing index construction[12]; and to which we (Parametric as implementation manager) will add tax management[13]. Each constituent's inclusion and weighting in the Calvert portfolio are subject to the business operating in a manner consistent with the Calvert Principles of Responsible Investing – environmental sustainability and resource efficiency, equitable societies and respect for human rights, and accountable governance and transparent operations, including (of course) good tax citizenship.

We simulate the performance of non-tax-managed ('non-TM') and tax-managed ('TM') versions of this Calvert Responsible Investing portfolio over the period 30 April 2015 to 30 April 2020. We assume each portfolio is fully invested, with no cash and no inflows or outflows; and all securities were available for purchase at market-on-close prices and sufficiently liquid. Our hypothetical superannuation fund investor, in appointing Calvert to implement its Responsible

[10] See PwC CFOdirect article, "Could focusing on stakeholders increase your company's value?", 6 February 2020: https://www.pwc.com/us/en/cfodirect/publications/point-of-view/esg-strategies-stakeholder-value.html

[11] We thank our colleague, Vassilii Nemtchinov, for his extensive assistance with this modelling work.

[12] See https://www.calvert.com/calvert-indexes.php

[13] Specifically, we simulate the tax management of rebalancing trades to incorporate techniques like tax lot selection, favouring tax loss over gain trades, trimming de minimis gain trades, deferring gain trades and limited sampling and stock substitution. No trades in our simulations are initiated for tax reasons, to stay well within the confines of Australian tax law. These simulations simplify (conservatively) our real-life approach to integrating tax awareness with other important passive equity portfolio implementation considerations such as sampling versus full replication, explicit and implicit transaction costs, liquidity and cash-flow management. Calculations reflect the tax profile of a complying superannuation fund in accumulation phase.

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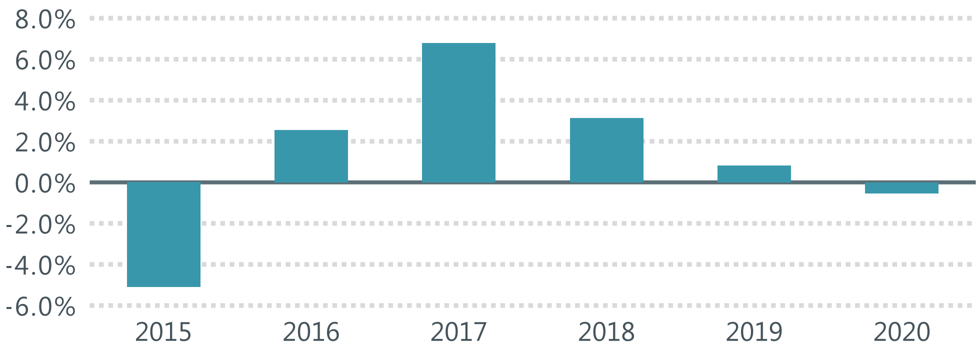
Investing principles, logically has the appetite for tracking error to the MSCI Index in order to pursue Responsible Investing. To incorporate tax-managed implementation in the TM Calvert portfolio, we add a further risk budget of 50 bps each year. This allows the TM Calvert portfolio to materially track the non-TM Calvert portfolio while reorienting to the after-tax return objectives of the superannuation fund investor; in other words, to target the twin goals of the fund of Responsible Investing and an after-tax return focus. Both Calvert portfolios (non-TM and TM) are rebalanced quarterly and risk-controlled through optimisation techniques using the MSCI Barra Global Equity Model. Optimisation involves setting tight constraints on stock, country, sector and style factors in the portfolio to implement Calvert's Responsible Investing insights effectively. However, the after-tax return objectives of the TM Calvert portfolio prompt us to loosen the optimisation bounds on momentum exposure based on two desirable properties of this style factor – its ability to act as a long term positive contributor to pre-tax returns and its innately attractive tax properties.[14]

Results – pre- and post-tax returns and active risk

We first want to understand our notional superannuation fund investor's pre-tax experience, year on year, in stepping away from a standard MSCI Index-tracking portfolio to incorporate Calvert's Responsible Investing principles. Effectively, the fund chooses to accept active risk (which we will measure by tracking error[15] to the MSCI Index), with Figure 1 showing the performance impact.

Figure 1: Annual pre-tax excess returns (May 2015-April 2020), non-tax-managed Calvert portfolio v MSCI World ex-Australia Index (hypothetical)



Source: Parametric, Calvert, MSCI (2020). Hypothetical. You cannot invest directly into an index. Part year results for 2015 and 2020 to reflect the analysis period. Returns are gross fees and transaction costs.

On average, there is positive annual pre-tax outperformance of the non-TM Calvert portfolio of 1.27%, though with significant variation year on year, from a (5.10%) drag in 2015 to a 6.78% excess return uplift in 2017. The active risk taken in the portfolio translates into tracking error averaging 4.90%. Clearly, it is not appropriate to think of this as an MSCI Index-tracking strategy but, rather, quite active. While the time series is too short to make firm conclusions about the alpha-generating qualities of a Responsible Investing approach, the initial experience, pre-tax, is promising and the risk budget reasonable.

