TAX MATTERS

Experience Matters: Addressing Five Common Criticisms of Tax Aware Long-Short (TA LS) Strategies

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As the AUM in tax-aware strategies continues to grow, so too does the number of myths, misconceptions, misunderstandings, and okay, maybe also reasonable and honest questions. In this article, we address five of the most common criticisms and questions, and argue that most of them are more about the "player" than the "game."

TA LS strategies will have higher costs (financing costs, t-costs, management fees) than traditional long-only strategies, which need to be compensated by the manager's alpha. Before taxes are considered, TA LS strategies must be evaluated on the merit of their pre-tax alpha per unit of active risk. That is why it is crucial to look for managers with a proven track-record and experience running long-short alpha strategies.

To summarize the discussion below: It is considerably easier for an experienced long-short manager to become tax-aware than for a loss-harvesting provider to start utilizing leverage and shorting to amplify tax losses without generating pre-tax net-of-costs losses. Without scale, expertise, and pre-tax alpha, the costs and risks of leverage and shorting are likely to undo any potential tax benefits from additional harvested losses.

Criticism #1: The financing costs of a TA LS strategy outweigh any (tax) benefits.

The financing costs in any long-short strategy arise from borrowing cash (long leverage) and borrowing securities (short leverage).

All-in financing costs of a TA LS strategy scale with leverage. An institutional manager can run a moderate tracking error (TE) 200/100 (200 long, 100 short),[1] TA LS strategy with all-in financing costs somewhere in the ballpark of 80bps annualized.[2]

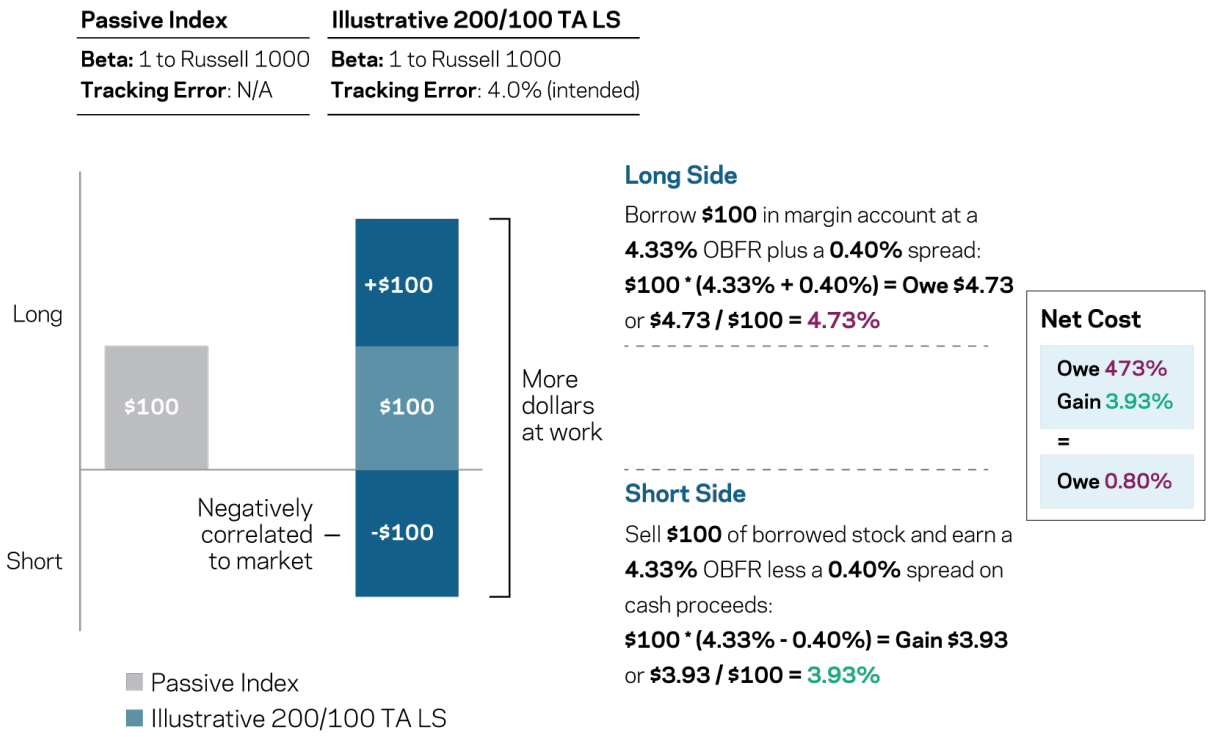
To get more specific, margin financing cost is usually quoted as an overnight rate (e.g., OBFR) plus a spread, while short rebates (the interest paid on the cash proceeds generated from selling borrowed shares used for shorting) are usually quoted as OBFR minus a spread (the stock borrow fee).

