Tax-Aware Investing: Further Reading

WORKING PAPER

Levering Up to Do Good: Direct Long-Short Investing and Charitable Giving

April 23, 2024

We use historical strategy simulations to evaluate the advantages of donating appreciated stock in the context of tax-aware long-short factor strategies. We find long-short strategies exhibit several advantages over long-only investments.

Read more

WORKING PAPER

Combining VPFs and Tax-Aware Strategies to Diversify Low-Basis Stock

March 7, 2024

We illustrate how combining VPFs (variable prepaid forwards) with tax-aware strategies can help diversify low-basis stock and thereby improve after-tax wealth accumulation. Long-run after-tax wealth outcomes are significantly better when a VPF is combined with tax-aware long-short factor strategies rather than with other alternatives, such as a direct-indexing strategy or a market index fund.

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JOURNAL ARTICLE

Loss Harvesting or Gain Deferral? A Surprising Source of Tax Benefits of Tax-Aware Long-Short Strategies

September 26, 2023

We explore the mechanism for how tax-aware long-short factor strategies, within their first three years since inception, can realize cumulative net capital losses exceeding 100% of initially invested capital, all while generating a significant pre-tax alpha – a result shown in previous research. Surprisingly, we find in these strategies that net capital losses arise not from an increased realization of capital losses but rather from the deferral of capital gains, especially short-term gains on long positions.

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JOURNAL ARTICLE

Beyond Direct Indexing: Dynamic Direct Long-Short Investing

May 3, 2023

On average, net losses realized by direct indexing loss-harvesting strategies taper off within the first few years after their inception, and these strategies also exhibit a high dispersion of net loss outcomes. We show that long-short strategies motivated by factor investing can significantly outperform direct indexing strategies from both a pre-tax and tax perspective.

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JOURNAL ARTICLE

When Fortune Doesn’t Favor the Bold: Perils of Volatility for Wealth Growth and Preservation

May 12, 2022

Entrepreneurs and executives holding much of their wealth in a highly appreciated single stock face either the high risk of idiosyncratic volatility and potentially catastrophic losses, or selling stock and facing an immediate, punitive tax burden. This paper evaluates this choice and explains how it relates to classic betting strategies and economic theory, finding tax-efficient techniques might strike the balance between the urgency to diversify concentrated risk and aversion to taxes.

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JOURNAL ARTICLE

Taxes, Charity, and Hedge Funds: Tax Implications of Charitable Contributions of Leveraged Partnership Interests

January 10, 2022

As a result of recent Treasury regulations, investors in investment partnerships, such as hedge funds, might end up recognizing capital gains when they contribute their partnership interests to a charity. We explain how such taxable gains upon charitable contributions arise and quantify how punitive they might be.

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JOURNAL ARTICLE

The Tax Benefits of Direct Indexing: Not a One-Size-Fits-All Formula

May 7, 2021

An investor holding a direct indexing portfolio can obtain tax benefits by harvesting losses on individual stock positions. We show that investors with allocations to hedge funds and derivatives are the most likely category of investors to have systematic short-term capital gains in their portfolios and, therefore, benefit the most from losses harvested by direct-indexing strategies. We show how tax benefits are affected by equalizing the tax rate applicable to long-term and short-term capital gains.

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JOURNAL ARTICLE

Limitation on Trader Fund Losses under the CARES Act of 2020

March 3, 2021

We explain how hedge fund investors might be affected by a limitation on excess business losses codified in recent tax legislation. In order to allocate business losses a hedge fund now must be a trader fund. After explaining the relationship between hedge fund losses and business losses, we illustrate with simple examples how the new provisions may affect hedge fund investors.

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JOURNAL ARTICLE

Integration of Income and Estate Tax Planning

September 1, 2020

Preservation and transfer of wealth to future generations is one of the central financial goals for most high-net-worth families. We show that a family that invests with income and estate tax efficiency in mind can achieve substantially higher wealth levels than a family oblivious to taxes.

Read more

WHITE PAPER

Understanding a Tax-Aware Defensive Equity Long-Short Strategy

April 17, 2020

We describe a hypothetical Tax-Aware Defensive Equity Long-Short strategy, including its construction and pre-tax and after-tax performance. The strategy closely replicates the pre-tax performance of a similar hypothetical tax-agnostic strategy and has the potential to achieve a meaningful tax benefit for a taxable investor.

