Factor/Style Investing

How Tax Efficient Are Equity Styles?

July 1, 2011

Chicago Booth Working Paper

Empirical asset pricing studies largely focus on the expected pre-tax real returns of asset classes and equity styles. For a taxable investor, however, the after-tax returns of assets are the critical input for investment decisions. We explore the after-tax performance, tax exposure and tax efficiency of commonly used (both in academia and practice) equity style portfolios. Specifically, we focus on equity styles based on size, value, growth and momentum, which dominate the cross-sectional return landscape.

First, we examine whether the relative after-tax performance of these styles is different than their pre-tax relative performance. Second, we decompose the capital gain, loss and income of each style to identify the drivers of its tax exposure. Finally, we analyze how much after-tax returns can be improved across styles through tax optimization and what the tradeoffs are between tax reduction and tracking error.

Our study focuses mostly on long-only investable "passive" indices from July 1974 to June 2010 (e.g., Russell 1000 and Russell 2000 core market, value and growth indices and AQR Capital Management's U.S. large- and small-capitalization momentum indices). In addition, we also examine portfolios constructed from the Center for Research in Security Prices (CRSP) going back to 1927.

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