



Tax Matters

The Enduring Appeal of Gain Deferral, Part 3

How much better does your next investment have to be to make the switch?

March 12, 2025

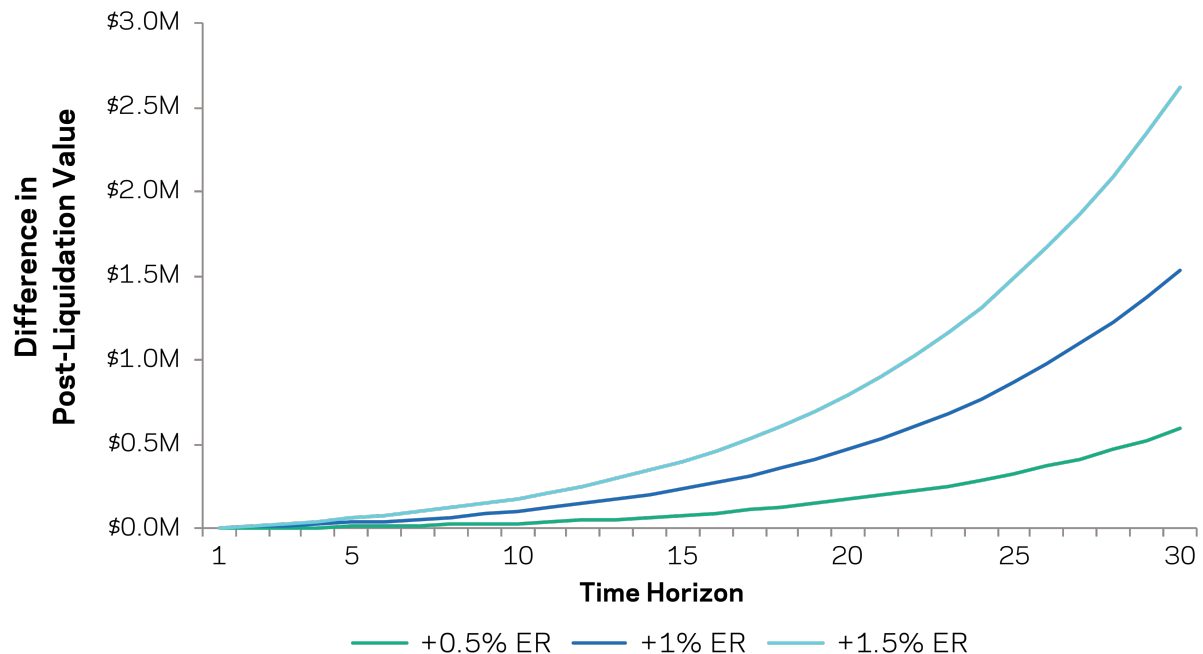
Our [first post](#) in this series showed the power of deferral for building wealth, and our [second](#) showed how robust the value of deferral is to changes in future tax rates on capital gains. But what if you're able to find a new investment with a higher expected return? In other words, how much of a return advantage does your *next* investment have to be to offset the value of gain deferral in your *current* portfolio?

Consider an investor holding an equity portfolio worth \$1M, with a 20% unrealized gain (or equivalently, an 80% cost basis). This investor has identified three new strategies that are similar to the current portfolio, except that each has a superior expected pre-tax return: the first with a +0.5% annual return advantage, the second with a +1.0% annual advantage, and the third with +1.5%.¹

Should the investor make the switch to any of these new strategies? Does the benefit from higher expected returns overcome the benefit of deferring the 20% unrealized gain? In each of these three cases, the answer—maybe surprisingly—is yes.

The graph below shows the post-liquidation cumulative benefit to making the switch for different investment horizons (i.e., a one-year horizon is the value of switching to the higher-returning strategy today and selling a year later compared to the value of staying with the current strategy and selling a year later. Positive values mean the investor is better off switching to the new investment). In each case, over each horizon, the investor is theoretically better off making the switch. In other words, sticking with the current strategy is what people usually call "letting the tax tail wag the investment dog."

"Crystallize" vs "Defer": The Advantage of Switching to A Higher Expected Return Strategy

