



Tax Matters

Food for Thought: Tracking Error

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A common misconception in health is that “calories are bad.” Similarly, a misconception in investing is that “tracking error is bad.”

Not All Tracking Error Is Created Equal

Calorie counting misses a key point: some foods are better for you than others. A piece of candy and a serving of broccoli may have the same calories, but their impact on health is different. Good nutrition depends not just on how many calories you consume, but also on where those calories come from.

Investing has a similar misconception: “tracking error is bad.” This oversimplification may do investors more harm than good. To beat a benchmark—whether before or after taxes—a strategy must accept some tracking error. And, just as with calories, investors have a choice about the kind they take on in their portfolios.

Tracking error can be thought of as either “rewarded” or “unrewarded”. Rewarded tracking error comes from seeking alpha, where investors deliberately take on risk because they expect compensation for it. By contrast, tracking error without the prospect of alpha is more like “empty calories”—risk with no reward.

Direct Indexing Versus Active Management

Direct Indexing and Active Management both have tracking error, but it comes from very different sources. Direct Indexing is designed to closely mirror a benchmark’s returns before fees, while harvesting tax losses along the way. The trades in these accounts are not made to predict which securities will win or lose; they are driven by whether a position can be sold at a loss for tax benefits. On a pre-tax basis, this type of tracking error is risk without the expectation of added return, which makes it sensible for managers to minimize it. Indeed, in practice, many direct indexing managers successfully keep this uncompensated tracking error low.

On the other hand, active strategies such as tax-aware long-short strategies are built to outperform a benchmark. Here, managers intentionally take positions by buying securities they believe are attractive and selling those they see as unattractive. In this case, tracking error is not incidental but essential—it represents the deliberate risk taken in pursuit of alpha. For these strategies, the objective is not to minimize tracking error, but to take the right amount of it to achieve investment goals. These strategies would take a similar level of tracking error even if tax efficiency were not a consideration.

The distinction can be compared to nutrition. Just as good health depends not on avoiding calories altogether but on consuming the right type and amount, investors aiming to outperform should not avoid tracking error. Instead, they should focus on ensuring their portfolios contain rewarded tracking error, and the right amount, to meet their long-term objectives.

in the implementation of an investor's own analysis and an investor's own view on the topic discussed herein.

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