Wall Street Takes Tax-Loss Harvesting to the Next Level

By Justina Lee
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What do you get the wealthy client who has everything?

The answer, if you're a clever money manager, is a loss-making investment.

That's the thinking behind Wall Street's latest innovation, a cunning spin on the famous tax-loss harvesting which has been a controversial feature of wealth management for decades.

Tax-loss harvesting is the strategy of selling losing investments to offset the tax owed on gains realized elsewhere in a portfolio. It's a powerful tool deployed often in equity holdings, but it has a key limitation: An investor doesn't always have losses to harvest. That can be especially true in a US stock market that keeps notching new records after tripling over the past decade.

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That's where a "tax-aware long-short" strategy comes in. The totally legal approach is a mashup of hedge fund and personalized portfolio which uses leverage in an individual investment account to bet on some stocks and against others. The goal overall is to make money, but the method practically guarantees there will also be losses to harvest from some of the hundreds of positions.

It's exactly the kind of slick Wall Street maneuver likely to raise the hackles of anyone fretting over rising wealth inequality. Tax long-short strategies are out of reach for most investors, and just like with other forms of tax-loss harvesting, the richest tend to benefit most. While the principle on which they're all based—that Americans don't face capital gains taxes until they choose to sell an asset—has survived numerous challenges, President Joe Biden has proposed taxing the unrealized profits of the super rich. Kamala Harris has gone silent on whether she would pursue such a measure, though she has previously backed his plan.

For now, with record-high equity prices and the AI boom having minted a horde of new tech millionaires—all of whom face potentially hefty tax bills if they want to sell their greatly appreciated stocks—the strategy is growing at a stunning rate. At AQR Capital Management, a pioneer of the approach, assets in tax long-short strategies nearly doubled over half a year to $9.9 billion at the end of September. Quantinno, a firm that started offering customized long-short strategies for taxable clients in 2021, has seen its assets more than double this year to $7 billion. Morgan Stanley says it's soon joining the fray, which already includes big guns like BlackRock Inc. and Invesco Ltd.

"Every client eats after-tax, not pre-tax return," says Cliff Asness, the co-founder of AQR, in an interview. "Frankly anyone taxable, regardless of wealth, is not served as best as they can be by a process that ignores taxes."

Engineering Losses

Tax long-shorts are more expensive than other approaches, complicated and only really effective for those with significant capital gains. But for investors in the right circumstances they're "wonderful," says John West, co-founder of Flatrock Wealth Partners at Newport Beach, California.

"You need to have unrealized capital gains somewhere in your capital stack, generally outside of your diversified investment portfolio," says the former partner at quant shop Research Affiliates, who has been offering these strategies to clients for a little more than a year. He reckons it works best "if you have a private business you might sell. You have a bunch of low-basis stock and you might sell. You're a 50-something who wants to downsize your Newport Beach home."

To understand the mechanics of a tax long-short, consider a poster child of 21st century American prosperity: A brilliant Apple Inc. engineer with $1 million worth of the company's shares after years of gains. The engineer is uncomfortable holding so much wealth concentrated in one stock, so wants to sell the shares and buy an S&P 500 index tracker instead.

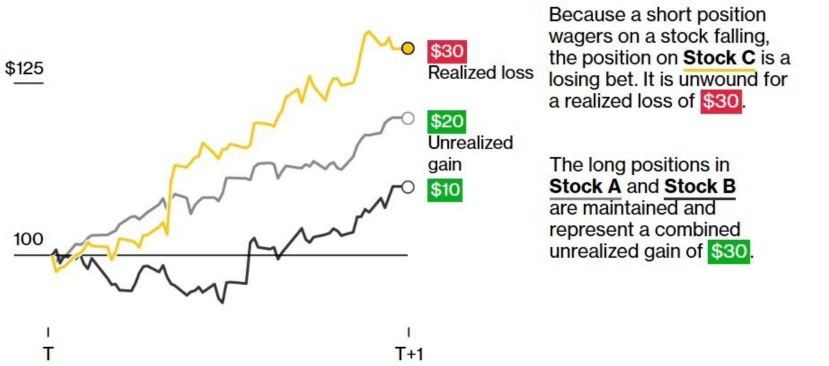
That sale would incur a potentially significant tax bill because of the embedded capital gains. So instead, the engineer uses the $1 million in Apple as collateral to establish a set of long and short exposures (wagers on and against shares, respectively). That's achieved using margin and by short selling, rather than with derivatives. With this portfolio, typically 130% long and 30% short, an investor is more likely to have losing positions and more likely to accrue them quickly.

