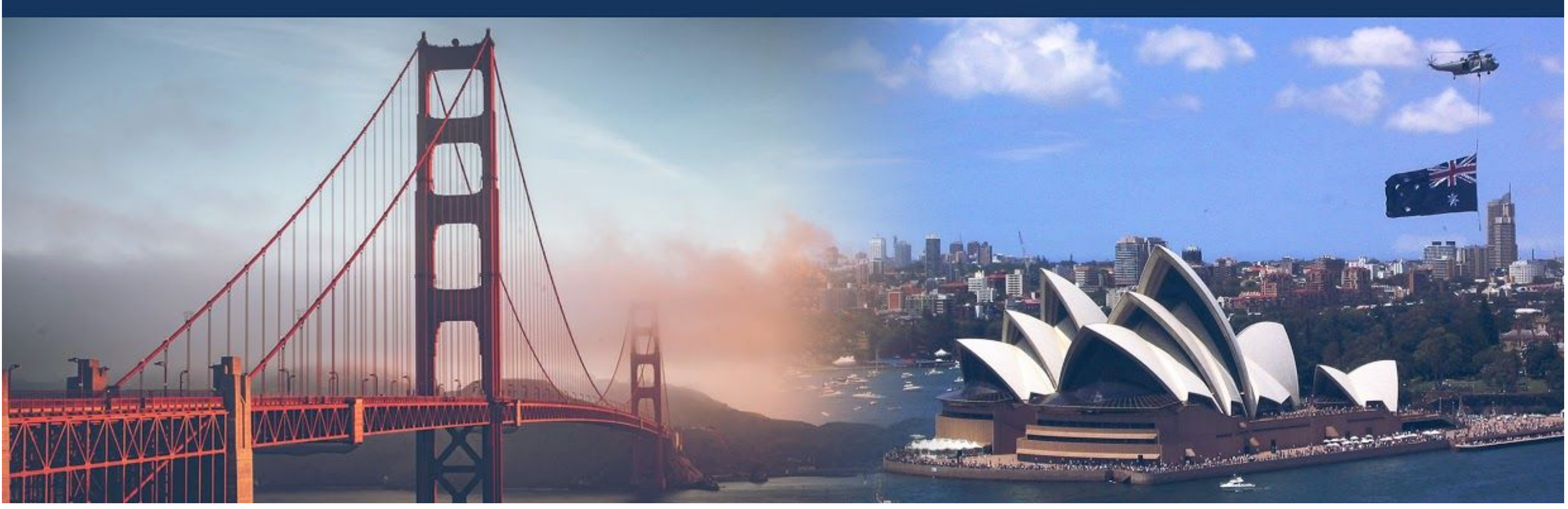
ARETÉ
WEALTH STRATEGISTS
AUSTRALIA

Australia Vs the United States:

Pros and cons of Managed Funds for Expat Investors

Considerations when choosing to locate your investment accounts in the United States or Australia



"In a complex mix of investment options, platforms, tax and regulation, it can be difficult to pinpoint where holding your investments might best work for you."

CONTENT

INTRODUCTION

Unpick Expat Investment Complexity

This guide looks at the pros and cons of managed funds investment in Australia and America for expat investors.

Wherever we find ourselves in the world, we can make better choices for our investments as we seek to improve management and returns. Whether you're a Sydney-sider living in New York, or an American whose swapped California for Brisbane - there's a range of ways to make the most of managed funds investment as an expat.

Managed funds investment is one of a huge range of investment options; and one of the few investment types where we can make a clear comparison between investing in Australia vs investing in America.

In a complex mix of investment options, platforms, tax and regulations, it can be difficult to pinpoint where holding your investments might best work for you.

Independent research with expert insights

The Arete Wealth Strategists team has 7 years of expertise in cross-border finances. We've analyzed years of independent data from Morningstar for insights into a comparison of managed fund investments across the two countries.

Morningstar is an independent Chicago-based investment research firm. Since 2009, the Morningstar Global Fund Investor Experience Study compares investor experience in 25 nations every two years. Nations are ranked based on four elements and assigned an overall score. This analysis uses the 2017 Morningstar Global Fund Investor Experience Study and the 2019 Morningstar Global Investor Experience Study 2019 (Fees and Expenses).

