TAX MATTERS

Regardless of How You Deal with Low-Basis Stock, Long-Short Strategies Can Help

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Most investors recognize that concentrated stock holdings are risky. Our recent paper, When Fortune Doesn't Favor the Bold, shows that even over just a few years, concentrated positions can lead to catastrophic losses of wealth.

One of the main reasons that investors are reluctant to sell (non-restricted) concentrated stocks is taxes. An outright sale of low-basis stock allows for the possibility of building a better investment portfolio, but at punitive tax burden. This dilemma led to development of several tax-efficient alternatives to an outright sale:

1. Completion portfolios
2. Exchange funds
3. Hedging strategies
4. Charitable techniques[1]

Exhibit 1 compares all five approaches, including an outright sale. The ***outright sale*** eliminates the idiosyncratic risk of the stock but results in a large tax burden in the year the stock is sold. In the ***completion portfolio*** approach, the overall portfolio risk is typically dominated by idiosyncratic risk of the stock, so, while the liquidation tax is avoided, the idiosyncratic risk exposure remains unacceptably high.[2] The ***exchange fund*** solution suffers from several well-known deficiencies: adverse selection in the stocks contributed to the fund, a 7-year lockup, high fees, and a potentially high tracking error with respect to a broadly diversified market portfolio when positions are distributed at the end of the lockup period.

The last two approaches, ***hedging strategies*** and ***charitable techniques***, are interesting for several reasons. First, in contrast to completion portfolios, they can substantially reduce or even fully eliminate exposure to the idiosyncratic risk of the stock. Second, they do not suffer from the inherent drawbacks of exchange funds. Finally, they may allow for deferral of gain recognition beyond the calendar year in which the idiosyncratic risk of the stock is diversified.

Exhibit 1. Low-Basis Stock De-Risking Methods

Technique	Exposure to the Stock's Risk of Loss	Capture of the Stock's Upside Performance	Realization of the Stock's Built-In Gain	Control over the Investment Portfolio Composition	Liquidity of the Stock Position*
Outright Sale	Eliminated	Eliminated	Fully realized in the year the stock is sold	Yes	Immediate
Completion Portfolio	Remains high	Remains high	Small to none	Partially: the stock substantially affects the portfolio	Immediate
Exchange Fund	Eliminated	Eliminated	None	No	After 7 years
Hedging Strategies, e.g., Variable Prepaid Forward	Largely eliminated	Partially retained	Deferred, possibly for years	Yes	After maturity (or early termination) of hedging contract
Charitable Techniques, e.g., Charitable Remainder Unit Trust	If stock is liquidated immediately, eliminated	If stock is liquidated immediately, eliminated	Deferred, possibly for decades	Yes	Immediate**

■ Advantages ■ Disadvantages

*At the cost of gain realization.

**The stock can be liquidated immediately within a charitable entity such as a charitable remainder trust, a private foundation, or a donor advised fund. In the case of charitable remainder unit trusts, the investor has a partial exposure to performance of the portfolio replacing the liquidated stock.

An important consideration for all five approaches is time—specifically, the time between diversification of idiosyncratic risk and the recognition of a taxable gain (see column "Realization of the Stock's Built-In Gain"). With an ***outright sale***, the investor only has until the end of the year to harvest losses. With ***hedging strategies***, such as variable prepaid forwards, gain recognition is generally deferred until the forwards are physically settled. This can postpone gain recognition for several years and give the investor a longer runway for tax-loss harvesting. With ***charitable techniques***, such as charitable remainder unit trusts, gain recognition is spread out over a couple decades and can even be backloaded into the future via proper structuring of the trust.

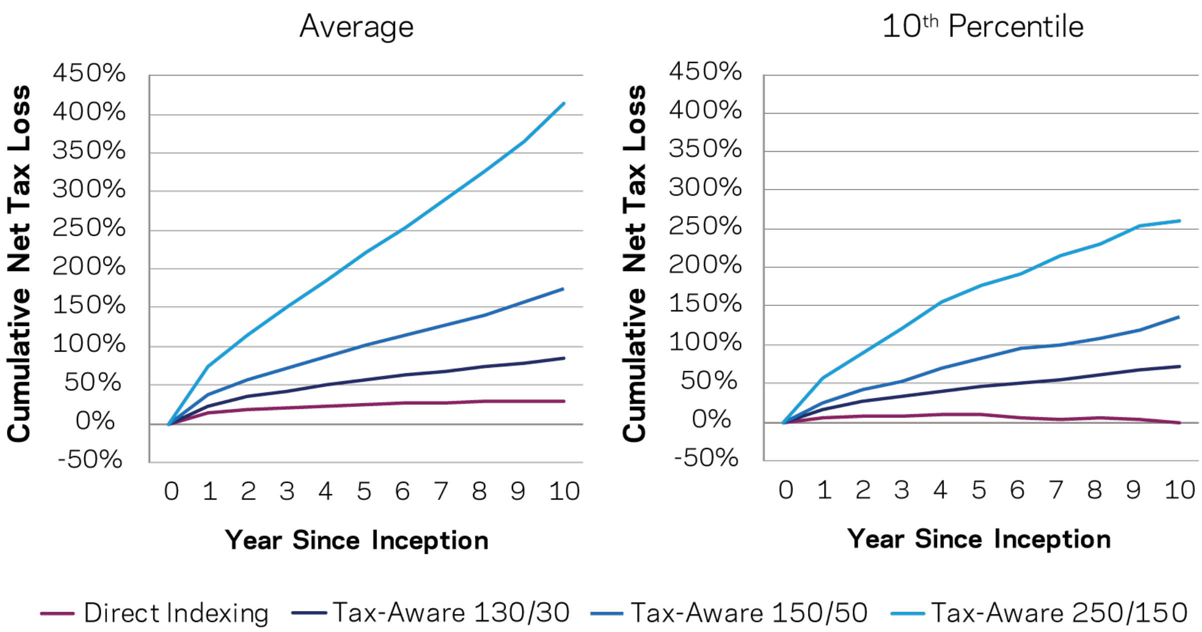
> *"Long-short strategies can help achieve tax-loss-harvesting objectives more effectively than traditional long-only direct indexing strategies"*