[14] We discuss the use of momentum in our 2019 research paper, see Raewyn Williams, Vassilii Nemtchinov "Fundamental Indexing: Why True Tax Efficiency Beats Simply Keeping Turnover Low", Parametric, December 2019, https://www.parametricportfolio.com.au/insights-and-research/fundamental-indexing

[15] We calculate tracking error as the standard deviation of the monthly time series of returns of the non-TM Calvert portfolio versus the MSCI Index (statistical n-1 method), and use a comparable methodology for other tracking error calculations in this paper.

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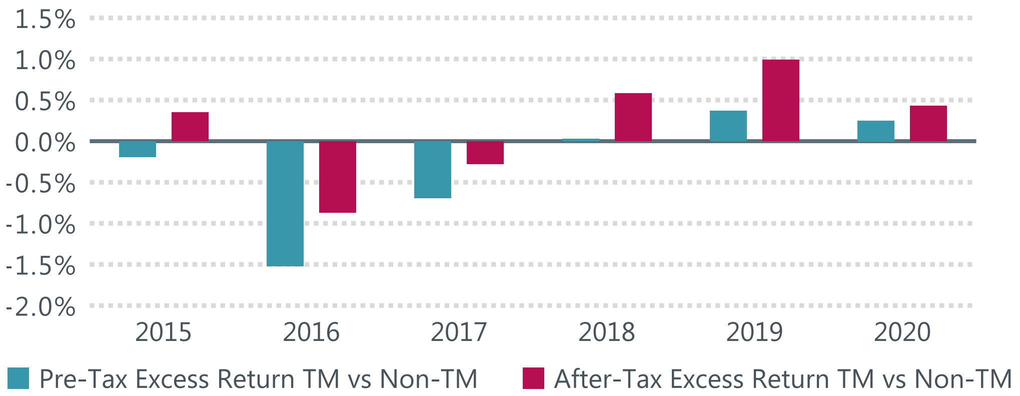
When after-tax return objectives (TM Calvert) are added to this Responsible Investing approach, we are interested in the impact the additional 50 bps risk budget will have on the pre-tax and after-tax returns of the portfolio. Figure 2 shows the pre-tax and after-tax results of our hypothetical non-TM versus TM Calvert Responsible Investing portfolios.

Figure 2: Annual pre-tax and after-tax excess returns (May 2015-April 2020), tax-managed v non-tax-managed Calvert portfolios (hypothetical)



Source: Parametric, Calvert (2020). Hypothetical. Part year results for 2015 and 2020 to reflect the analysis period. Returns are gross fees and transaction costs.

Focusing first on the blue bars, we see that the pre-tax experience of the after-tax focused portfolio (TM Calvert) through time presents as a random variance to the non-TM portfolio year on year – costing the TM portfolio in 2015, 2016 and 2017 and benefitting the portfolio in 2018 (mildly), 2019 and 2020. For the short time series we have studied, the additional active risk (46 bps realised tracking error annually – almost the full risk budget) has created, on average, a 35 bps pre-tax performance drag each year for the TM portfolio relative to the non-TM Calvert portfolio. In other words, around a quarter of the non-TM Calvert portfolio's annual pre-tax outperformance of 1.27% (versus the MSCI Index) has been given back here in pursuit of better after-tax returns.

This draws us to the pink bars in Figure 2 which answer the critical question: has the additional active risk generated an after-tax performance uplift; and enough to say this risk is well-compensated? We see the tax-managed Responsible Investing portfolio has outperformed its non-tax-managed counterpart by an average 25 bps annually after tax. The benefits of tax management, year on year, are delivered in a smoother way (more consistently positive) than we saw in Figure 1 for Responsible Investing. The positive performance contribution from tax management is shown by the pink bars in every year either clawing back some of the (blue) pre-tax lag (2015, 2016, 2017) or building further on the pre-tax outperformance (2018, 2019, 2020). In 2015, the small pre-tax lag is completed recovered and delivered as after-tax outperformance for that year. The powerful 'tax alpha' story is that the TM Calvert portfolio generates a smaller tax bill or higher tax offsets than non-TM Calvert; the explicit after-tax focus delivers an average 60 bps in tax alpha each year over the non-tax-managed portfolio. The experience, overall, is very positive as the 60 bps in tax alpha allows TM Calvert to make up the 35 bps pre-tax drag in full, and add 25 bps in after-tax returns on top (-35+60=25 bps). In our opinion, this seems like a good reward for the small extra tracking error (46 bps) incurred.