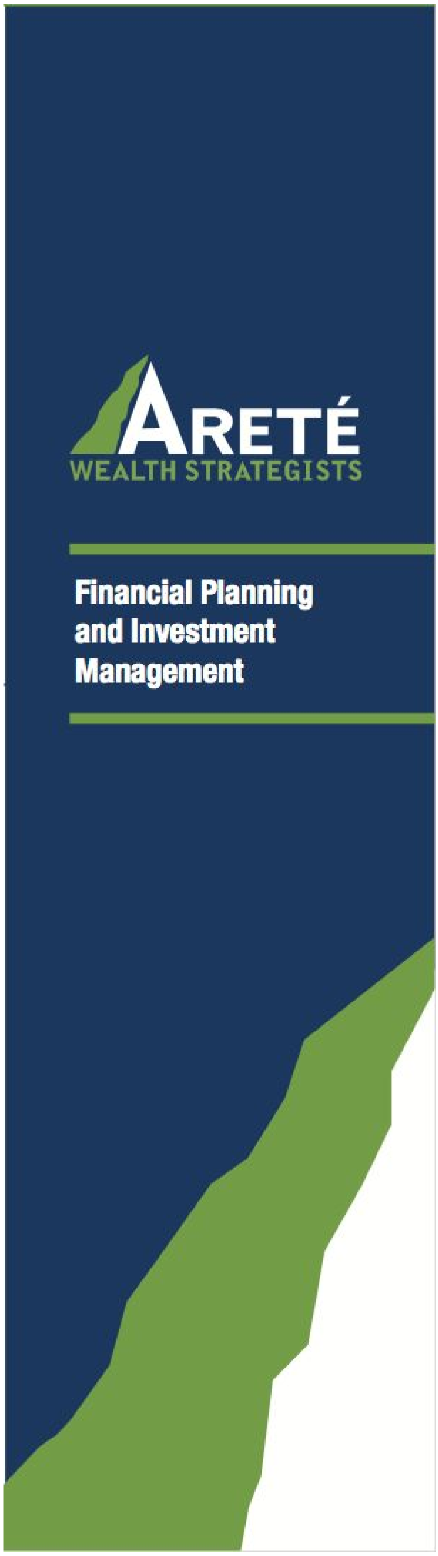
Partnering For Financial Success

In both Australia and the US, the financial services landscape gets complicated, fast, and missed opportunities can be costly. Expat investors in either country making decisions without specific advice on tax, fees and regulation, may be risking reduced returns and/or lack of compliance.

About Arete

If your financial life reaches across borders, look for a partner who understands the financial systems in both countries to create an investment plan that works.

Arete Wealth Strategists Australia works with Americans in Australia, Australians living long-term in the US, or Australians leaving the US. We bring strategy, structure, clarity, confidence and compliance to our client's financial lives.



"Expat investors in either country may be navigating complex choices and information without specific advice on tax, fees and regulation."

EXECUTIVE SUMMARY

The US edges out Australia overall, but not in every category

Top	Above Average	Average	Below Average	Bottom
United States	Australia			

Despite the trend towards passive investing and Exchange Traded Funds (ETFs), managed investment funds[1] often play an important role in investment strategies. The bulk of invested assets still reside in this investment vehicle. When looking at the Australian and US investment markets, comparing the investment experience across managed funds is one of the few ways of standardizing a comparison between countries.

Each country has strengths and weaknesses in their managed investment fund environments. A thorough understanding of the strengths and weaknesses of each environment empowers investors to make better investment decisions.

Key Insights From Independent Research

Our expert analysis found the key differences in investing in these two markets:

- Both countries must improve regulation and taxation for non-resident foreign investors - the US outperforms Australia, albeit with a below average grade
- The US ranks highest in disclosure. Australia suffers from a lack of compulsory disclosure laws
- Fees and expenses appear to be on a par, but a deeper analysis of Australia's fees shows that the US is somewhat more cost-effective.

[1]Continuously offered, pooled investment funds under the professional investment supervision of a manager are known as 'mutual funds' in the United States and 'managed funds', or 'Unit Investment Trusts' in Australia. For the purposes of this paper, we shall use the term 'managed investment fund' for both.

"...there's a complex set of factors underpinning that choice demands research, unbiased advice and expertise."

At A Glance: America Vs Australia

The United States outperforms Australia across most categories. Experienced advisors know the expat investment experience is more nuanced and depends on individual circumstances and investor profiles.