While it is true that, compared to long-only, LS strategies incur financing costs, these costs can vary widely. Financing spreads are often negotiated between the stakeholders – meaning larger, more established managers are able to run portfolios at significantly lower costs than, say, most individuals, or less established managers.

For decades, long-short managers have utilized leverage and shorting to generate returns in excess of financing costs. There is no reason for investors to view TA LS strategies differently from any other long-short investment: When evaluating a TA LS strategy, it is important to ensure the pre-tax alpha expectations are high enough to meet return objectives net of *all financing costs and fees*. As stated above, it is significantly easier for an experienced long-short manager to become tax-aware than for a long-only loss-harvesting provider to become a profitable long-short manager.

Exhibit 1: Illustrative Financing Costs of an Institutional-quality TA LS strategy

Margin Financing Cost	Short Rebate	Overall Financing Cost (200/100 TA LS)	Pre-Tax Gross Alpha Expectation
OBFR + 40bps	OBFR - 40bps	80bps	?



Source: AQR, Federal Reserve Bank of New York. OBFR of 4.33% is as of 5/20/2025. These costs are meant to be illustrative estimates. Actual negotiated rates may be more favorable. For illustrative purposes only.

Criticism #2: Reg T (margin) limitations make TA LS strategies infeasible.

"Reg T" is a regulatory margin framework which generally limits the amount an investor can borrow to purchase equities at 50% of the purchase price (i.e., 2x maximum leverage). Reg T requirements of 50% apply to the initial purchase (or short sale) of a position. Subsequently, a lower maintenance margin requirement applies which can vary across brokers.

Reg T is indeed prohibitive for higher-TE LS strategies, but institutional managers (sub-advising for wealthy individuals in a separately-managed account) have access to financing arrangements providing higher leverage, including a framework called "Portfolio Margin." For well-behaved TA LS portfolios, Portfolio Margin can offer margin levels as low as 15% which translates into available leverage up to 6.67x.

Again, while Reg T would clearly be a limiting factor for an *individual's* make-it-at-home TA LS strategy, it's not a problem for the bigger institutional players. It's worth reiterating that the "bigger institutional players" can get competitive margin and financing terms for individual clients who choose to work with them.

Since everything depends on established relationships between the manager and the prime broker offering leverage, again, going from long-short management to tax-aware implementation is easier than from loss-harvesting to long-short management.

Criticism #3: Margin accounts are exposed to the risk of margin calls.

When using margin financing, there's indeed always the possibility that a margin call can lead an investor to liquidate (parts of) the portfolio at inopportune times.

This is especially problematic for portfolios with concentrated positions as adverse movements on larger positions by definition have a bigger portfolio impact. This can be disastrous for do-it-yourself leveraged portfolios. However, for experienced institutional-quality TA LS managers, avoiding margin calls is business-as-usual.

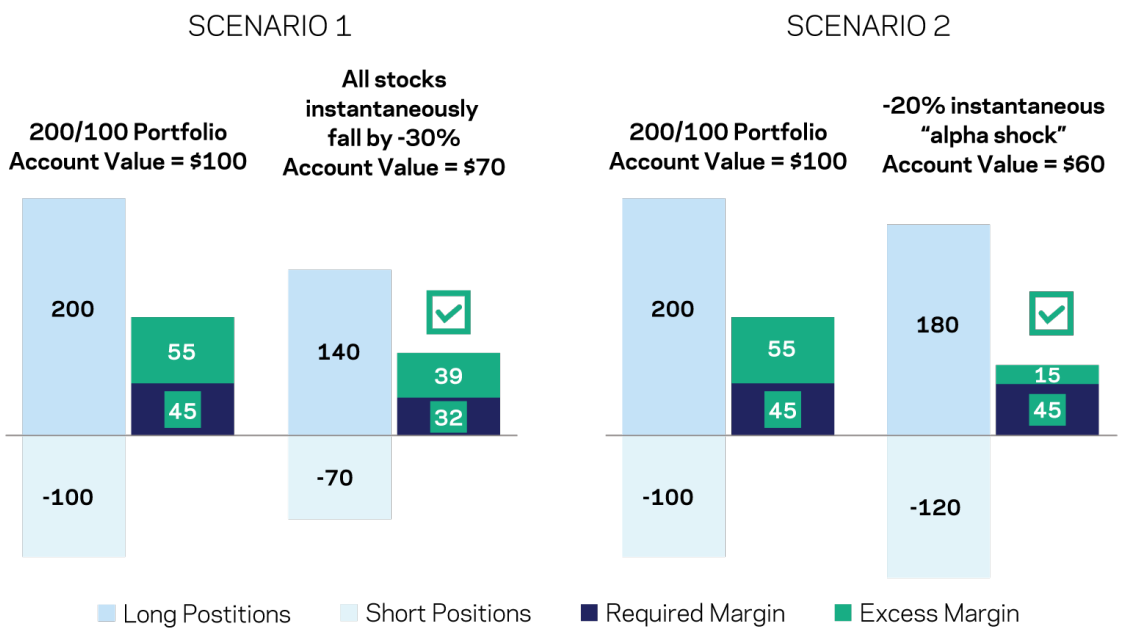
An experienced manager can hold a diversified (not concentrated) portfolio, have excess margin to cushion against adverse market moves, trade liquid securities to make systematic rebalancing possible, and actively monitor (and manage) leverage and shorting to ensure that margin as a percent of equity capital is at an appropriate level at any point in time.

