PERSPECTIVE

Now There's Nothing Certain But Death

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For almost my entire career I've been vexed that investments for taxable investors didn't focus enough on after-tax returns, and many taxable investors didn't seem to care.[1] Whenever the subject would come up – and it did come up – we'd hear a chorus of comments like, "investors focus on gross returns, not net-of-tax returns, so if you give up any of the former to maximize the latter you won't be rewarded." This was particularly true in the area of taxable mutual funds. Got to be at the top of that leaderboard (of course measured in gross-of-tax return)! And, unfortunately for taxable investors everywhere, that advice has been mostly right for at least a quarter of a century. Well, over the last few years we've intentionally ignored such wise admonitions and built a considerable effort in tax-optimized investing. Admittedly, this is a little bit of a "if we build it, they will come" venture. And, also admittedly, perhaps containing a tad of arrogance, as we now think we're in more of a position to affect, not merely accept, conventional wisdom.

Thus, it is gratifying to see my colleagues Joey Liberman, Clemens Sialm, Nathan Sosner, and Lixin Wang win the Top Graham and Dodd Award for this topic that I've long thought deserved a much more prominent place in asset management, and more generally rewarding to witness us build a body of top-notch taxable investing research, all of which is about as practical as investment research gets (the paper won the award in 2020, selected by members of the CFA Institute leadership, Board of Governors, and Financial Analysts Journal editorial team, and bestowed annually for the best research articles published in the Journal, recognizing the contribution of the article to the practice of investment management). For private investors, tax costs can be on par with, or even higher than, management and advisory fees. In addition, investment returns going forward might be elusive with stocks and bonds priced very expensively versus history.[2] However, diligently deferring gains and realizing losses (when economically sensible) to reduce the tax bite can still deliver a meaningful and reliable source of value even if long-term (or short-term) returns don't come through. Nonetheless, industry – even the segment of it that caters specifically to taxable investors – and academia – which has also historically overemphasized pre-tax returns and management fees at the expense of highly value-additive tax management – haven't changed much.

A generous explanation for ignoring taxes is that taxes are just hard. To become reasonably well-versed in taxation, an investment professional must master an entirely new discipline (and one not always as logical as some others!). Also, taxes create frictions that interfere with elegant investment theories. As a result, taxes (if even mentioned) are often delegated to the category of "future extensions" that never materialize. A far less generous explanation for avoiding any mention of taxes is that active management might look much less value-additive after tax (not that they need any help looking tepid).

For over two decades, my colleagues and I have dedicated ourselves to demystifying complexity and dispelling myths in the field of investing. Frankly, such a complex and nuanced topic as taxation of investments seemed like a perfect opportunity for us to get involved (long overdue, actually). Which brings me back to the award-winning paper "The Tax Benefits of Separating Alpha from Beta."

The paper asks the following practical question: In a world dominated by tax-agnostic managers (i.e., managers that ignore the tax costs of their trading), how can investors design their strategy allocations to improve the tax efficiency of their overall investment portfolios? Using both Monte-Carlo simulated returns and historical stock returns, my colleagues show that investors seeking both manager alpha and market beta could achieve higher after-tax returns by investing separately in a market neutral (tax-agnostic) strategy and an index fund than by investing in a long-only (tax-agnostic) strategy that utilizes the same alpha signals as the market neutral strategy.[3] The reason for that is simple: In pursuit of investment alpha, a long-only active manager realizes taxes on *both* the market appreciation and the alpha it adds on top of market return. On the other hand, a market neutral manager realizes taxes *only* on the alpha it achieves, while investors who separated alpha investments from beta exposure can enjoy the market appreciation (almost) tax free by investing in an index fund.

Consistent with this insight, the paper shows the following relationships. First, for a strategy that separates alpha and beta (what the authors call a "composite strategy") tax costs are driven by pre-tax alpha, while for a long-only strategy tax costs are driven predominantly by market returns. Second, when market return is positive, at any level of model alpha, portfolio turnover is more punitive from a tax cost perspective for the long-only strategy than for the composite strategy. Moreover, the difference in tax costs between the long-only and the composite strategy increases with the level of market return. Finally, when the pre-tax alpha is zero or negative, the composite strategy does not generate tax costs, while the turnover of the long-only strategy still triggers taxes on market appreciation. All this can make investing in a long-only active strategy with poor pre-tax alpha a pretty dismal after-tax experience.

There are many other interesting (and practically relevant) observations in the paper, from robustness to different tax regimes, to tax costs of manager replacement, to tax-aware portfolio management, but for those I refer you to the original.

This paper may be the one that won the big award, but it was only the latest in a broad public research agenda we have produced on this topic. I (arrogantly yet again) think we've written and assembled the biggest and best set of research on tax-efficient investing out there. For the interested reader's convenience we've put all our published research on tax in one place (our Tax-Aware Investing Learning Center page).

As an example, one paper on this page "Taxes, Shorting, and Active Management" (*Financial Analysis Journal, 2018*) asks whether allowing shorting in stock selection portfolios can help tax optimization. The answer is, yes. Another paper "Should Taxable Investors Shun Dividends?" (*Journal of Wealth Management, 2019*) asks, as can be guessed from its title, whether it makes sense for taxable investors to shun dividend-paying stocks. The answer is, counter to the conventional wisdom of many, no. There are many more journal articles and white papers on the page, on topics ranging from tax-aware portfolio management, to tax accounting methods, to after-tax reporting, to estate tax planning.

Our research on tax-aware investing has immediate practical implications for managing private (or any taxable) wealth. Alternative strategies, suitably implemented, can be highly tax-efficient and even tax-beneficial to a broader investment portfolio. They can also help breathe new life into highly appreciated portfolios. Even hedge funds don't have to be a boogeyman of tax inefficiency. Investors don't have to stay in the dark about the tax implications of their hedge fund investments until they get the K-1s – not only is it possible, but it is also advisable to accurately report after-tax returns on a monthly basis. The existing paradigms for designing tax-efficient investment portfolios and the transfer of wealth to heirs can also be improved upon.

Over the past 2–3 years you've seen me stand fast in defense of value investing.[4] Indeed, value is an important element of our investment philosophy, one that suffered the most in the recent times, but also the one we believe has highly favorable medium-term odds going forward, as I explain in this post. With my necessary attention to value, it should not be lost on the reader that factor investing (value and other factors that we've written about extensively in the past) is only one component of what we do as a firm to create long-term value for our investors. Factors and markets will inevitably go through cycles, but thoughtful portfolio design, risk management, minimizing trading costs, and, yes, optimizing for taxes where appropriate are, and always will be, at the core of our process and the key to our long-term success. With that, I would like to again congratulate my colleagues on the significant achievement of winning the Graham and Dodd Award on a topic that is so near and dear to my heart and is so important to our taxable investors.

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[1] Among other things I read this piece one year into my career on Wall Street.

[2] See here for a discussion (at the end) of reasonable long-term expected returns on broad portfolios of stocks and bonds (and on our favorite exception to this "super expensive" rule – value stocks).

[3] For example, a market neutral strategy goes long stock A and short stock B, while a long-only strategy using the same alpha signals overweights stock A and underweights stock B relative to an index.

[4] Not the 10+ years you often see cited as the worst bear market for value ever. Readers of this blog will recall that as late as 2017 I was cautioning against assuming value was super cheap just because it had been super lousy. Of course since then we've joined others in being creamed by value (and I have indeed been screaming it's very cheap!).

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