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J O U R N A L   A R T I C L E

Tax-Efficient Portfolio Transition: A Tax-Aware Relaxed-Constraint Approach to Switching Equity Managers

March 2, 2020

For a taxable investor with a highly appreciated equity portfolio, replacing the portfolio manager is likely to trigger substantial tax liabilities. We find that a tax-aware relaxed-constraint post-transition strategy significantly outperforms a traditional tax-agnostic long-only strategy in its ability to preserve and grow the investors after-tax wealth over the long term.

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J O U R N A L   A R T I C L E

Lot Layering: The New Frontier for Hedge Fund Partnership Allocations

October 11, 2019

Despite its unavoidable deficiency caused by current regulations, we believe that lot layering aligns tax and economics more closely than any of the “aggregation” methods presently used by most hedge funds.

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J O U R N A L   A R T I C L E

Partnership Allocations and Their Effects on Tax-Aware Fund Investors

May 1, 2018

We discuss certain accounting principles relevant for investors in tax-aware funds structured as limited partnerships. We present a simple stylized model that illustrates that under such accounting principles new investors do not materially suffer from unrealized gains accumulated in a tax-aware fund.

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J O U R N A L   A R T I C L E

Multi-Period After-Tax Reporting: A Practical Solution

March 29, 2018

We propose an after-tax performance report aimed at enhancing wealth preservation and accumulation for taxable investors.

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J O U R N A L   A R T I C L E

Should Taxable Investors Shun Dividends?

June 13, 2019

We evaluate the tax benefit of dividend avoidance for quantitative multi-style strategies and find that dividend avoidance generally reduces implementation efficiency, thus lowering expected pre-tax returns.

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J O U R N A L   A R T I C L E

The Tax Benefits of Relaxing the Long-Only Constraint: Do They Come from Character or Deferral?

October 15, 2018

Are there tax benefits from relaxation of the long-only constraint? If so, what are the sources? To answer these questions, we decompose the total tax benefit (or liability) of a strategy into two components.

Read more

J O U R N A L   A R T I C L E

Taxes, Shorting, and Active Management

February 22, 2018

This paper examines the consequences of short selling by quantitative investment strategies held by individual investors in taxable accounts.

Read more

J O U R N A L   A R T I C L E

The Tax Benefits of Separating Alpha from Beta

May 14, 2018

We show how separating a portfolio into an active long-short portfolio and a passive index portfolio can have significant tax benefits.

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W H I T E   P A P E R

Understanding the Tax Efficiency of Market Neutral Equity Strategies

May 9, 2017

Tax-aware equity market neutral strategies can be inherently tax efficient. We explain why and illustrate our thinking through historical strategy simulations, as well as explore potential practical applications.

Read more

W O R K I N G   P A P E R

How Tax Efficient Are Equity Styles?

July 1, 2011

We explore the after-tax performance, tax exposure and tax efficiency of commonly used equity-style portfolios. We focus on equity styles based on size, value, growth and momentum, well known within the cross-sectional return landscape.

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Risks of Tax Aware Strategies

This list is not exhaustive; there are numerous advantages and risks associated with our Tax Aware Strategies that are not fully discussed here.

Underperformance of pretax returns: tax-aware strategies are investment strategies with the associated risk of pretax returns meaningfully underperforming expectations.

Adverse variation in tax benefits: deductible losses and expenses allocated by the strategy may be less than expected.

Lower marginal tax rates: the value of losses and expenses depends on an individual investor's marginal tax rate, which may be lower than expected for reasons including low Adjusted Gross Income (AGI) due to unexpected losses and the Alternative Minimum Tax (AMT).

Inefficient use of allocated losses and expenses: the tax benefit of the strategy may be lower than expected if an investor cannot use the full value of losses and expenses allocated by the strategy to offset gains and income of the same character from other sources. This may occur for a variety of reasons including variation in gains and income realized by other investments, at-risk rules, limitation on excess business losses, or insufficient outside cost basis in the partnership.

Adverse changes in tax law or IRS challenge: the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.