Ideas @ Edelweiss Multi Strategy Funds – Post Tax Value & Momentum

Most quantitative analyses of strategies are based on the assumption that investors pay no tax. However, in the new normal world of lower returns, it has become essential to understand the tax impact of active strategies as the income tax department can take a large bite out of your portfolio's returns. In this month's Ideas we illustrate how to think about the interaction of taxation and investing through a stylized example of two of the most common investment styles: value investing and momentum or trend-following.

To keep things simple, we considered a simple long-only market timing strategy that holds either the NIFTY or a liquid fund. The value strategy holds more equities when the NIFTY P/E is low, while the momentum strategy holds a greater percentage in stocks when the NIFTY's past 1 year return is high. NIFTY holdings can range from 0%-100% and the portfolio is rebalanced monthly. We assumed that investors paid short-term capital gains taxes at the current short-term rate of 15.45% on a FIFO basis and no long-term capital gains tax. For the sake of simplicity we assumed the investor incurred no other transaction costs.

Over a 15 year period, the pre-tax return of the value strategy was 13.61% and the post-tax return was 12.37%. In contrast, the momentum strategy had a pre-tax return of 12.99% and a post-tax return of 13.12%. Putting aside the relative efficacies of the two strategies, the value strategy had a significant tax drag of 1.24% per year, whereas the momentum strategy actually had a small tax bounty of 0.13% per annum. The reasons for this difference are the asymmetry of taxation and the fundamental role price plays in both strategies. The value strategy tends to buy when prices fall and sells when prices rise, whereas the momentum strategy does the reverse. The value strategy tends to book more profits while the momentum strategy tends to cut its losses and lets its winners run.

The best advice to avoid the value-tax drag is to rebalance less frequently or to implement the strategy using a non-taxable entity like a mutual fund like the FT Dynamic PE Fund of Funds. In either case, we encourage investors to make taxation intrinsic to their investment decisions rather than something that is superficially evaluated ex-post.