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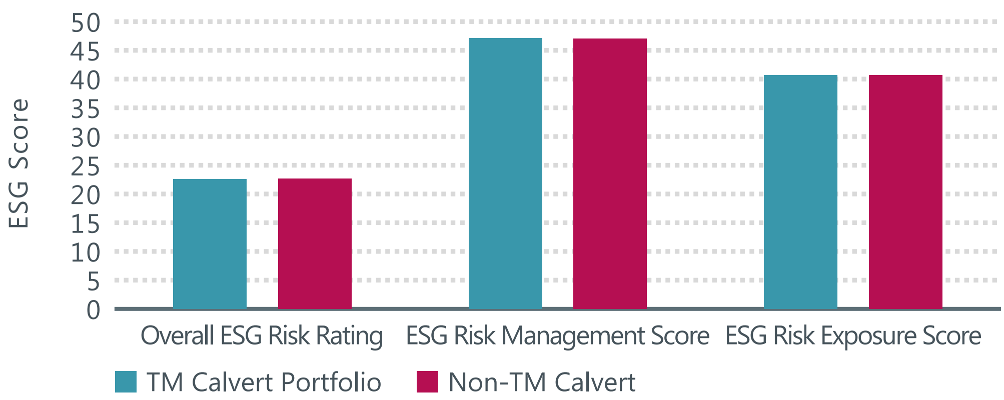
Results – ESG scores

Finally, it is crucial to compare ESG snapshots to reassure our hypothetical superannuation fund investor that its Responsible Investing principles are not a casualty of its after-tax implementation approach. Figure 3 below compares the non-TM and TM Calvert portfolio ratings at analysis period end based on the following ESG metrics[16]:

Metric	Description	Scale
ESG risk exposure	Measures a company's sensitivity or vulnerability to ESG risks *(lower is better)*	Low: 0-35 Medium: 35-55 High: 55-100
ESG risk management	Evaluates a company's performance on managing its exposure to ESG issues *(higher is better)*	Strong: 100-50 Average: 50-25 Weak: 25-0
Overall ESG risk rating	Measures the degree to which a company's economic value is at risk driven by ESG factors *(lower is better)*	Negligible: 0-10 Low: 10-20 Medium:20-30 High: 30-40 Severe: >40-100

Figure 3: ESG scores as at 30 April 2020, non-tax-managed v tax-managed Calvert portfolio



Source: Parametric, Sustainalytics (2020). Analysis of hypothetical portfolio holding data as at 30 April 2020 based on Sustainalytics ESG ratings as at 29 September 2020.

Happily, we see from Figure 3 the healthy ESG characteristics of the non-TM Calvert Index portfolio preserved in our tax-managed Responsible Investing portfolio, TM Calvert. Relative to non-TM Calvert, the TM Calvert portfolio's ESG risk exposure score remains unchanged (medium risk score), its ESG risk management score improves marginally (high-average score) and its overall ESG risk rating falls marginally, remaining at the favourable 'low-medium' score range.

These simulations, themselves, are conservative and likely magnify the risk and ESG impacts of adding an after-tax focus compared with a live managed portfolio. Simple rules and algorithms sit behind this modelling, whereas a real-life tax-managed Responsible Investing portfolio benefits from a team of (human) portfolio managers who, day in and day out, can consider the risks, Responsible Investing and tax sensitivities in light of market conditions and manage them in real time.

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Conclusion

We have successfully mapped out the principles for a companionable co-existence of Responsible Investing goals and an after-tax investment focus for Australian superannuation funds. The ideas behind tax-managed Responsible Investing, far from being 'uncomfortable bedfellows', sit squarely within the regulatory framework of superannuation funds and the eminently responsible idea of funds diligently managing their array of stakeholders, including fund members and the Tax Office. The principles embody our description of a tax equilibrium superannuation funds must strike between their 'responsible' tax citizenship obligations and the very real stake fund members have in funds managing the tax implications of their investment decisions well. The opportunity is for superannuation funds to bring a neat, holistic coherence to their own two-sided (tax) stakeholder management as funds holds companies to account around the same principles.

Our exemplar Calvert portfolio of global equities shows why Responsible Investing is a step away from passive index-tracking and requires some appetite for active risk. Our analysis suggests, on average, this risk is rewarded in terms of investment performance, although the year-on-year journey can be bumpy. Of course, one should exercise caution about our findings given the short time period of our analysis. The other reward for this active risk is for a superannuation fund to know that its portfolio is genuinely constructed around Responsible Investing principles that are shaping society and are strong convictions of a growing cohort of fund members.

We can further encourage a superannuation fund uneasy about if and when its Responsible Investing convictions might pay off financially for fund members: our hypothetical tax-managed Responsible Investing portfolio added a quarter of a percent in after-tax returns each year over a non-tax-managed version. If one is prepared to treat the pre-tax performance impact of tax management as random (centering on zero through time), the benefits of tax-managed Responsible Investing may be closer to 60 bps each year. For a superannuation fund prepared to take on active risk to implement Responsible Investing, it seems an easy and useful extension to add a much smaller risk budget to pursue Responsible Investing in a tax-managed way, with results that are smoother, measurable and more immediately harvestable.

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