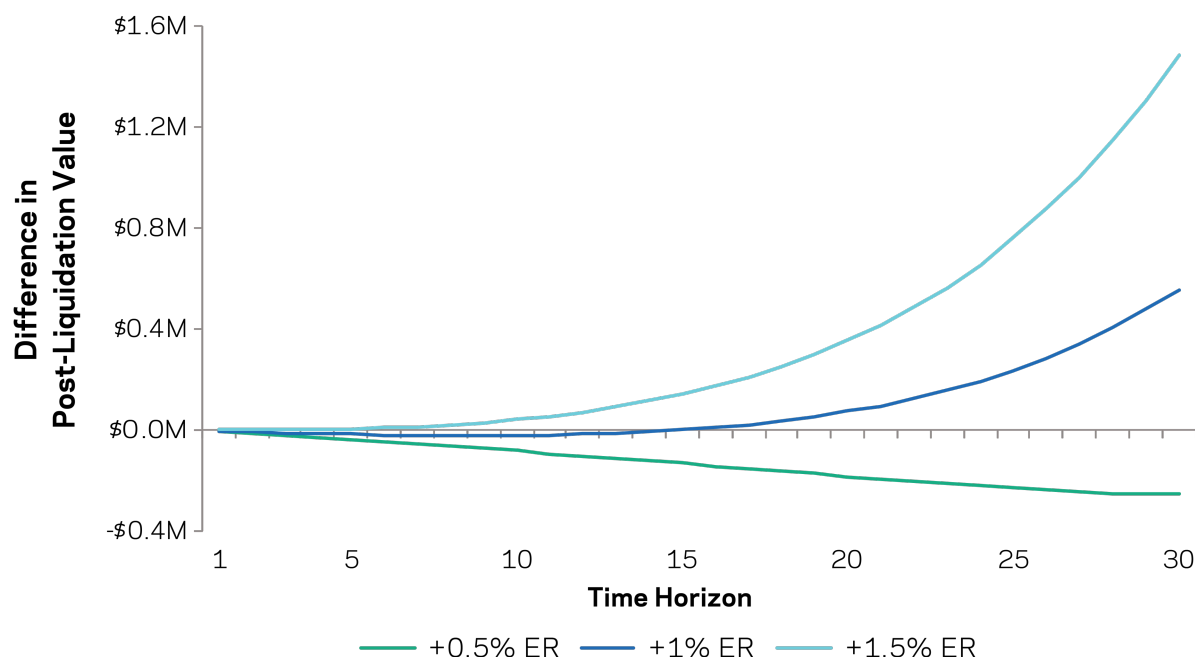


Source: AQR. Chart shows difference in post-liquidation values for comparability. The hypothetical base case portfolio ("Defer") starts with \$1M value and \$0.8M cost basis (20% unrealized gain) with an annual pre-tax return of 7%. The three lines show the post-liquidation value advantage (over base case) of scenarios in which the investor immediately liquidates ("crystallizes" the unrealized gain) and pays taxes to switch to a higher 7.5%, 8%, or 8.5% pre-tax return investment. We assume 23.8% long-term capital gains tax for all horizons with no income/realized gains while holding the investments. This tax rate implies a starting portfolio value and basis of \$952,400 for the three "Crystallize" portfolios. The post-liquidation value for any portfolio with return r_i is calculated as $S(1+r_i)^n(1-T) + B(1-T)^n$, where S is the starting portfolio value, n is the investment horizon, T is the tax rate (23.8%), and B is the portfolio cost basis.

The first example assumed the current portfolio had an unrealized gain of 20%, i.e., a cost basis of 80%. What if instead the current portfolio's unrealized gain was 80%, or a cost basis of 20%? (For context, an investment in the S&P 500 in November 2020 would have had more than an 80% unrealized gain at the end of 2024.)

Now the picture gets more complicated because the value of deferral is larger. In fact, for all horizons shown below, the investor is now better off avoiding the new investment with the +0.5% annual pre-tax return advantage altogether. Put another way, in this scenario, compounding more money at a lower rate of pre-tax return is better than compounding less money at a higher rate of pre-tax return.

Even the investment with the +1.0% annual return advantage doesn't help for a long while. Here the investor would need a holding period of 16 years before breaking even on switching. And finally, for the investment with the +1.5% annual return advantage, an investor would need at least a four-year horizon before expecting to be better off making the switch.



Source: AQR. Chart shows difference in post-liquidation values for comparability. The hypothetical base case portfolio (“Defer”) starts with \$1M value and \$0.2M cost basis (80% unrealized gain) with an annual pre-tax return of 7%. The three lines show the post-liquidation value advantage (over base case) of scenarios in which the investor immediately liquidates (“crystallizes” the unrealized gain) and pays taxes to switch to a higher 7.5%, 8%, or 8.5% pre-tax return investment. We assume 23.8% long-term capital gains tax for all horizons with no income/realized gains while holding the investments. This tax rate implies a starting portfolio value and basis of \$809,600 for the three “Crystallize” portfolios. The post-liquidation value for any portfolio with return r_i is calculated as $S(1+r_i)^n(1-T)+B(1-T)$, where S is the starting portfolio value, n is the investment horizon, T is the tax rate (23.8%), and B is the portfolio cost basis.

In all examples here, we’ve assumed that the investor liquidates the current strategy and pays taxes on the entire realized gain before investing in the higher-returning strategy. In part four of this series, we’ll investigate the role of making the transition between the strategies more tax-efficiently.

Read Part 4

[1] For simplicity, in this example we assume the pre-tax return is the same as the after-tax return for these strategies. Examples of these could be equity-benchmarked long/short strategies, based on the same active investment model, and managed at different levels of tracking error (the strategy with the +0.5% expected excess return would have half the targeted tracking error as the strategy with the +1.0% expected excess return), and done tax-efficiently, as shown in [Sialm and Sosner \(2018\)](#).

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