Overall Grade

Top	Above Average	Average	Below Average	Bottom
United States	Australia			

Regulation and Taxation

Top	Above Average	Average	Below Average	Bottom
			United States	Australia

Disclosure

Top	Above Average	Average	Below Average	Bottom
United States			Australia	

Fees and Expenses

Top	Above Average	Average	Below Average	Bottom
United States				
Australia				

Sales and Customer Experience

Top	Above Average	Average	Below Average	Bottom
Australia		United States		

WHITE PAPER REPORT

A Comparison Of The AU Vs. US Investor Experience

Our analysis of the independent research looks at factors influencing the expat investment market including:

- Regulation and Taxation
- Disclosure
- Fees and Expenses
- Sales and Customer Experience
- Other factors expat investors must be mindful of including issues with Passive Foreign Investment Corporation (PFIC) funds, foreign exchange risk, and the risks of concentrating your investments in one country's economy.

1. Comparison of Regulation and Taxation

Regulation and taxation that can be compared across the AU-US market include:

- How tax operates at a fund level
- How individuals are taxed
- Rate of capital gains tax (CGT) for resident investor's

On the face of it, the US and Australia have similar individual and fund level taxation structures; specific tax treatment for capital gains, dividends and interest on the individual level and annually distributed dividends and capital gains at the fund level.

Based on the hypothetical 6.29% model used in the research, Australia delivered a slightly higher return than the US example. However, it receives a Bottom grade in Regulation and Taxation thanks to high investment taxes, treatment of dividends, and a lack of independence on fund boards.

Fund level taxation

Refers to the tax the fund's themselves are incurring from their trading activities. This analysis purposely focuses on the tax treatment at both an individual investor and fund level.

Fund Level Taxation

Managed funds have similar tax treatment in Australia as they do in the United States in that realized gains/losses that occur at a fund level are distributed to shareholders of the fund annually.

Australia - Individual Level Taxation

Australia and the US are amongst a few countries to tax 'interest income' - interest on investments paid to you by a financial institution. In Australia, interest income is reported to the Australian Taxation Office (ATO) and subject to the same marginal tax rate as earned income. Investors avoid double taxation by receiving 'franking credits' for corporate taxes paid on dividends - which actually results in a much lower effective tax rate on domestic dividends. In Australia, all taxpayers are taxed as individuals (i.e. there are no tax filing statuses).

For an Australian managed fund gain of 6.29% annual pre-tax gain, the expat can expect a 4.9% after-tax return. That translates to tax reduction of 1.39%.

The US - Individual Level Taxation

Managed investment fund gains, held for more than 365 days, are categorized as long term capital gains; the investor pays a discounted capital gains rate as well as a discounted rate on qualified dividends. Ordinary income is taxed at the applicable Federal and State marginal tax rate that applies depending on one's filing status. Earned income from work, short-term capital gains and interest income are taxed as ordinary income. Unlike Australia, the United States applies a filing status to each taxpayer; either Single, Married Filing Joint, Married Filing Separate or Head of Household.

The specific detail of Australian and US marginal tax rates, and Capital Gains Tax rates can be found in the AWSA 2020/21 Key Financial Data sheet.

As the US does not have a franking credit system, it effectively double-taxes corporate earnings. Despite this, the overall effect for investor's is offset by the US having a much lower corporate tax (21%), and lower tax rates for both qualified dividends and long term capital gains.

Assuming an annual after tax gain of 6.29%, the investor takes home around 4.71%, which means a reduction of 1.58% annually for taxes.

Explainer

How does the US account value in this analysis end up lower despite lower taxes and fees overall? This occurs due to the assumptions Morningstar used; namely, a hypothetical investment held for five years, by a couple making a combined income of $100K, consisting of 60% equity 40% fixed-income. We must assume Morngingstar included payroll taxes and State taxes for the US to come out lower. However, with the tax cuts and jobs of 2017, we know that tax in the US have since declined, leading to a higher investor return after taxes. The results would also be different if the study's assumptions used a higher income earning couple as US tax rates increases to the highest marginal rates slower than what Australia does.

