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The Long/Short of It: Understanding Long/Short Direct Indexing

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Tax-aware investing is about more than reducing taxes in a single year. It is about coordinating investment strategy with a client's broader financial plan. In this video, Grimes & Company Senior Investment Analyst Tom Dunlap explains how direct indexing and tax-aware long/short equity strategies can create additional opportunities for tax-loss harvesting, particularly for investors with appreciated assets, recurring capital gains, concentrated stock, or a major liquidity event.
Tom also explores the trade-offs that come with these strategies, including added complexity, leverage, tracking error, and cost. By understanding where long/short strategies may fit, and where a simpler direct indexing or ETF-based approach may make more sense, investors can better evaluate which tools align with their tax profile, time horizon, and long-term wealth management goals.

VIDEO TRANSCRIPTION:

Hi, I'm Tom Dunlap, Senior Investment Analyst at Grimes & Company.

Tax-aware long/short equity strategies are getting a lot of attention right now, and some of that attention is deserved.

For the right client, these strategies can create real planning value, especially when the client is dealing with appreciated assets, recurring capital gains, or a major liquidity event. **But it comes down more to math than magic.**

The goal today is to explain why this topic is gaining attention and how we at Grimes & Company evaluate when these strategies may fit.

Before getting into long/short, it helps to start with the foundation of many tax-aware stock strategies: direct indexing.

Most investors are familiar with index funds or ETFs. You buy a fund, and that fund owns the underlying stocks of a strategy or index and can track it quite closely.

Direct indexing takes a different approach. Instead of owning the fund, an investor owns many, but not all, of the underlying stocks of a specific strategy or index directly, in a separately managed account.

This approach creates two primary benefits.

First, customization. Restrictions can be placed on certain stocks or sectors. And certain factors and segments can be emphasized.

Second, and more importantly for many taxable investors, it creates the ability to harvest losses at the individual security level while still seeking to track the target strategy or index.

Even in a year when the overall market is up, some stocks inside the index will usually be down. A direct indexing strategy can systematically sell positions at a loss, replace them with similar – but not identical – stocks, and preserve the broad market profile.

Those losses can be used to offset gains elsewhere or be carried forward.

That is the appeal: market exposure, customization, and tax management. Long-only direct indexing is not new. It has been used by wealthy investors for decades and remains a powerful tool today.

But there is a limitation.

Over time, especially in a rising market, a long-only direct indexing account can become ossified. That simply means many positions have appreciated, and losses become more difficult to harvest.

That is not necessarily bad, and it is usually years down the road. Tax deferral and reinvested tax savings can still compound over time. But eventually, the loss-harvesting machine can start to run out of fuel.

That is where tax-aware long/short enters the conversation.

A tax-aware long/short strategy builds on the general framework of direct indexing, but adds long and short positions traded on margin.

A common structure "130/30". For every $100 of client capital, the account will hold about $130 of long exposure and short $30 of stocks.

Why do that?

Because the short side can create another source of tax-loss harvesting. If markets rise, short positions may generate losses. If markets fall, the long side may create loss opportunities.

The goal is to create a **more** consistent loss-harvesting engine across different market environments, and potentially for a longer period of time.

That is why these strategies are interesting. They may help clients with recurring capital gains, concentrated stock, a business sale, real estate gains, or a portfolio transition that would otherwise create a large tax bill.

But the key word here is “more.”

Yes, there is potential for more losses. But there is also more complexity, more cost, and more potential tracking error relative to the target strategy or benchmark.

Losses are valuable only if the client can use them. If the client does not have gains to offset, and does not expect future gains, they are paying for complexity they do not need.

There is also a broader investment issue at play: these strategies should not simply be viewed as a loss generating tool. There needs to be a credible investment rationale in the decision making process. That might mean maintaining broad market exposure, reducing concentration risk, improving risk control, or pursuing pre-tax alpha. Tax benefits are important, but they cannot be the only reason a strategy is used.

And the complexity is real.

Long/short strategies involve higher fees, financing costs, tracking error, short-selling risk, liquidity constraints, and more complicated reporting. The exit strategy matters too. Once the tax problem has been addressed, reducing leverage may make sense, but unwinding long and short extensions can itself create tax consequences.

This is why portfolio construction and partner selection matter. There should be a credible investment process driving the portfolio, with objective oversight on leverage, and risk relative to the target benchmark.

So who is the right client for long/short accounts?

In our view, it is typically a taxable investor with meaningful assets, material current or future capital gains, a long time horizon, and enough sophistication to understand the trade-offs.

This tends to be someone selling a business, managing appreciated assets, or financial executives.

Who is it not for?

A client with no gains to offset.

A client who needs liquidity.

Or a client who is uncomfortable with leverage, tracking error, or owning hundreds of underlying positions.

It is also not ideal for someone who actively trades individual stocks outside the strategy, or who has multiple uncoordinated advisors managing individual securities, because wash-sale and tax-coordination issues can become real problems.

Some clients may be better served by long-only direct indexing, or even a simpler ETF-based strategy.

So, the long and short of long/short is this:

Tax-aware long/short SMAs can certainly expand the opportunity set in search of better after-tax outcomes, but the math only works for the right investor, with the right tax profile, time horizon, and expectations.

Not to be overlooked, long-only Direct indexing is an excellent tool for taxable investors who want more control and more tax efficiency than a commingled fund can offer.

The foundation for our analysis is simple: what is the client's long-term planning and investment objective, and what is the simplest set of tools that can help get them there efficiently?

As always, this is not tax, legal, or personalized investment advice. These strategies should be reviewed with a qualified tax professional. For more information, visit grimesco.com. Thank you.