

Evaluating Long-Short Tax Aware Managers: Key Questions Investors Should Ask

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Introduction

The long-short tax aware investing landscape has experienced remarkable growth and expansion in recent years - hedge funds, investment managers, and fintech startups are all offering variations of these types of strategies. This growth stems from the potential for long-short tax aware strategies to provide investors with broad U.S. or global equity exposure, meaningful pre-tax alpha, as well as significant tax realization benefits. With the proliferation of so many choices for investors, a structured approach to objectively assess the long-short tax aware landscape is needed. In this article, we introduce a general framework and set of key questions for investors to ask when evaluating the long-short tax-aware landscape.

Our perspective spans two decades of asset & wealth management experience at firms ranging from trillion-dollar investment managers such as PIMCO, bulge bracket Wall St. banks such as Goldman Sachs and J.P. Morgan, as well as newly launched startups such as Simplify Asset Management (\$0 to over \$10B AUM in 5 years). At Dishmi Capital, we are practitioners as well, having implemented long-short tax aware strategies for many clients who are at major inflection points in their financial lives, including navigating an upcoming business sale, diversifying low-basis single stock positions, receiving private equity distributions, and rejuvenating ossified portfolios.

As part of our due diligence process of the long-short tax aware landscape, we evaluated managers from both a quantitative and qualitative perspective. This is meant to serve as general guidance to help investors start their own research and diligence process, and of note, there are many more questions to be asked. We invite readers to join the conversation, and if you're looking to assess the investment merits, potential tax benefits, and operational robustness of long-short tax aware strategies, please read on:

Evaluating Investment Merits: Benchmark Exposures, Tracking Error, and Alpha

Key Questions to Ask:

- What are the various index exposures or benchmarks available through the strategy?
- What are the various leverage or tracking error levels available to investors?
- What is the historical pre-tax outperformance (i.e. pre-tax "alpha") of the strategy versus its benchmark?

We start by evaluating the investment merits of long-short tax aware strategies - tax loss realization is important, but when it comes to investment decisions, letting the tail (tax decisions) wag the dog (portfolio construction) may lead to sub-optimal results. One attractive area of long-short tax aware strategies is that they can provide systematic, active exposure to broad U.S. and global equity indices including the S&P 500, Russell 1000, Russell 3000, and MSCI World, thus serving as a portfolio building block and part of a broader asset allocation. Understanding the different types of exposures offered by

each manager, and how they align with your overall investment goals and objectives is a good place to start when evaluating these strategies. In addition, many long-short tax aware accounts can be finetuned to restrict or hold specific securities, adding a custom touch to each investor's portfolio (more on this later).

Beyond selecting the long-short tax aware strategy's designated benchmark, how much leverage and tracking error to implement is another major decision investors will be faced with. For example, investors may come across long-short tax aware strategies offering leverage ranging from 130% long / 30% short, 145% long / 45% short, 175% long / 75% short, 200% long / 100% short, 225% long / 125% short, 250% long / 150% short, to 300% long / 200% short. These portfolios all have various amounts of leverage, but roughly a 1.0 beta as the long and short extensions net out, approximately. We would note that there is also the possibility to opt for long-short tax aware portfolios with beta less than 1.0, such as a 115% long and 45% short (0.7 beta). For brevity, we'll start by focusing on portfolios targeting a 1.0 beta.

Investors should seek to understand the impact of leverage and tracking error on investment performance and tax loss realization of their long-short tax aware portfolio. With higher tracking error strategies, there is the potential to both significantly outperform *and* underperform, relative to the strategy's designated benchmark. With more leverage, there are higher fees and financing costs, as well as the potential for greater tax realization benefits. Weighing these tradeoffs holistically will help an investor make better decisions on how much leverage and tracking error is appropriate to implement.

Investing in long-short tax aware strategies also entails costs such as management fees, trading costs, and financing costs. These additional expenses should be considered alongside the manager's net of fee outperformance versus its benchmark (i.e. pre-tax alpha). Investors will want to dig in and seek to understand the manager's approach to alpha generation - was the outperformance due to the manager's stock selection process, tactical overweights or underweights, factor tilts, or some other investment decision making process? Does this security selection process make economic sense, is it institutional grade, and does it seem repeatable across a multi-year investment horizon? These are just a few important conversations to have when considering allocating to a long-short tax aware strategy.

