TAX AWARE

Beyond Direct Indexing: Dynamic Direct Long-Short Investing

May 3, 2023

On average, net losses realized by direct indexing loss-harvesting strategies taper off within the first few years after their inception. In our historical simulations, they reach a maximum average cumulative level of about 30% of the initially invested capital.

In addition, direct indexing strategies exhibit a high dispersion of net loss outcomes. Long-short strategies motivated by factor investing can significantly outperform direct indexing strategies from both a pre-tax and tax perspective. We model two types of long-short factor-based strategies: relaxed-constraint and composite long-short. Both types of strategies, if implemented with a sufficiently high level of leverage and tracking error, can realize a cumulative net capital loss of 100% of the invested capital within a few years and, at the same time, substantially outperform the benchmark index before tax net of implementation costs.

We further show that leverage and tracking error of long-short strategies can be managed dynamically in a highly tax-efficient manner. For example, an investor who becomes less optimistic about the prospects of factor investing can reduce the leverage and tracking error substantially, albeit not all the way to zero, without recognizing net capital gains. We find that a full liquidation of the long and short extensions results in realization of most of the previously deferred gains.

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