INTERVIEW

Q&A: Nathan Sosner on Tax-Aware Investing

November 20, 2019

What is a tax-aware strategy?

A tax-aware strategy can mean different things depending on who you ask. At AQR, we refer to an actively-managed systematic investing strategy that takes into account realized capital gains and losses during regular portfolio rebalances.

We view the tax costs of realized capital gains in much the same way as transaction costs. Asset managers routinely incorporate transaction costs into portfolio construction because investors care about returns net of transaction costs. Similarly, managers running strategies for taxable investors interested in returns net of tax costs should incorporate potential capital gain and loss realization in their portfolio construction process.

Why should taxable investors consider tax-aware strategies?

Alternative strategies may lose their attractiveness after taxes, which is one reason many taxable investors choose to avoid them. Managers of active strategies seek to achieve positive risk-adjusted returns (or alpha) through periodic rebalancing of their portfolios. Rebalancing without factoring in built-in gains often results in realizing such a large amount of capital gains that pretax returns might be completely offset by taxes on realized gains.

In other words, managers who disregard the tax consequences of their trading can generate very concrete and immediate tax costs in hopes of achieving much less certain future pretax returns. Tax-aware strategies, on the other hand, incorporate tax burdens of realizing gains and tax benefits of realizing losses directly into the portfolio construction process. We find that with systematic factor-based strategies, investors can achieve substantial tax savings with a relatively small impact on their pretax returns.[1] As a result, tax awareness partially evens the playing field between taxable and tax-exempt investors in actively managed strategies.

Why is a systematic factor-based approach well suited for tax-aware strategies?

A few attributes of factor-based strategies, such as value, momentum, quality, or defensive, make them suitable for tax-aware investing. Consider, for example, factor-based stock-selection strategies. Such strategies use many stocks to represent just a handful of factors. This gives a manager the flexibility to use different positions to capture factor exposures while being mindful of the tax consequences of trading. In addition, factor-based strategies typically have holding periods that are long enough to allow a manager to defer capital gains from the short term to the long term but short enough to realize sizable short-term capital losses as a part of normal strategy portfolio rebalancing. Finally, systematic factor-based strategies naturally allow for shorting—a manager can go long relatively attractive stocks and short relatively unattractive stocks. From a tax perspective, a long-short approach to portfolio construction gives the manager the ability to realize capital losses on short positions in rising markets and on long positions in falling markets.[2]

How do tax-aware alternative strategies fit into an investor’s portfolio?

While circumstances might vary, one appropriate place for a tax-aware alternative strategy is within a larger allocation to alternative investments. Tax-agnostic alternatives often generate large short-term capital gains. We find that when tax-aware factor-based strategies are implemented in a long-short portfolio, short positions significantly enhance opportunities for realizing short-term capital losses.[3] These losses can offset short-term capital gains from less tax-efficient alternatives and thereby increase the tax efficiency of the overall allocation to alternatives. This is a key potential benefit, especially for investors who have been reluctant to consider alternatives due to their tax inefficiency.

Why is AQR uniquely qualified to manage tax-aware strategies?

Systematic factor-based long-short strategies are uniquely well suited for tax optimization, and AQR has always been at the frontier of factor-based investing. Our research on the subject is extensive and has been published in numerous industry and academic publications. Moreover, we’ve had decades of experience managing the risks and costs of long-short portfolios. As a result, our investment process already includes all the components necessary for tax-aware portfolio management—highly diversified portfolios, medium-term holding periods, ability to invest both long and short, a systematic approach to portfolio construction and rebalancing. So rather than creating an investment process around tax management, we merely incorporated tax awareness into the process that we have been running successfully for more than two decades.

[1] See Israel and Moskowitz (2012); Sialm and Sosner (2018); Dunn, Huupponen, Krasner, and Sosner (2018).

[2] See Sialm and Sosner (2018) and Sosner, Krasner, and Pyne (2019).

[3] See Sialm and Sosner (2018) and Sosner, Krasner, and Pyne (2019).