TAX AWARE

Making VPFs Work Harder for You

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There is a range of solutions aimed at reducing the risk of concentrated stock tax-efficiently: completion portfolios, exchange funds, charitable giving, just to name a few. But for some investors, Variable Prepaid Forwards (VPFs) are a favorite. It's not hard to see why—from the investor's point of view, the VPF:

1. Provides downside protection,
2. Allows for some upside participation,
3. Generates significant cash up-front,
4. And defers recognition of the capital gain to a later date.

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Our latest paper looks at how investors can use #3—the up-front cash—to maximize the after-tax value of their investment portfolio.

Two decades ago, it was cutting-edge for an investor to put that cash into a tax-loss harvesting strategy, such as Direct Indexing. The investor would collect the equity premium, while also realizing capital losses that would offset some of the capital gain realized at maturity of the VPF.

But Direct Indexing has limitations. First, transaction costs and fees can create a pre-tax return drag compared to a passive index fund. Second, the tax losses it realizes tend to be fairly muted in the early years of the strategy and degrade toward zero in the years that follow. Those tax losses also have an unfortunate sensitivity to the market environment—they tend to be smaller when markets are up (i.e., exactly when you'd want them to be larger).

Our paper finds long/short tax-aware factor strategies can be a significantly better choice for investing the VPF's upfront cash proceeds than Direct Indexing. These strategies have been shown to be substantially more tax-beneficial than Direct Indexing, both in magnitude of tax losses and their consistency across market regimes. Importantly, these strategies generate pre-tax active returns at the same time as they deliver these tax benefits. Maybe even more uniquely, they don't even have to be tied to an equity benchmark—which means investors could choose a benchmark that fits better with their investment goals.