Evaluating Tax Realization Potential and Implementation

Key Questions to Ask:

- What is the projected tax loss realization for different levels of leverage and tracking error?
- What types of securities are acceptable for funding an account with, and how will you manage these securities?
- How often do you rebalance? What if I need to withdraw cash to fund my lifestyle, or transfer securities for gifting? Can I switch between different tracking error levels?

Beyond the investment merits, investors will want to focus on tax loss realization potential and the actual implementation of the strategy. Before we dive in here, we would encourage readers to consult a qualified tax professional on all tax related matters given the uniqueness of each individual's tax situation.

When it comes to tax loss realization within long-short tax aware strategies, two of the most impactful decisions an investor will make are:

1. How much leverage and tracking error to implement

2. Funding considerations for the strategy, including which types of securities to fund with and how the manager will manage these securities

In general, higher levels of leverage and tracking error will result in greater tax loss realization. Choice of securities used to fund the strategy will further impact potential tax loss realization. In our research, we found key differences amongst managers in what types of securities are eligible for funding - these may include cash, equities, ADRs, ETFs, mutual funds, U.S. Treasuries, and municipal bonds. Some managers may disallow ETFs with leveraged or inverse, crypto, or municipal bond exposure. There may also be seasoning requirements with securities used to fund these strategies, which may delay implementation. These nuances will vary by manager, and investors will want to confirm acceptable funding sources for their respective long-short tax aware strategy.

In addition, investors may also need to decide how much latitude to permit in the day to day management of the core funding portfolio. Allowing the manager full latitude to manage the funding portfolio (in addition to the long and short extensions), may result in greater tax loss realization. This blended or "integrated" approach may be helpful if funding with cash or a single stock position as the manager will need to tailor the overall positioning of the funding portfolio to be in line with tracking error and benchmark targets. In the event the funding portfolio contains securities with embedded gains, this may temporarily reduce tax loss realization as any losses may get "used up" to diversify the funding portfolio as deemed appropriate by the manager.

In instances where a diversified basket of ETFs or mutual funds is used as a funding portfolio, investors may also have the option to request that only the long and short extensions be actively managed. This "overlay" approach allows the investor to maintain control and active management of the funding portfolio, but may also result in diminished tax loss realization potential.

As most long-short tax aware strategies are managed within separately managed accounts ("SMAs"), investors may also request customizations such as identifying specific stocks to hold, restrict managers from investing in specific stocks, or even avoid entire sub-sectors or sectors entirely. Investors have real time visibility into their long-short tax aware SMAs, and managers may be able to accommodate custom operational requests such as cash withdrawals to fund lifestyle expenses, security transfers to fund philanthropic goals, and adjustments in tracking error levels. These customizations further allow an investor to express his or her views, preferences, goals, and objectives as part of the long-short tax aware investment journey.

Evaluating Trading Operations and Risk Management

Key Questions

- What is the net cost of financing to run the strategy? What does it cost to finance the long extension, and what is the short rebate earned for the short extension?
- What are the management fees and are there any other costs I should be aware of?
- Please describe your experience managing long-short portfolios, including use of portfolio margin. How much in AUM do you manage in long-short tax aware strategies?

Long-short tax aware investors should also aim to assess day to day trading operations, risk management, as well as a firm’s expertise in managing long-short tax aware strategies. A core component of these strategies is the embedded cost of financing, which includes a long extension and short extension. This cost of financing can be broken out into two parts - the cost to finance the long extension, and the cost to finance the short extension. For the long extension, the portfolio may pay a cost of borrowing tied to a floating interest rate benchmark (i.e. Secured Overnight Financing Rate or SOFR), as well as a fixed spread. For the short extension, the portfolio gets paid a floating interest rate benchmark for selling securities short (i.e. “short-sale proceeds”); the portfolio also pays a securities lending fee to borrow stocks to sell short. Established managers with institutional size and scale may be able to negotiate favorable financing costs, which in aggregate net out to tens of basis points in costs to the investor.

While conducting our research, we found that not all managers pay the same financing rates, and in some rare cases, managers may not receive short-sale proceeds. In other words, the investor pays to borrow long, but does not get paid to lend short. With benchmark interest rates such as SOFR currently hovering around 4%, not getting compensated for short-sale proceeds can introduce significant additional costs to investors of these strategies.