So where do long-short strategies come into play? In all these approaches, whether the investor has several months, a few years, or a couple of decades until the liquidation gain is recognized, long-short strategies can help achieve tax-loss-harvesting objectives more effectively than traditional long-only direct indexing strategies. We discussed this fact in an earlier post, *Improving Direct Indexing*, where we showed material improvements in loss harvesting capabilities that long-short strategies offer in comparison to direct indexing. Moreover, long-short strategies may also help investors to tax-efficiently realign the portfolios that they receive from ***exchange funds*** which may not be aligned with their long-run investment objectives. This can be achieved by using techniques described in our earlier post Tax-Efficient Portfolio Transition, or How to Rejuvenate Ossified Equity Portfolios.

"Long-short strategies achieve much higher levels of cumulative net tax loss realization, both on average and in the case of a relatively poor outcome"

Exhibit 2 compares tax-loss-harvesting capacity of tax-aware long-short beta-one strategies that utilize various levels of leverage—130/30, 150/50, and 250/150—to that of a traditional long-only direct indexing strategy.[3] The direct indexing strategy on average realizes a cumulative net tax loss of just under 30% of the initially invested capital over 10 years (see the left chart) but has a meaningful chance of not delivering any net tax losses (see the right chart plotting 10th percentile outcomes). In contrast, long-short strategies achieve much higher levels of cumulative net tax loss realization, both on average (left chart) and in the case of a relatively poor outcome (10th percentile in the right chart).

Exhibit 2. Tax-Loss-Harvesting Potential of Long-Only and Long-Short Strategies



Source: AQR, XPressFeed, S&P, MSCI Barra. We run 27 separate 10-year strategy simulations starting on January 1 of every year from 1986 to 2012 and show the average (left chart) and the 10th percentile (right chart) cumulative net loss outcomes for every year since inception across these 27 vintages. Each month, for direct indexing, we minimize tax costs, subject to staying within a 1% tracking error (computed using the MSCI Barra risk model) to the Russell 1000. For tax-aware 130/30, 150/50, and 250/150 in each monthly rebalance, we maximize exposure to a value-momentum-quality factor model and minimize tax costs, subject to staying within a pre-specified tracking error (computed using the MSCI Barra risk model) to the Russell 1000: 1.5%, 4% and 6%, respectively. The tax cost term in the optimization treats realization of gains as a cost and realization of losses as a benefit.

Bottom-line: whether an investor diversifies idiosyncratic stock risk via an outright sale or via tax-efficient methods, such as hedging strategies or charitable techniques, using long-short tax-loss-harvesting strategies in the mix can help enhance the tax efficiency of diversification.

[1] See, e.g., Welch, S. 2002. “Comparing Financial and Charitable Techniques for Disposing of Low Basis Stock.” *The Journal of Wealth Management* 4 (4): 37–46; Brunel, J. L. P. *Integrated Wealth Management*: *The New Direction for Portfolio Managers*, 2nd ed. London: Euromoney Institutional Investor Plc. 2006; Wilcox, J., J. E. Horvitz, and D. diBartolomeo. *Investment Management for Taxable Private Investors*. Charlottesville, VA: The Research Foundation of CFA Institute. 2006. We do not consider here complex tax structuring transactions that artificially create basis in a low-basis stock. Such transactions carry a significant tax risk, as can be seen, for example, in *Jade Trading*, *LLC ex rel. Ervin v. United States*, 598 F.3d 1372 (Fed. Cir. 2010) and *Stobie* Creek *Invs*. *LLC v. United States*, 608 F.3d 1366 (Fed. Cir. 2010), both of which were lost by taxpayers.

[2] To acquire a completion portfolio, the investor could raise funds via borrowing against the concentrated stock, using available savings, or combining borrowed and saved funds. In any event, sufficiently diversifying the portfolio might require significantly more cash that the investor could raise.

[3] Importantly, all the long-short strategies use a factor-based alpha model to inform their active portfolio longs and shorts. The tax-aware approach to trading the portfolio balances expected pre-tax benefits of the trades (profit motive) with their tax attributes (tax costs of realizing gains and tax benefits of realizing losses).

5. **Larger tax on redemption or lesser benefit of gifting**: gain deferral and net tax losses may result in large recognized gains on redemption, even in the event of pre-tax losses. Allocation of liabilities should be considered when calculating the tax benefit of gifting.

6. **Adverse changes in tax law or IRS challenge**: the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law, or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.