TAX AWARE

Understanding the Tax Efficiency of Market Neutral Equity Strategies

May 9, 2017

Market neutral equity strategies can be very tax efficient. Not only can they have low tax burdens, but they can also yield tax benefits. These tax benefits can be further increased through tax-aware rebalancing. Importantly, in our paper we find that tax-aware market neutral strategies achieve these tax benefits with only a small degradation in pre-tax returns.

What's Inside

- We explain why market-neutral strategies can be inherently tax-efficient, and illustrate this through historical strategy simulations of pre-tax and after-tax performance of tax-agnostic and tax-aware market neutral strategies.
- The tax-agnostic strategy, instead of realizing tax liabilities, on average realizes a small tax benefit resulting from short-term capital losses on short positions.
- Tax awareness further improves tax outcomes. By deferring the realization of capital gains and accelerating the realization of capital losses, the tax-aware strategy realizes tax benefits similar in magnitude to pre-tax returns.
- The tax benefits of the tax-aware market neutral strategy are high and persistent over time. Additionally, they are positively correlated with the market return, implying there are greater tax benefits in bull markets, exactly when they are needed the most.
- We conclude with potential practical applications of tax-aware market neutral strategies including: diversification of portfolio returns, increasing the overall portfolio tax efficiency through realization of capital losses, and diversification of concentrated low-basis positions.

Conclusion

Market neutral equity strategies can be very tax-efficient because short positions give rise to opportunities for realizing short-term capital losses. Adding tax-aware portfolio construction can further improve after-tax returns, and may even yield tax benefits similar in magnitude to pre-tax alpha. Moreover, our study finds that tax benefits of the tax-aware market neutral strategy can persist in the long run and are positively correlated with market returns. Based on these results, we conclude that tax-aware equity market neutral strategies can be an important tool in the toolbox of a taxable investor from both the tax and pre-tax perspectives.

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.