Let's consider an example of a 200/100 strategy with an account value[3] of $100 ($200 - $100) and a gross notional value (i.e., total dollars at work) of $200 + $100 = $300. Let's assume a 15% margin requirement (i.e., the account value has to be equal to at least 15% * $300 = $45). At the start of the example, Scenario 1 below, the account value reflects $55 of *excess* margin ($100 - $45) – an extra "cushion" against adverse movements.

Scenario 1 shows the impact of an immediate -30% market crash, where all stock prices fall – meaning the portfolio's long positions lose $60 (falling from $200 to $140) *but* its short positions make $30 (falling from $100 to $70). The post-market-crash account value is $140 - $70 = $70. The new gross notional value is $210, so the 15% margin requirement means the account value needs to be equal to at least $32 (15% * $210). In this example, the account value not only covers this requirement (at $70) but also has $39 of excess margin.[4] The portfolio was hit hard, but margin wasn't an issue.

Let's now consider a more interesting, purposefully exaggerated scenario, Scenario 2. Here, we assume an extreme negative "alpha shock" where both the long *and* short extensions lose -20%.[5] In this scenario, the portfolio's long positions lose $20, falling from $200 to $180 and its short positions lose $20, rising from $100 to $120. The post-shock account value is $180 - $120 = $60. The gross notional value remains at $300, so the 15% margin requirement also remains the same at $45 (15% * $300). Again, the portfolio not only meets this requirement (with its $60 account value) but also has $15 of excess margin. The point of this admittedly crazy scenario (and the first) is that the risk of a margin call is negligible if you are not using exorbitant amounts of leverage.[6]

Exhibit 2: Managing Margin Risk During Market Crashes and "Alpha Shocks"



Source: AQR, Bloomberg. Each scenario assumes a 200/100 TA LS portfolio and a 15% margin requirement. Scenario 1 assumes all stocks in the market fall by -30% instantly. This scenario is similar to the worst-ever daily decline in the S&P 500, which was -20.5%, on October 19, 1987. Scenario 2 assumes both the long extensions and the short extensions lose -20% instantly. The most drastic losses for many diversified quantitative equity strategies occurred during the so-called "Quant Crisis" (7/25/2007 – 8/9/2007), which would be a loss of approximately -3.8%. Unlike that historical example (in which a liquid strategy would have been able to rebalance to address margin needs), we assume here a shock that occurs instantaneously. For illustrative purposes only.

If diversification is an important tool in managing margin risk, does that mean that borrowing against a single stock is a bad idea? While it's true that borrowing against a single stock does increase risk, this can be managed with a thoughtful TA LS implementation and robust margin agreements with financing providers. Firstly, while TA LS can't eliminate the risk immediately, it can stay true to the principle of maintaining excess margin. Secondly, the manager has the ability to quickly transition from a concentrated stock position to a more diversified portfolio (in a tax efficient manner). All of this is of course easier said than done. Experience managing long-short strategies is critical for preventing margin calls. Again, just taking leverage to amplify tax losses without requisite expertise is risky business.

Criticism #4: What about short recalls? Changes in the short borrow cost? Short squeezes?

These events can indeed wreak havoc in the life of an inexperienced investor. However, with a systematic investment process and a highly specialized and experienced investment team, short borrow cost changes, squeezes, and recalls all fall in the "business-as-usual" bucket. This is what LS managers do for a living.

Before we dive into the challenges of shorting, it's important to remember one crucial fact: while the long portfolio might be somewhat concentrated at first (e.g., when an investor funds the TA LS portfolio with eligible concentrated holdings), the short portfolio will naturally be *highly diversified* due to the systematic stock selection process.

