Tax Matters

Our Research into Tax-Aware Long-Short Investing

Clarifying a Few Important Things

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Research on the benefits of tax-aware long-short investing, to which AQR has made significant contributions, has grown in recent years. With this growth, the concept of "long-short tax-loss harvesting" has started to percolate through the financial planning community, with more and more investors and their advisors using this powerful and highly customizable approach to wealth management.

However, with this growth, there has also been a blurring of terminology, strategy design, and investment objectives. As the concept of tax-aware long-short investing becomes a mainstay of private wealth planning, we wanted to clearly articulate some core findings of our research,[1] and help parse the jargon of this rapidly growing but sometimes confusing area.

Three Misconceptions

To begin, let us address three potential misconceptions about tax-aware long-short strategies in general and the conclusions of our research on these strategies in particular.

1) Tax-Aware Long-Short is not supercharged Direct Indexing

The first common misconception is that tax-aware long-short factor strategies evolved as an improvement to direct indexing. The narrative is roughly: The tax benefits of direct indexing are relatively small and degrade rather quickly. The addition of long and short extensions (and leverage) makes the tax benefits larger and helps them last longer.

The right part of this narrative is that the benefits are larger and last longer. But for us, this narrative gets two critical elements wrong. First, the modeling of tax-aware long-short and direct-indexing strategies originates from diametrically opposite starting points (active management for the former versus passive indexing for the latter); second, they pursue very different investment objectives (maximizing returns within a given risk budget for the former versus minimizing active risk for the latter).

2) Benchmark returns are not the objective

The second misconception is that tax-aware long-short factor strategies should seek to minimize tracking error (i.e., deviations from the benchmark) while maximizing tax benefits. Historically, this has been the objective of direct indexing research, where, from a pre-tax perspective, deviations from the benchmark are viewed as merely noise—extra volatility without any pre-tax return compensation.

In contrast, tax-aware long-short factor strategies introduced in our research seek to *beat* the benchmark pre-tax, i.e., to deliver pre-tax alpha. The greater the tracking error, the higher the expected pre-tax alpha. Tracking error and leverage are only valuable to the extent that they provide access to pre-tax alpha.[2] This point is particularly pertinent in light of our recent post on the importance of economic substance.

3) Tax-Aware Long-Short is not only for billionaires

The third misconception is that tax-aware long-short factor strategies are only available for institutional-sized accounts. While this may have once been true, innovations in the financial industry have made these strategies accessible to individual investors with account sizes orders of magnitude smaller than what some headlines might suggest.[3]

A Very Brief Overview of the History of Our Tax-Aware Research

It's one thing to assert that pre-tax alpha is a core part of our tax-aware research agenda; it's another to back it up. Here we have over a decade of published papers to point to.[4]

AQR's formal exploration of tax-aware factor investing began in 2011 with the paper, How Tax Efficient Are Equity Styles? which studies the ability of managers to improve the tax efficiency of factor strategies through tax-aware portfolio rebalancing.

Our research on tax-aware factor investing continued with the next important milestone, Taxes, Shorting, and Active Management, which

explores the preservation of pre-tax alpha after taxes. There, we found that tax-aware long-short strategies not only retain most of the pre-tax alpha but can also realize tax benefits as part of regular portfolio rebalancing.

Subsequent research on tax-aware investing sought to elaborate on these results and explore its practical applications. These papers have led to the following conclusions: (1) pre-tax alpha is critically important for long-term wealth compounding, (2) long-short strategies offer a better implementation of pre-tax alpha, and (3) tax-aware long-short strategies can deliver pre-tax alpha highly tax-efficiently.

Furthermore, in our recent paper, Loss Harvesting or Gain Deferral? A Surprising Source of Tax Benefits of Tax-Aware Long-Short Strategies, we show that long-short factor strategies—whether tax-agnostic or tax-aware—realize substantial gains and losses as part of regular portfolio rebalancing. We find that the main feature of tax-aware strategies is not greater loss realization but rather the slowing of the unnecessary realization of capital gains.[5]

In Summary

What might confuse a casual observer of our research is that tax-aware long-short factor strategies, which *primarily pursue pre-tax alpha*, realize higher and more persistent tax benefits than direct indexing strategies, which *primarily pursue tax benefits*. At first glance, this may seem to suggest that the former are somehow seeking higher tax benefits than the latter. And herein lies the fallacy that our papers clear up: Tax-aware long-short factor strategies realize higher tax benefits than direct indexing not because they try harder, but because they (1) trade quite a bit due to changes in pre-tax alpha, (2) hold large positions relative to invested capital due to leverage, and (3) can slow unnecessary gain recognition without significantly impacting pre-tax alpha, thanks to relatively long holding periods and highly diversified portfolios.

While net capital losses may provide additional value, the core strength of tax-aware long-short strategies lies in their ability to align pre-tax performance with the needs of tax-sensitive investors.

To come full circle, while net capital losses may provide additional value,[6] the core strength of tax-aware long-short strategies lies in their ability to align pre-tax performance with the needs of tax-sensitive investors. As this approach to managing factor strategies gains traction and becomes available to a larger universe of investors, we remain as committed as ever to advancing research on its benefits and applications.

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[1] As described, e.g., in Lieberman et al. (2023).

[2] In fact, Lieberman et al. (2023) clarify that the relationship between leverage (and the amount of shorting) and tracking error is calibrated to maximize pre-tax alpha per unit of tracking error.

[3] Lieberman et al. (2023).

[4] Some additional perspective is important here. Although we have published a number of articles on tax-conscious investing, they represent only a tiny sliver of AQR's overall research on investment signals, portfolio construction, and asset allocation. Our articles on tax-related topics always cite the relevant investment-focused literature, which serves as a foundation for tax-aware long-short factor strategies

[5] In this context, unnecessary realization refers to achieving a bit more pre-tax alpha at a disproportionately high tax cost.

[6] As shown, e.g., in Liberman and Sosner (2024), some investors might find interesting applications for the net capital losses realized by tax-aware long-short factor strategies (achieved primarily by slowing unnecessary gain realization). However, the core value proposition of these strategies is their ability to deliver pre-tax alpha of a top-tier institutional asset manager to taxable investors.

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