Tax Matters

Misconceptions about Tax-Aware Long-Short: Misleading Parallels with Direct Indexing, Part III

October 12, 2026

In Part I and Part II of this series, we explored how comparisons with direct indexing can lead to misconceptions about the mechanics of tax-aware long-short (TA LS) investing and the sources of its potential tax benefits. We reiterated that TA LS is, first and foremost, an active investment strategy: it seeks pre-tax alpha, while incorporating tax considerations into how the portfolio is managed.

In this final installment, we address two additional misconceptions investors often have about the risks TA LS strategies take and the trade-offs involved in managing them.

Misconception 5: Minimizing tracking error is a key benefit of the strategy

Investors often view tracking error—the degree to which a strategy's returns differ from its benchmark—as something to minimize. This instinct makes sense for direct indexing, where the objective is to closely track an index while harvesting tax losses along the way. Because direct indexing does not attempt to predict which stocks will outperform or underperform, any deviation from its benchmark is not expected to generate additional pre-tax return. As a result, many direct indexing managers intentionally minimize this uncompensated tracking error.

For an active strategy such as TA LS, however, tracking error plays a key role. By trading an underlying alpha model, the strategy deliberately buys stocks it views as attractive and shorts stocks it views as unattractive in an effort to outperform its benchmark. This naturally causes the portfolio to differ from the benchmark. In that sense, tracking error is not an unfortunate side effect; it is intentional and necessary to beat the benchmark.

In our simulations, tighter tracking-error constraints reduced the strategy's ability both to express its alpha model and to defer gains, while greater tracking error and leverage increased opportunity to pursue both excess returns and tax benefits.

Misconception 6: Calibrating loss realization is simple

On the surface, managing the tax considerations of a strategy might seem relatively straightforward: realize capital losses and defer capital gains. While this may apply to direct indexing strategies, it overlooks a TA LS strategy's primary objective: pursuing pre-tax alpha.

TA LS portfolio construction needs to balance several considerations at once: following the alpha model, managing investment risk, controlling transaction and financing costs, and accounting for the tax consequences of each trade. Tilt too far toward alpha and it may unnecessarily realize taxable gains; tilt too far toward tax considerations and the strategy may sacrifice attractive investment opportunities.

In contrast to direct indexing, the purpose of a properly designed TA LS strategy is definitively not to "maximize losses." Instead, for a TA LS strategy, portfolio construction requires calibrating the trade-offs between expected returns, risk, costs, and taxes. And as we said before, if a TA LS strategy does not do that, it's best to steer clear.

Conclusion

Across all three parts of this series, a common theme emerges: viewing tax-aware long-short investing through a direct-indexing lens can lead to conclusions that sound intuitive but miss critical differences between the two.

Our point is not that one approach is inherently better than the other. Rather, TA LS and direct indexing are two distinct strategies pursuing unique investment outcomes, and that familiarity with one does not provide a complete framework for understanding the other.

This material is intended for informational purposes only and should not be construed as legal or tax advice, nor is it intended to replace the advice of a qualified attorney or tax advisor. The recipient should conduct his or her own analysis and consult with professional advisors prior to making any investment decisions.

Like any investment strategy designed to generate pre-tax returns, tax-aware investment strategies are subject to the risk of pre-tax returns meaningfully underperforming expectations.

Unavailability of potential tax benefits: The expected tax benefits associated with the tax-aware strategy may be less than expected or may not materialize due to the economic performance of the strategy, an investor's particular circumstances, prospective or retroactive changes in applicable tax law, and/or a successful challenge by the IRS. In the case of an IRS challenge, penalties may apply.

This document is not intended to, and does not relate specifically to any investment strategy or product that AQR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

This document has been provided to you solely for information purposes and does not constitute an offer or solicitation of an offer or any advice or recommendation to purchase any securities or other financial instruments and may not be construed as such. The factual information set forth herein has been obtained or derived from sources believed by the author and AQR Capital Management, LLC ("AQR") to be reliable but it is not necessarily all-inclusive and is not guaranteed as to its accuracy and is not to be regarded as a representation or warranty, express or implied, as to the information's accuracy or completeness, nor should the attached information serve as the basis of any investment decision. This document is not to be reproduced or redistributed to any other person. The information set forth herein has been provided to you as secondary information and should not be the primary source for any investment or allocation decision. Past performance is not a guarantee of future performance. Diversification does not eliminate the risk of experiencing investment losses.

This material is not research and should not be treated as research. This paper does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of AQR. The views expressed reflect the current views as of the date hereof and neither the author nor AQR undertakes to advise you of any changes in the views expressed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this presentation has been developed internally and/or obtained from sources believed to be reliable; however, neither AQR nor the author guarantees the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. There can be no assurance that an investment strategy will be successful. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. Diversification does not eliminate the risk of experiencing investment losses.

The information in this paper may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons.

Shorting/Short Selling is a trading strategy in which a trader aims to profit from a decline in a security's price by borrowing shares and selling them, hoping the stock price will then fall, enabling them to buy the shares back for less money.

Alpha is a statistical measure of an investment's unique return (return not attributable to other known return sources such as equity market returns).

Tracking Error is a statistical measure of the variation in excess returns between and fund and its benchmark index.

Leverage is the use of borrowed capital to increase potential return.