



Tax Aware

Now You Don't Have to Choose Between Diversification and Tax Efficiency

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For as long as there's been an AQR, we've argued for more diversification in investor portfolios. Don't get us wrong—the equity risk premium and bond risk premium are great. But with [both major asset classes priced to deliver low returns compared to history](#), traditional risks aren't a sure-fire way to reach your 5- to 10-year return goals. Even more acutely this year, with losses in equity and bond markets, traditional portfolios have suffered peak-to-trough losses not seen since the global financial crisis. For a wide range of investors, the need for diversification has become more urgent than in over a decade.

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But for taxable investors in particular, diversification alone isn't enough. The additional requirement for individuals and families is for their diversifying strategies to be attractive not just pre-tax, but also *net of taxes*.

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Alternatives have long been treated as a pariah by taxable investors—and for good reason. Some estimate that hedge funds give up to 60% of their pre-tax returns to fees and taxes.¹ At AQR, we've made a significant progress on increasing the tax efficiency of alternatives. Based on our research, we argued that "alternative strategies, suitably implemented, have the ability to be [highly tax-efficient and even tax-beneficial](#) to a broader investment portfolio." In a series of papers, we've outlined our vision that alternatives:

- 1) [give access to diversifying sources of return more tax efficiently than traditional long only investments](#),
- 2) [may be made even more tax efficient via tax-aware portfolio management](#),
- 3) [and may provide character and deferral tax benefits that reduce the tax burden of an investor's aggregate portfolio](#).

“Now taxable investors don’t have to choose between diversification and tax efficiency”

Furthermore, we’ve developed hypothetical product concepts, such as [tax-aware equity market neutral](#) and [tax-aware equity long-short](#) strategies, that may offer both diversifying pre-tax returns and tax benefits. The goal: now taxable investors don’t have to choose between diversification and tax efficiency when building a portfolio resilient to markets’ ebbs and flows.

[1] See Lucas, S.E., and A. Sanz. 2017. “The 50% Rule: Keep More Profit in Your Wallet.” *The Journal of Wealth Management* 20 (2): 23-28.

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Risks of Tax Aware Strategies

Like any investment strategy designed to generate pre-tax returns, tax-aware investment strategies are subject to the risk of pre-tax returns meaningfully underperforming expectations.

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.