Just like in simpler versions of tax-loss harvesting, those losses can be realized by selling positions. Cash from the sales is reinvested in economically similar securities (to maintain the balance of the portfolio), while the losses are booked and used to offset capital gains elsewhere. The engineer can gradually offload Apple shares, minimizing their tax bill by deducting the losses created in the long-short strategy.

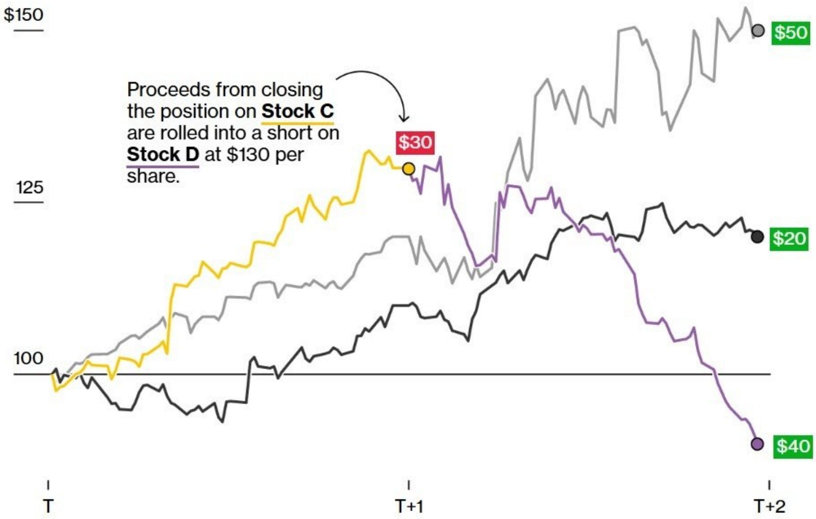
"Three years down the road when there's a need to tap the asset for perhaps college education or buying a second home, there are losses banked there for them to use to offset gains from the sale of that stock," says Michael Storer, senior regional director at Symmetry Partners, which works with AQR and Quantinno to offer these solutions to financial advisers.

How Long-Short Portfolios Can Harvest Tax Losses

An investor portfolio holds two long positions on **Stock A** and **Stock B** respectively, and one short on **Stock C**, all initially trading at $100 per share at time T. At rebalancing, all three stocks are up.



The harvested loss of $30 can be used to offset any capital gains from elsewhere in the investor's portfolio, or any gains from trimming the other profitable positions.



Source: Bloomberg

Tax long-short strategies make use of separately managed accounts, investment vehicles run by professional money managers that can be customized for each specific client. Those have existed on Wall Street for decades, chiefly as a tool for rich investors, but as technological advances have made them easier to run and lowered the barriers to entry they've boomed to become a $3 trillion industry, according to Cerulli Associates.

Much of the demand stems from their usefulness in tax-loss harvesting strategies, in particular for what is known as direct indexing. That's when an investor holds a portfolio matching a benchmark like the S&P 500, but unlike when they buy an index fund, they own each share individually—meaning they can harvest any losses that arise.

The boom is a much-needed propellant of fee income in an era when many index funds are practically free, which helps explain why firms including Morgan Stanley, Vanguard Group and Franklin Resources have acquired SMA platforms over the last four years. Tax long-shorts offer even more earning potential: Symmetry estimates these strategies generally charge 50 basis points in management fees and another 30 basis points for financing, working out at about double the typical charge for direct indexing.

The flip side is that their complexity means they aren't a mass-market product. The minimum required investment for a tax-aware long-short strategy typically starts at seven figures, whereas for a regular SMA it's now as low as $5,000 at a provider like Fidelity Investments.

"Long-short is trending toward the ultra-high net worth space," says Eve Cout, managing director at BlackRock's US Wealth Advisory business. "It requires infrastructure and deep knowledge of how to deliver personalized SMAs at scale to clients."

'Problematic'

The key to tax-loss harvesting strategies, including long-short, is that Americans can choose when to realize gains or losses on their investments.