2. Comparison of Disclosure Policies

Top	Above Average	Average	Below Average	Bottom
United States			Australia	

The US remains the leader regarding disclosure policies, despite an improvement from Australia. Disclosure practices - both regulated and voluntary - are key to investors understanding the investments they make and for the market to benchmark across the industry.

Information that may be subject to disclosure policies includes:

- How fund managers are compensated
- Fund performance reporting
- Fee itemization
- Shareholder reports

Australia

Australia lacks regulation that compels managed funds to disclose financial data and information about fund managers to investors.

Most managed funds give current year and previous year data. Expat investors may find their statements lacking; managed funds are not compelled to inform investors of performance fees and other itemized fees. Most countries compel managed investment funds to give a semiannual and annual report which includes itemized fees - but Australia does not. Some managed funds send annual reports, but there is no such requirement in Australia.

Managed funds give investors a Product Disclosure Statement (PDS), similar to the detailed managed investment fund prospectus used in the US.

In the PDS, investors get important information like fee structures, benefits, risks, and the complaint process. Expat investors with more than one managed fund in their superannuation plan have multiple PDS documents - some investors may have dozens of individual policies.

The US

US managed investment funds are required to send out a simplified prospectus, a more detailed prospectus and annual reports to members. Investors can also receive shareholder reports.

Regulations make fee comparison transparent: funds itemize fees that make up more than 5% of the expense ratio, and managed investment funds must disclose their fees in a standard format.

3. Comparison of Sales and Customer Experience

Top	Above Average	Average	Below Average	Bottom
⬆ Australia		▬ United States		

In a world of increasing complexity and customer expectations, the sales and distribution environment can have a major effect on investor outcomes. Here we focus on the standard of care an investor is owed; either a fiduciary relationship or the less investor-friendly suitability option. We also review the overall investment distribution environment.

Australia

Australia has gone from laggard to leader in sales practices, boosted by major regulatory reform including the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, and the Future of Financial Advice (FoFA) reforms. The reforms were introduced as a Government response to the Parliamentary Joint Committee on Corporations and Financial Services' Inquiry into financial products and services.

In great news for expat investors, Australian managed funds no longer carry a front-load sales fee or commission - unless you have a grandfathered account set up before government reforms removed commissions in a wide-ranging structural change. Government reforms are underway to move those grandfathered accounts into funds with no trailing commission.

Regulations also protect terms like ‘financial adviser’ from being used without specific qualifications.

The US

Regulations prohibit brokerages and plan providers from offering only their own captive financial products[2]. So, while a financial distributor/product manufacturer may primarily offer their own funds, they will also have a small selection of outside funds. This has increased investor choice and opened up a bigger market compared to countries which limit provider options.

The Department of Labor Fiduciary rule proposed during the Obama administration was overturned in early 2019, leaving a bifurcated landscape of investor standards of care. The suitability standard requires a broker make recommendations that are merely suitable based on a client's personal situation. It does not require the advice to be in the client's best interest. The fiduciary standard of care demands that an advisor must act in the best interests of their clients and place clients' best interests before their own[3]. Advisors must act free from conflicts of interest to provide sound and accurate financial advice.

But to the everyday investor, the ‘broker’, ‘financial adviser’, and ‘life insurance salesman’ are seen as one and the same, and often are. This changes the customer experience; the duty of care for a financial adviser should be higher than that of a financial product salesman.

Types Of Investment Advisors In The US

1. **Fee-only** - Registered Investment Advisor (RIA). RIAs have a fiduciary obligation and are a minority of the FA market - much, if not all, of what is said about the US doesn't apply when dealing with a fee-only RIA.
2. **Fee and Commission** - Wirehouse/Broker-Dealer Investment Advisor (including “hybrid” RIAs)
3. **Commission-only** - (Broker/Dealer, Wirehouse rep (E.g. Merrill Lynch, Morgan Stanley), Insurance B/D rep)

[2] Page 207 of 209 | Morningstar Global Fund Investor Experience Study | 3 October 2017

[3] Areté Wealth Strategists is a fee-only fiduciary, legally obligated to act in a client’s best interests, 100% of the time.

4. Comparison of Fees and Expenses

	Top	Above Average	Average	Below Average	Bottom
United States					
Australia					

The independent research studies compare the two environments for managed funds as a whole, since a like-to-like comparison across all fund types is almost impossible. To make sense of the data, Morningstar uses median expense ratios, excluding one-time fees in the calculation of the median expenses.

