TAX AWARE

Looking Under the Hood of Long/Short Tax-Aware Strategies

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We've published a range of papers that show long/short strategies may be more "tax beneficial" than long-only ones.[1]

But where do these additional benefits come from?

Consider two long/short equity strategies. Both have the same underlying investment themes, the same investment universe, and so on. But there's one difference: one strategy focuses on generating attractive pre-tax returns; the other on generating attractive after-tax returns. Obviously, you'd expect the first to look better pre-tax and the second after-tax, but what actually causes that difference? Specifically, does the second strategy's (after-tax) outperformance come from being quicker to liquidate its losers, or from it being slower to liquidate its winners? Or, said in tax-speak, is it more about harvesting losses or about deferring gains?

The answer, according to our latest paper: gain deferral.

This might be surprising, since for passively indexed strategies such as direct indexing, the source of so-called "tax alpha" is clearly from harvesting losses.[2] But when it comes to long/short factor strategies, it's mostly the opposite. The benefits of being tax-aware are mostly due to deferring short-term gains on long positions—sometimes it pays to wait! (In contrast, the tax-agnostic version would trade to realize those gains in pursuit of pre-tax alpha.)

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A natural follow-on question is whether a long/short tax-aware portfolio ends up looking a lot different than one that doesn't care about taxes. For example, if you believe in value, momentum, and quality investing, do you have to subvert those beliefs if you want to be efficient about taxes? To answer this, we compare the trading decisions of the two strategies (the tax-aware one and the tax-agnostic one), and we find a resounding, and reassuring, "no". The majority of turnover in both versions is in the direction of "alpha".

Why does all this matter? In general, an investor who cares about one thing (e.g., maximizing return) will hold a portfolio that can look very different from an investor who cares about something else (e.g., minimizing risk). This paper suggests that when it comes to diversified long/short equity factor strategies, the differences between a portfolio that cares about taxes and one that doesn't may be smaller than you think.

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[1] For those looking for a very, very short summary: compared to long-only, a long/short approach can facilitate net capital losses that are 1) larger, 2) less sensitive to market direction, and 3) meaningfully longer-lasting.)

[2] There's a reason these are called tax-loss harvesting strategies, after all…