Often these approaches amount to a deferral of taxes, rather than an elimination, since any money saved is reinvested and the portfolio overall should grow. Ultimately it will likely be liquidated and tax will be due on any gains then—and if an investor sold a stock at a loss and later bought it back, they might even have larger gains in the future because the purchase price was lower.

But overall the investor should have benefitted from having more cash invested for longer, and ideally will only unwind once they retire into a lower tax bracket or state.

To Alan Auerbach, a law and economics professor at the University of California, Berkeley, the realization-based system "has always been problematic." He reckons a significant share of capital gains is never realized at all, either thanks to a clever use of charitable contributions or because an investor continuously defers selling, and gains reset to zero when they die and pass the assets to their kin.

"Money has time value," Auerbach says. "Even if it were just deferral, if we're talking about a year or two, it's not a big deal. If we're talking about 50 years, it is a big deal."

A plan touted by Vice President Harris to impose new taxes on the very richest Americans could upend the calculus. Her campaign recently declined to clarify if this would cover unrealized capital gains. That suggestion has previously been panned for discouraging investment, and a recent Supreme Court case offered mixed clues on whether such a tax would survive a constitutional challenge. Harris has also proposed raising the long-term capital-gains tax rate for those earning at least $1 million.

That might add even more fuel to Wall Street's tax-loss harvesting strategies. The practice is completely legal, as long as trades don't break certain anti-abuse restrictions. For instance, you can't harvest losses from one security and buy back something too similar within 30 days. Nor can you simultaneously bet both on and against the same security, realizing losses on one trade and deferring gains on the other.

The whole business feeds off the complexity of the current rules, according to David Schizer, a professor at Columbia Law School. In his view, far too much time and energy is being expended as sophisticated players pursue a lower effective tax rate. "From the system's perspective, you really shouldn't encourage that kind of effort," he says.

As it stands, for individuals with enough taxable gains to offset, it is worth the effort—and quants like AQR say the new breed of long-short strategies are particularly effective. In a pitch deck from the systematic firm seen by Bloomberg News, the money manager projected that a $10 million investment in a solution that goes 145% long and 45% short can generate losses adding up to $14 million over a decade, compared with $3.9 million for direct indexing.

That stock-picking strategy also aims to beat an equity benchmark by 0.8% a year before taxes. Asness likes to characterize the losses as the cherry on top of the cake that are the established models at AQR, which runs $116 billion overall. The firm's tax-aware products take its long-standing approaches to equity selection and then try to balance the outputs with tax considerations. For instance, if the signal for an appreciated stock is just gently flashing red, a strategy might delay selling it to take the holding past the one-year mark, making it subject to the lower long-term capital gains rate.

"We are first and foremost about providing pre-tax alpha," Asness says. "We got a little lucky here because many aspects of our process simply lent themselves naturally to being tax-aware."

Handing Out Cards

Taxes paid by the wealthiest Americans tend to fluctuate with the market, which may explain why tax-loss harvesting is enjoying a moment. In 2021, well-before the current record run for US stocks, capital-gains realizations as a percentage of the economy reached the highest in four decades, according to an analysis by the Congressional Budget Office. For the top 1% of taxpayers, the category accounted for 39% of their gross income that year, data from the Internal Revenue Service show. (The agency declined to comment on this story.)

The rapid growth of Quantinno is testament to the demand for tax long-short solutions. The firm has a minimum investment threshold of $1 million, and counts family offices and wealth managers among its clients. Hoon Kim, the founder who spent more than a decade at AQR, says Quantinno's edge is in combining the best of hedge funds and SMAs.

"We can basically take advantage of a sophisticated strategy but in a vehicle that taxable clients prefer because it's highly liquid," he says. "Their assets are not leaving their accounts and it's fully transparent."

Elsewhere, Jeremy Milleson, director of investment strategy at Parametric, Morgan Stanley's direct-indexing arm, says the firm will release a long-short strategy by year-end to help clients with concentrated positions. Invesco, which recruited Tarun Gupta in 2019 from AQR to help run quant strategies including tax-managed stocks, has $200 million in their long-short product.

"You're having a tremendous amount of wealth generated in growth tech companies right now as well as AI companies, and these individuals are seeking to lock in that wealth," says Eddie Bernhardt, head of SMAs at Invesco. Wealth managers are "sitting in parking lots to meet with engineers as they come out and just hand out cards," he says.

— With assistance from Mathieu Benhamou and Josh Wingrove