Tax Matters

Why More Alpha Can Mean More Tax Benefits

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Tax-aware long-short strategies have sparked a debate: Are they simply direct indexing with leverage and shorting layered on to harvest more losses, or are they genuine alpha engines implemented in a tax-efficient way?

Our latest paper, The Tax Benefits of Pre-Tax Alpha, tackles a surprisingly underexplored question: does pre-tax alpha help or hurt the tax benefits of tax-aware long-short strategies?

Conventional wisdom drawn from direct indexing might suggest a trade-off. In long-only tax-loss harvesting, higher returns typically mean fewer losses to harvest. If markets rise broadly, there are simply fewer opportunities to realize losses. Following that logic, one might assume that more pre-tax alpha would lead to fewer tax benefits.

That intuition turns out to be incomplete — and for long-short strategies, often wrong.

It's true that higher returns reduce tax losses as a percentage of assets. If everything is going up, fewer positions sit below cost. That basic arithmetic still applies.

But higher alpha also accelerates NAV growth. Even if tax benefits shrink as a percentage of assets, they are applied to a larger and faster-growing base. In dollar terms, the benefits can actually increase.

There's another factor at work. Our paper highlights an underappreciated but powerful mechanism: alpha in long-short portfolios creates new positions. When a long-short strategy earns alpha, its leverage drifts below target. To rebalance, the manager must add new long and short positions. Those newly created positions start without embedded gains.

In effect, alpha behaves like a recurring capital contribution — except without the investor needing to add new cash. This position-creation effect does not exist in traditional long-only direct indexing; it is unique to long–short implementations.

The paper also examines an important practical question: do these alpha-driven tax benefits survive the transition from a long-short portfolio to long-only?

The short answer is yes. Higher alpha reduces built-in gains relative to gross notional value in tax-aware long-short strategies. New positions dilute embedded appreciation, and the combination of higher alpha and higher leverage amplifies this effect. The practical implication is that transitioning to long-only becomes less costly from a tax perspective. Higher alpha not only increases pre-tax wealth; it can enhance tax benefits and reduce transition costs.

Of course, all of this depends on actually generating alpha. If alpha is negative net of financing costs, transaction costs, and fees, tax benefits alone are not enough to justify the strategy, either pre-tax or after-tax.

The conclusion is straightforward: in tax-aware long-short investing, alpha is not optional — it is central. Unlike in long-only strategies, pre-tax alpha in long-short portfolios does not undermine tax benefits; it amplifies them.

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