

Not Locked Up: Accessing Liquidity in Tax-Aware Portfolios

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Tax-aware long-short strategies have demonstrated the potential to balance pre-tax alpha and tax efficiency, largely by deferring gains rather than realizing them. ¹ Close Krasner et al. (2024). But that same gain deferral can raise a practical question: What happens when an investor needs access to cash? Fully liquidating a tax-aware strategy may trigger capital gains taxes that offset some of the benefits accumulated along the way.

Our latest paper, *Liquidity without Liquidation*, asks whether there is another option. The results suggest that investors may be able to withdraw meaningful amounts of cash without fully liquidating the portfolio or eroding accumulated tax benefits. Critically, across a range of withdrawal scenarios, tax-aware long-short strategies were able to maintain their pre-tax returns, target tracking error, and leverage.

Putting Withdrawals in Perspective

Consider an investor who starts with \$10 million in a 150/50 tax-aware long-short strategy. Beginning at the end of year two, the investor withdraws capital annually, with each withdrawal sized according to how much the portfolio can accommodate while preserving high exposure to the underlying alpha model and managing capital gain realization. The exhibit below shows that, across our simulations, those withdrawals totaled about \$10.2 million on average by the end of year ten. Importantly, that is the cumulative amount withdrawn over time, not a liquidation of the original \$10 million; portfolio growth allows cumulative withdrawals to potentially exceed the amount initially invested.

The same analysis produced average cumulative withdrawals of approximately \$12.4 million for a 200/100 strategy and \$13.9 million for a 250/150 strategy, assuming the same \$10 million starting investment. In general, tax-efficient withdrawal capacity increases with the tracking error and leverage of the strategy.

Simulated Cumulative Withdrawals from Tax-Aware Long-Short Strategies (\$)

Source: AQR. We model three long-short strategies—150/50, 200/100, and 250/150. All strategies are constructed over the Russell 1000 Index universe, use the Russell 1000 Index as the benchmark, and target a beta of 1.0 to this benchmark. The long-short strategies target tracking errors (TEs) of 2%, 4%, and 6% to the benchmark, respectively. The strategies are rebalanced monthly. All dividend income is assumed to be reinvested until the investor makes a withdrawal. Pre-tax returns are computed net of transaction costs and financing costs and gross of management fees. See Liberman et al. (2023) for more details.

However, liquidity needs do not always arrive on a schedule. An investor may instead face a large, one-time expense or another unexpected need for cash. Here, too, the simulations suggest meaningful available capital. For example, a one-time tax-efficient withdrawal from a 150/50 strategy averaged as much as 43% of initial capital after two years. Again, higher-leverage strategies generally supported larger withdrawals. The paper emphasizes that, in all these scenarios, the strategy preserves its pre-tax

characteristics—pre-tax return, tracking error, and leverage.

Why Flexibility Matters

The timing and design of withdrawals can be just as important as their size. Rather than following a fixed schedule that may eventually require capital gains to be realized, an adaptive approach can adjust withdrawal amounts based on the strategy's age, market environment, and capacity at a given point in time: taking more when conditions allow and less when they do not.

There is, however, an important tradeoff. Liquidity has value, but so does staying invested. Our simulations show that, if money left in the tax-aware strategy earns a higher after-tax return than money withdrawn and reinvested elsewhere, tapping the strategy for liquidity has a real cost in terms of cumulative after-tax wealth.

Overall, results show that capital invested in a tax-aware long-short strategy is not permanently locked up. Partial withdrawals have the potential to turn liquidity from an all-or-nothing decision into another consideration that can be incorporated into ongoing portfolio management.

Source: <https://www.aqr.com/Insights/Research/Tax-Aware-Investing/Not-Locked-Up-Accessing-Liquidity-in-Tax-Aware-Portfolios>