Quick Clips Q&A

Tax Aware Alternatives

Hear from Ted Pyne, Head of AQR's U.S. Wealth Group, on the potential benefits of tax aware alternatives for U.S. taxable investors. To learn more about AQR's approach to tax aware investing, visit aqr.com/tax.

What is tax aware investing?

For taxable investors in the United States, wealth compounds after tax, so taxes can matter just as much as fees or excess return. Tax aware investing aims to help investors maximize their after-tax returns. AQR's tax aware offerings are actively managed, systematic strategies that seek to deliver pre-tax returns tax efficiently and in some cases tax beneficially.

What are the potential benefits of tax aware alternatives for U.S. taxable investors?

Having alternatives in a portfolio can provide valuable diversification. However, taxes often reduce the value alternatives provide because a typical alternative investment does not appreciate tax efficiently. Instead, it may incur a substantial tax drag.

Tax aware alternatives are designed to help U.S. taxable investors get the full measure of benefit from an alternative allocation and compound wealth more quickly after tax. A small, but growing, number of investment managers offer alternative investment strategies in a tax aware implementation. These strategies can range from long-short equity strategies to multi-asset strategies and sophisticated multi-strategy alternatives.

Tax aware alternative strategies seek to deliver a positive investment return tax efficiently, and may even deliver an additional tax benefit, making them an attractive type of investment for taxable investors. As an example, a tax aware strategy that uses both long and short positions can better facilitate tax loss harvesting, regardless of the direction of the market. In other words, a book comprised of long and short positions reflecting a view of the relative attractiveness of stocks allows investors to harvest losses while the strategy works as designed to produce a positive investment return.

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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.

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