



Tax Matters

Misconceptions about Tax-Aware Long-Short: Misleading Parallels with Direct Indexing, Part III

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In [Part I](#) and [Part II](#) of this series, we explored how comparisons with direct indexing can lead to misconceptions about the mechanics of tax-aware long-short (TA LS) investing and the sources of its potential tax benefits. We reiterated that TA LS is, first and foremost, an active investment strategy: it seeks pre-tax alpha, while incorporating tax considerations into how the portfolio is managed.

In this final installment, we address two additional misconceptions investors often have about the risks TA LS strategies take and the trade-offs involved in managing them.

Misconception 5: Minimizing tracking error is a key benefit of the strategy

Investors often view tracking error—the degree to which a strategy's returns differ from its benchmark—as something to minimize. This instinct makes sense for direct indexing, where the objective is to closely track an index while harvesting tax losses along the way. Because direct indexing does not attempt to predict which stocks will outperform or underperform, any deviation from its benchmark is not expected to generate additional pre-tax return. As a result, many direct indexing managers intentionally minimize this uncompensated tracking error.

For an active strategy such as TA LS, however, tracking error plays a [key role](#). By trading an underlying alpha model, the strategy deliberately buys stocks it views as attractive and shorts stocks it views as unattractive in an effort to outperform its benchmark. This naturally causes the portfolio to differ from the benchmark. In that sense, tracking error is not an unfortunate side effect; it is intentional and necessary to beat the benchmark.

In [our simulations](#), tighter tracking-error constraints reduced the strategy's ability both to express its alpha model and to defer gains, while greater tracking error and leverage increased opportunity to pursue both excess returns and tax benefits.

Misconception 6: Calibrating loss realization is simple

On the surface, managing the tax considerations of a strategy might seem relatively straightforward: realize capital losses and defer capital gains. While this may apply to direct indexing strategies, it overlooks a TA LS strategy's primary objective: pursuing pre-tax alpha.

TA LS portfolio construction needs to balance several considerations at once: following the alpha model, managing investment risk, controlling transaction and financing costs, and accounting for the tax consequences of each trade. Tilt too far toward alpha and it may unnecessarily realize taxable gains; tilt too far toward tax considerations and the strategy may sacrifice attractive investment opportunities.

In contrast to direct indexing, the purpose of a properly designed TA LS strategy is definitively not to "maximize losses." Instead, for a TA LS strategy, portfolio construction requires calibrating the trade-offs between expected returns, risk, costs, and taxes. And [as we said before](#), if a TA LS strategy does not do that, it's best to steer clear.

Conclusion

Across all three parts of this series, a common theme emerges: viewing tax-aware long-short investing through a direct-indexing lens can lead to conclusions that sound intuitive but miss critical differences between the two.

Our point is not that one approach is inherently better than the other. Rather, TA LS and direct indexing are two distinct strategies pursuing unique investment outcomes, and that familiarity with one does not provide a complete framework for understanding the other.

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Unavailability of potential tax benefits: The expected tax benefits associated with the tax-aware strategy may be less than expected or may not materialize due to the economic performance of the strategy, an investor's particular circumstances, prospective or retroactive changes in applicable tax law, and/or a successful challenge by the IRS. In the case of an IRS challenge, penalties may apply.

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Shorting/Short Selling is a trading strategy in which a trader aims to profit from a decline in a security's price by borrowing shares and selling them, hoping the stock price will then fall, enabling them to buy the shares back for less money.

Alpha is a statistical measure of an investment's unique return (return not attributable to other known return sources such as equity market returns).

Tracking Error is a statistical measure of the variation in excess returns between a fund and its benchmark index.

Leverage is the use of borrowed capital to increase potential return.