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.

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[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.

Risks of Tax Aware Strategies (Not Exhaustive)

1. **Underperformance of pre-tax returns**: tax aware strategies are investment strategies with the associated risk of pre-tax returns meaningfully underperforming expectations.

2. **Adverse variation in tax benefits**: deductible losses and expenses allocated by the strategy may be less than expected.

3. **Lower marginal tax rates**: the value of losses and expenses depends on an individual investor's marginal tax rate, which may be lower than expected for reasons including low Adjusted Gross Income (AGI) due to unexpected losses and the Alternative Minimum Tax (AMT).

4. **Inefficient use of allocated losses and expenses**: the tax benefit of the strategy may be lower than expected if an investor cannot use the full value of losses and expenses allocated by the strategy to offset gains and income of the same character from other sources. This may occur for a variety of reasons including variation in gains and income realized by other investments, at-risk rules, limitation on excess business losses and/or net interest expense, or insufficient outside cost basis in a partnership.

5. **Larger tax on redemption or lesser benefit of gifting**: gain deferral and net tax losses may result in large recognized gains on redemption, even in the event of pre-tax losses. Allocation of liabilities should be considered when calculating the tax benefit of gifting.

6. **Adverse changes in tax law or IRS challenge**: the potential tax benefit of the strategy may be lessened or eliminated prospectively by changes in tax law, or retrospectively by an IRS challenge under current law if conceded or upheld by a court. In the case of an IRS challenge, penalties may apply.