Long-short tax aware portfolios also entail non-trivial expenses such as management fees, which often increase with higher levels of tracking error. Strategies with lower levels of tracking error (i.e. 130/30, 145/45, etc.) start at around 45 bps for management fees, while higher levels of tracking error (i.e. 250/150, 300/200) can range from 150-200 bps for management fees. For unique seeding circumstances such as low-basis single stock portfolios where a single stock is restricted from being sold, there may be additional expenses involved as well. As with most things in life, the lowest cost option is not always the best choice - obtaining a comprehensive view of costs and expenses associated with these strategies should help investors make an apples-to-apples comparison and ultimately choose the right solution for their goals and objectives.

Thus far, we’ve covered a lot of ground and will leave the reader with one last topic around evaluating long-short tax aware solutions - how experienced is the manager when it comes to managing long-short portfolios? While it may be disadvantageous to new entrants (of which there are a number of high-quality long-short tax aware managers), one heuristic might be to simply look at the AUM of a manager’s long-short tax aware suite as there is informational value to be gleaned from this data point.

Beyond surface level metrics such as AUM, it’s also worth discussing with the manager how they might navigate a rare left-tail event where both the long and short extensions were to lose value

simultaneously (i.e. an “alpha shock”). A manager’s ability to implement portfolio margin, rebalance portfolios, avoid margin calls, all while navigating choppy markets is par for the course for an institutional caliber long-short manager. At Dishmi Capital, our preference is to work with highly experienced long-short managers who also happen to offer a tax aware solution – for us, the jury is still out on legacy long-only direct indexing/tax-loss harvesting managers who recently launched long-short implementations of their strategies.

Long-short Tax Aware: Experience Matters

In conclusion, we introduced a general framework for assessing long-short tax aware managers, with the goal of helping investors considering these strategies make better and more informed decisions. In our process, having spent hundreds of hours analyzing the long-short tax aware landscape, we arrived at a somewhat obvious conclusion - experience truly matters. Partnering with a long-short manager with a track record of navigating market cycles has many benefits - from lower financing costs, track records of delivering pre-tax alpha, and institutional grade risk management and operations - there are quantitative and qualitative reasons why an experienced long-short manager may outshine an unproven one.

For startup investment managers and legacy long-only direct indexing providers entering the space, we’re eager to learn about the innovations being introduced and maintain an optimistic outlook for these new solutions. Proving out the ability to manage high tracking error long-short accounts, generate pre-tax alpha, as well as building the operational scale to execute these strategies across many accounts are areas investors will likely pay close attention to for the years to come.

About Us

Shang Chou is Co-Founder and Managing Partner of Dishmi Capital, an independent multi-family office focused on tax alpha and alternative investments. Shang has nearly two decades of experience building companies and products in the asset & wealth management industry, as well as a strong track record of advising institutional and ultra-high net worth investors at firms such as Goldman Sachs, J.P. Morgan, and PIMCO.

Shang has played a key role in scaling multiple startup asset management firms from “zero to one”. Prior, he served as Chief Revenue Officer of a London-based active equity manager backed by Index Ventures and Accel. Before that, Shang was one of the first employees at Simplify Asset Management where he played an instrumental role in developing, launching, and marketing over twenty derivatives-based, fixed income, and alternative ETFs, while helping scale Simplify to over \$10B in AUM. He has also served in a strategic capacity to Cache, an asset manager focused on single stock concentration.

Earlier on in his career, Shang was a Vice President at Goldman Sachs where he specialized in portfolio construction, asset allocation, and hedging solutions. He has also held investment management and investment banking roles at J.P. Morgan, PIMCO, and Credit Suisse.

Shang holds a bachelor of science degree from MIT, an MBA from the UCLA Anderson School of Management, and has earned the Certificate in Quantitative Finance (CQF) designation. He serves as an Educational Counselor for MIT Admissions and is active within the MIT Club. He sits on the Advisory Board at the UNLV Lee Business School and is an adjunct professor in the MS program in Quantitative Finance.

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The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market.

The S&P 500 Index, which is a market-capitalization weighted index containing the 500 most widely held companies chosen with respect to market size, liquidity, and industry.

The Dow Jones Industrial Average is a price-weighted index that tracks 30 large, publicly-owned companies trading on the New York Stock Exchange and the Nasdaq.

The MSCI EAFE Index (International Equities) is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 826 constituents, the index covers approximately 85% of the free float adjusted market capitalization in each country. The MSCI EAFE Index is based on the MSCI Global Investable Market Indexes (GIMI) Methodology.