Now, back to those points. A short recall occurs when a lender recalls the lent security from the borrower who is forced to close out the position (prematurely). This can happen, but it is extremely rare for an institutional player focusing on mostly easy-to-borrow securities

(i.e., if it happens at all, it's fewer than a handful of times per year). Again, this is mostly a problem for investors with *highly concentrated* short positions where a single short being recalled can have an outsized impact on the entire portfolio. This is nearly impossible in a well-designed quantitative portfolio.[7]

Changes in the short rebate can arise from the market fluctuations in the borrow cost for hard-to-borrow shorts. The borrow cost for easy-to-borrow (general collateral, "GC") stocks are agreed to in advance. If the portfolio is diversified (there's that word again) and well-designed with a meaningful pre-tax alpha goal, then changes in hard-to-borrow costs are unlikely to have a material effect on overall portfolio performance. Furthermore, the TA LS portfolio construction process explicitly takes short financing costs into account in the context of other strategy objectives – pre-tax alpha generation, leverage and volatility targeting, and tax-efficiency.

And short squeezes? See the points above (and log off r/WallStreetBets).

The key takeaway is that the natural diversification of long-short quantitative strategies protects the investor from all of these risky outcomes since individual position sizes are small (typically sized in basis points), and thus impact on the portfolio is mitigated.

Criticism #5: What if there is no pre-tax alpha (or worse, it's negative)?

If the active risk being taken in a TA LS strategy is not well-compensated (i.e., there is negative pre-tax alpha), that is a problem.[8] In fact, this is especially a problem for TA LS strategies (say, relative to passive ETFs or direct indexing funds) because—as we addressed above—they are costlier to run (financing costs, t-costs, fees, etc.).

The pre-tax alpha objective needs to be both commensurate with the level of active risk being taken (good return bang per risk buck—aka "information ratio") *and* big enough to overcome all the financing costs and fees associated with running the strategy (see Criticism #1).

To put it simply: meaningful risk (TE) combined with zero or negative expected return (alpha) is never a good idea, whether or not the strategy has tax benefits. This is why it's critical to implement a TA LS strategy with an experienced alpha manager. This last point is particularly relevant to our main message: it is drastically harder for a loss-harvesting provider to design a profitable alpha-generating process than for an experienced long-short alpha manager to turn on tax awareness. (Without trivializing the complexity of running a tax-aware process, we can say that alpha generation is much harder).

Conclusion

Most (not all) of the above criticisms are valid, primarily for someone considering building a TA LS strategy without prior experience. Investors should be aware of all the costs, fees, and risks associated with LS portfolio construction, and no one, really, should be attempting this at home.

Many institutions have decades of experience running LS strategies of every variety and have good answers to (and proven track records of overcoming) the challenges listed here. Don't underestimate the importance of economies of scale: larger organizations tend to get better terms (i.e., lower costs) *and* have larger teams to deal with all the operational issues described above.

At the end of the day, these questions are important and should be asked. And the purveyors of these strategies should not only have good answers but a proven track record of implementing LS strategies successfully and at scale.

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[1] The additional $100 long and $100 short positions are sometimes called "extensions." We will use this language later in this post.

[2] Financing costs fluctuate in the real world for many reasons. Think of this as a loose estimate rather than a permanent, fixed cost. For a more detailed examination of TA LS costs and fees, see Goldberg, L.R., T. Cai, and B. Schneider. 2024. "A Guide to 130/30 Loss Harvesting," Journal of Asset Management vol. 25: 445-459. Note that the costs we use in this paper are meant to be illustrative estimates. Actual negotiated rates may be more favorable. Also note that the overall financing cost is comprised of two components and that, while the authors do not clarify the composition of the spread, for simplicity, we assume that each component is 40bps.

[3] This is also referred to as "margin equity."

[4] Galaxy-brained readers (people who can count) will notice that $39 + $32 does not equal $70. The chart numbers are rounded.

[5] For a typical 200/100 portfolio targeting an annualized TE of around 4.0%, this type of event has an infinitely-small probability of occurring (even if we assume zero pre-tax alpha). This is meant to show that even an extreme black swan negative alpha shock does not *necessarily* lead to a margin call.

[6] Or really poor-quality collateral. Basically, the risk of a margin call is close to zero for well-managed TA LS strategies.

[7] We only say "nearly" because in theory everything is possible — e.g., all the shorts can be recalled at once. In reality, the probability that a short recall has any impact on a quantitative strategy portfolio is effectively zero.

[8] We're talking about alpha over a multi-year horizon. Even a strategy with a positive long-term alpha can experience bouts of weak or bad performance over shorter horizons like a few months or quarters.