One-time fees and performance fees weren't included in the calculation of the median expenses, but are discussed here separately.

Australia

Australia has lower than average median fees, with regulation making pricing transparent and competitive. The median expenses are:

- 0.90% for allocation funds
- 1.23% for equity funds
- 0.60% for fixed income funds.

- **Allocation Funds** - invest in a mix of asset classes like stocks and bonds, in fixed percentages
- **Equity Funds** - mutual funds invested in stocks
- **Fixed Income Funds** - known as bond funds, fixed income funds are mutual funds that own fixed income securities such as government, corporate and municipal bonds.

In a global comparison, Australia has the second-lowest allocation fund fees, seventh-lowest equity fund fees, and 13th-lowest for fixed income fund fees. Allocation funds are often used as default investment alternatives.

Around 15% of managed funds (mostly grandfathered accounts), still contain a front-load fee (a commission). But most Australian managed funds no longer charge the fee, unlike some US advisors that work through brokers/dealers and major banks.

Some grandfathered accounts still have ongoing commission arrangements. There is legislation underway to halt these arrangements - a positive for Australian managed funds and the investors who still have these accounts.

Australian investors incur higher transaction fees, and investment platform fees. That affects the overall evaluation of fees and expenses as it is not factored in Morningstar's analysis.

Advice Fees

The high ranking in the 'Sales and Customer Experience' cuts both ways. For example, Australians with a less than optimal superannuation account may understand they would be better served by an open platform alternative such as Hub24 or NetWealth - but require a Statement of Advice (SOA) from a Financial Advisor to work with the platform. An SOA is likely to cost at least $2,000. The inclusion of advice fees to invest on an open investment platform adds to the total cost of investing.

Performance Fees

Australian managed funds have performance fees separate from the management fees. Performance fees in Australia are asymmetrical; fund managers do not lose anything if the fund loses value. Managers don't carry risk as they're generally not affected with underperformance other than a lower return of their own.

Platform Fees

Fees for open platform alternatives like Hub24 or NetWealth are generally passed on to investors indirectly via advisor fees. If investors choose to sign up directly, which requires a Statement of Advice (SOA) from an advisor, they will pay an ongoing fee for platform access.

The US

US managed investment funds rank as the lowest cost environment for fees and expenses.

Median fees are:

- 0.42% on allocation funds
- 0.59% for equity funds
- 0.60% for fixed income funds.

Globally, the US ranks first in cost-effectiveness for allocation funds, second for equity funds and fifth for fixed income funds.

The US also leads the sales load. While some managed investment funds still have a front sales load (around 29%), the market climate has led to a preference for the non-load, non-trailing commission arrangement similar to Australia. However, Australia regulates to ban commissions, and the US doesn't[4].

Investors will like to know that due to a broad move towards investor empowerment, most managed investment fund sales and activity has moved away from advisers and managers using commissions and sales loads. The need for objective and client-centric services has led to the growth of fee-only fiduciaries, who are required to base their advice on their clients' best interests 100% of the time.

Due to the best-in-class disclosure policies of the US, there's no hidden fees and charges to affect the investment.

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[4]Areté Wealth Strategists uses only no-load funds.

Performance Fees

Outside of the Hedge Fund environment, it is rare for US managed investment funds to charge performance fees. For such funds that do charge performance fees, they are calculated as part of the management fee. In a sense, performance fees are symmetrical wherein the fund also participates in the losses partially in the form of lost fees, like the fulcrum fee structure by Fidelity ContraFund, which has a fee range of ±.20% with a base fee or .55% depending on performance, as per a 2018 Wealth and investment Study.

Advice Fees

In the US, retail investors have access to open architecture platforms, and may perform rollovers and other financial services without the need of a financial advisor.

