Tax Aware

Understanding the Tax Efficiency of Market Neutral Equity Strategies

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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.

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