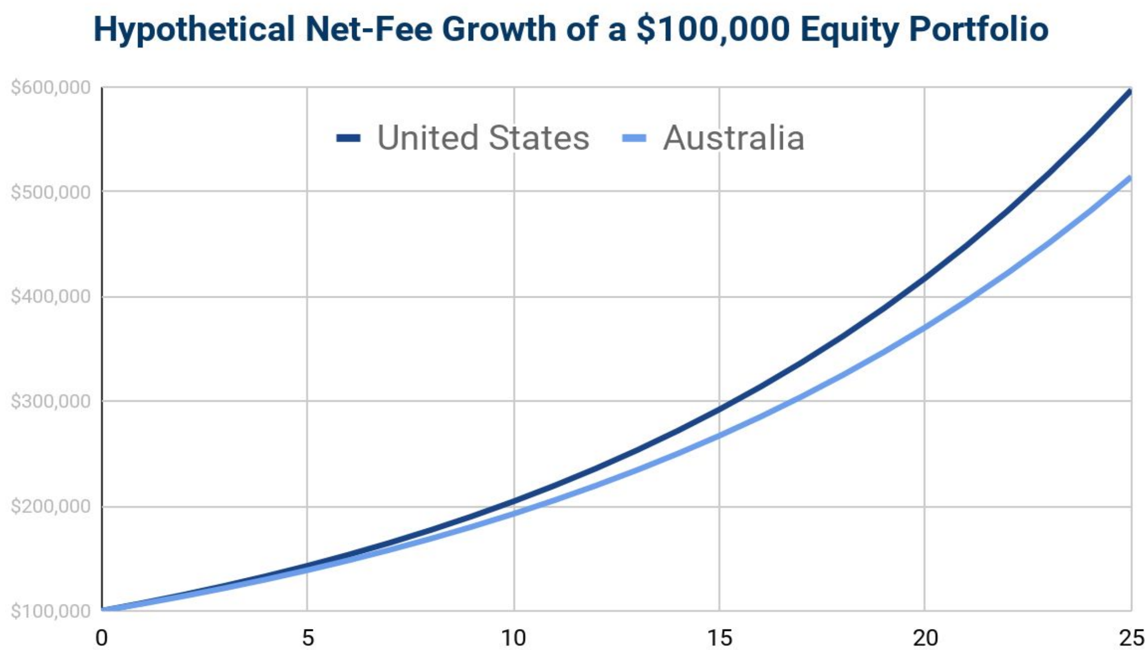
How Fees And Expenses Affect Returns

While Australia is top-ranked in fees and expenses across the research, in actual percentage terms, it still lags far behind the US.

The good things they have in common? Both countries have relatively low fund expense ratios, and front-load commissions are either banned or rare. The US and Australia are the only nations with an ongoing fee of less than 1% for allocation funds. But Australian equity funds charge a median of 1.23%, compared with 0.59% in the US. And this study doesn't include platform/custodial fees payable in Australia (typically ~0.40%), making the difference in practice even starker.

What Does That Look Like For Returns?

Assuming a 6.5% annual compound return from a 60% equity / 40% fixed income moderate portfolio using Morningstar's median fee data for equity and fixed income portfolios we see a 0.45% fee difference resulting in $43K difference attributable to higher fund management fees in Australia over a 25 year period, and that's not including transaction, platform or advice fees!



What Else Is At Play In Expat Investment In The US?

The Tax Problems Created by Non-American Funds for an American Citizen

Debate regarding the application, taxation and reporting of Passive Foreign Investment Corporation (PFIC), to do with Superannuation accounts continues due to vague rules. There is surprisingly little research about the impact PFICs make on the investment experience of US investors abroad. However, there's no debate about the impact of an American person investing in managed funds abroad; PFIC tax rules impose a significant opportunity cost on US persons abroad.

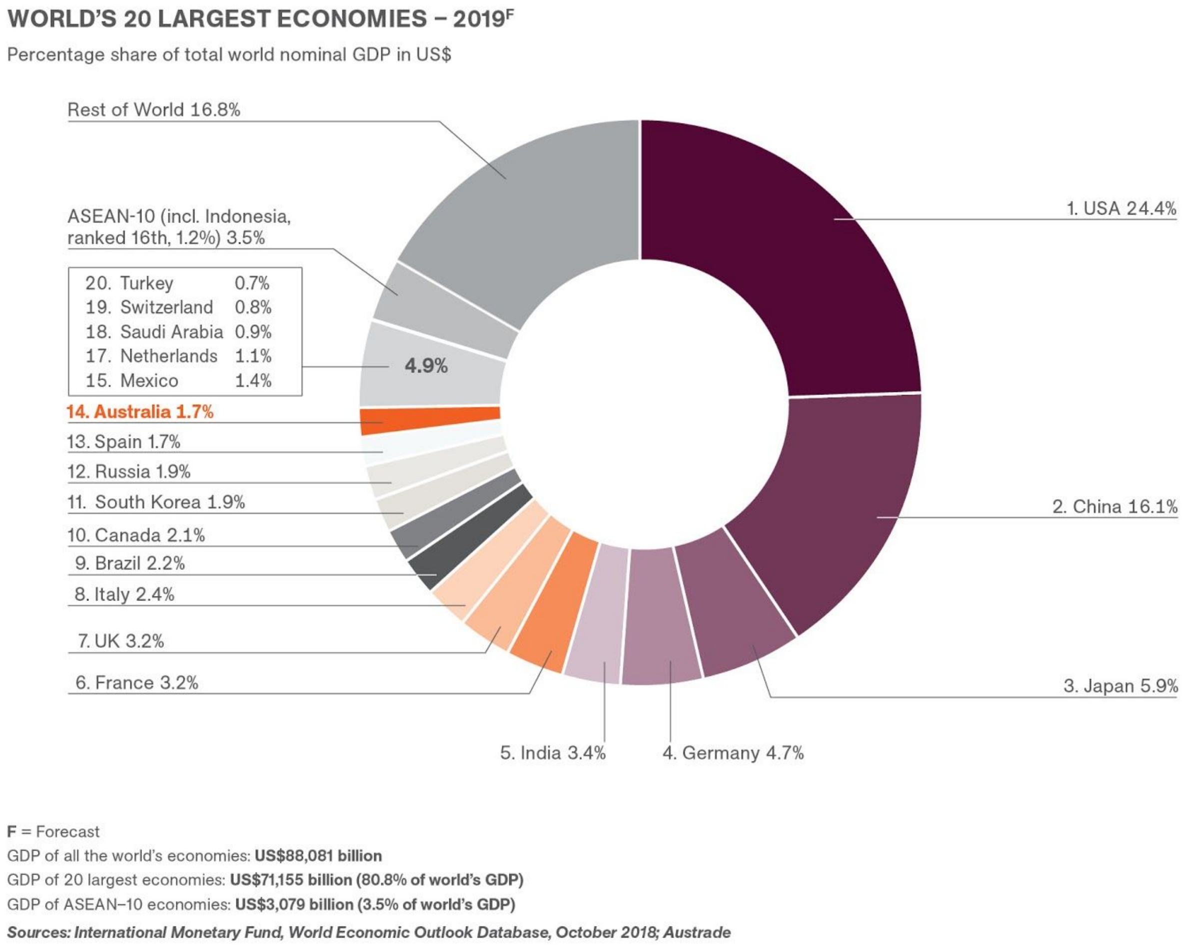
"Consulting with a financial adviser can help expatriates decide on funds with a global outlook."

Exposure in Foreign Exchange Risk

Expatriates will find currency volatility an additional risk factor when investing abroad. Unhedged currency movement can have unexpected positive or negative impacts on returns. Additionally, there is the cost of conversion. The AUD and USD have a spread cost; the selling price and buying price of a currency can create a gap that can add up with large conversions.

The US dollar is still the world's reserve currency, and as such, in times of economic stress, assets denominated in USD experience a boost providing inherent risk mitigation.

Home Bias Investing - Australia comprises <2% of Global GDP



Investors have a well-documented tendency to invest in companies familiar and local to them, known as 'home bias,' This bias can impact Australian investors when considering that Australia's economy makes up less than 2% of global GDP. This is especially problematic in the current environment as Australia seeks to reposition itself between its largest trading partner, China, and its military ally, the United States.

Choosing Your Expat Investment Strategy

As we can see from Morningstar study, the US comes out on top - but the expat investment experience is more nuanced. There are long-term implications in choosing where to invest your money that investors must be aware of:

- Fees, specifically higher management fees, platform/custodial fees, and trading fees
- For US persons, having the IRS consider your managed fund a PFIC leads to much higher tax rates as well as burdensome reporting and compliance.
- The volatility of currency movements can take a big bite out of returns
- The superior transparency of the US market
- The superior range of investment offerings
- The USD is the world's reserve currency

Getting the help of an unbiased fee-only fiduciary means the best advice without bias or a commission at stake.

"The US comes out on top - but the expat investment experience is more nuanced."

Please visit arete-wa to schedule a consultation.

Get Started!