Is momentum tax efficient? Here's what we've learned…

Momentum has long been recognized as one of the best-performing factors in global equity markets. Decades of academic research and real-world implementation have demonstrated its persistence and reliability, whether used as a stand-alone source of alpha or as a complementary component in a diversified multi-factor portfolio. The core principle of momentum investing is straightforward: buy stocks that are currently outperforming and rotate out of those that are underperforming. This approach naturally results in higher portfolio turnover than traditional buy-and-hold strategies, which often invites concerns about the impact of trading costs and taxes on overall returns.

To address the first concern—trading costs—our recent research paper, *Momentum and Trading Costs*, provides compelling evidence that these costs need not erode the momentum premium. When executed with a disciplined focus on liquidity and cost-aware trading techniques, momentum strategies can preserve their alpha, even in the face of higher turnover. This suggests that careful implementation plays a crucial role in mitigating the structural frictions associated with frequent trading.

Often accompanying concerns about trading costs are worries about tax inefficiency. It is a common assumption that momentum strategies, due to their higher turnover, generate frequent taxable events that reduce after-tax returns. This perception has led some investors, particularly those in taxable accounts, to dismiss momentum in favor of lower-turnover alternatives. However, turnover alone is not a reliable proxy for tax efficiency. The tax impact of a strategy depends not only on how frequently securities are traded, but also on how gains and losses are realized during that process. In reality, the manner in which momentum strategies operate can be more tax-efficient than many anticipate.

This point is explored in depth by Ronen Israel and Tobias Moskowitz in their influential working paper, *How Tax Efficient Are Equity Styles?* (2020). Their study compares the after-tax returns of several popular equity styles, including momentum. Surprisingly, they found that momentum and value strategies experience similar effective tax rates, despite momentum exhibiting approximately five times the turnover of value strategies. The key reason lies in the nature of momentum's trading behavior. Momentum tends to realize substantial short-term losses, which can be used to offset taxable capital gains elsewhere in the portfolio. At the same time, it often holds on to winners, deferring gains and thus delaying tax liability. Value strategies, by contrast, while exhibiting lower turnover, tend to produce significant dividend income, which is taxed annually—often at less favorable short-term rates.

An additional layer of tax efficiency emerges when momentum is included within a broader multi-strategy portfolio. The short-term losses realized by momentum can be strategically used to offset gains from other holdings, providing a net tax benefit across the full portfolio. This complementary characteristic reinforces the role momentum can play not only in boosting returns but also in enhancing after-tax outcomes when used alongside other investment styles.

This theme is also addressed in the landmark 2014 paper, *Fact, Fiction, and Momentum Investing*, authored by Clifford Asness, Andrea Frazzini, Ronen Israel, and Tobias Moskowitz. The authors take on several prevailing myths about momentum, including its perceived tax inefficiency. They argue persuasively that, with thoughtful execution, momentum strategies can be implemented in a tax-conscious way that minimizes unnecessary liabilities and enhances net returns.

Further support comes from a 2017 study published by AQR, *Implementing Momentum: What Have We Learned?* This paper analyzes the implementation costs and tax implications of AQR's own live momentum portfolios over a seven-year period. Their findings reinforce the notion that long-only momentum strategies do not have to generate excessive trading costs or tax burdens. In practice, the authors observed that careful optimization and structural decisions can significantly reduce both trading frictions and tax exposure. They conclude that momentum is not only a high-performing factor but also an implementable and practical one for taxable investors.

Taken together, these studies offer a more nuanced and informed view of momentum investing. While the strategy does involve frequent trading, the tax implications are often more favorable than they first appear. By harvesting short-term losses and deferring gains, and by carefully managing exposure to dividends and trading frictions, momentum strategies can achieve levels of tax efficiency comparable to, or even better than, other styles. For investors concerned with after-tax returns, momentum should not be dismissed outright. Instead, it deserves a thoughtful and informed evaluation as part of a well-constructed investment approach.

Tax Efficiency in IMC's Investment Process

At IMC, we have observed that the natural structure of our investment strategy results in higher tax efficiency than typically expected—especially given the elevated turnover rate commonly associated with momentum investing.

Our process emphasizes a disciplined and objective approach to both investment selection and portfolio management. A key component of this process is our sell discipline, which focuses on acknowledging and exiting losing positions quickly when their positive price/fundamental trends decline. By doing so, we frequently realize short-term capital losses, which can serve to offset short-term gains and reduce overall taxable income. This proactive approach to managing underperformers supports the broader tax profile of the strategy.

In contrast, our winners tend to be held for comparatively longer periods. This holding behavior is a byproduct of our philosophy—seeking companies where price trends reflect strong fundamental trends and the potential for accelerated future growth—and our conviction in positions that continue to demonstrate strength. As a result, when gains are ultimately realized, a greater portion of them can be longer term in nature, and thus typically subject to more favorable tax treatment.

We conducted an internal study[1] using our emerging markets small cap and non-US small cap private funds over a nine-year and five-year period, respectively, to better understand the realized tax impact of our strategy. On average, we found that greater than one-half of all net realized gains were long-term. However, the analysis can be dependent on starting points for individual investors and their unique tax considerations should always be analyzed on their own. Still, we believe this analysis does reflect the consistency and repeatability of our methodical process and will likely persist over long periods of time.

Additionally, our emphasis on innovative, financially improving companies naturally leads us to firms with low or no dividend payouts. Lower dividend exposure contributes further to tax efficiency, as dividend income is taxed annually and often at ordinary income rates.

While tax efficiency is not an explicit objective of our investment process, the results of our study—and the structure of our approach—demonstrate that tax-aware outcomes can be achieved through disciplined, systematic investing. Our method of quickly cutting losses, allowing winners to run, and naturally gravitating to low-dividend companies creates a tax profile that can benefit investors, particularly in taxable accounts.

[1] The study was performed by looking at individual investor outcomes in the EAM Emerging Markets Small Cap Fund for the 9 years ending 12/31/2024 and in the EAM International Small Cap Fund for the 5 years ending 12/31/2024. The terms of each study include all completed years of the funds' existence excluding the first year. Representative investors within each fund were selected based who did not have a cashflow event during each year.

About IMC

IMC is solely focused on helping clients build better portfolios through our Informed Momentum investment approach. This approach has been applied consistently across all strategies since the inception of the firm in 2007 (formerly EAM Investors*). The daily application of our systematic process is designed to deliver consistent and predictable results. Since our entire company works for a single objective, it only makes sense to align the name of our brand with exactly what we do every day.

We are **the Informed Momentum Company**.

About the Authors

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Travis is the chief investment officer, responsible for oversight of all of IMC's strategies, as well as a portfolio manager for IMC's US and Global strategies. Travis co-founded The Informed Momentum Company, formerly EAM Investors, in 2007. Prior to that, Travis was a partner, managing director and portfolio manager with Nicholas-Applegate Capital Management where he had lead portfolio management responsibilities for their Micro and Ultra Micro Cap investment strategies and a senior role in the firm's US Micro/Emerging Growth team. He has 27 years of institutional investment experience specializing in momentum-based strategies. He holds an MBA from San Diego State University and a BA in Economics and a BA in Psychology from the University of Arizona.

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David is the director of applied research at IMC. Prior to joining the company in 2021, David was director of research at Denali Advisors, an institutional equity manager with US and Non-US strategies. He has additional experience in research and risk management from Nicholas-Applegate Capital Management. David also serves as an adjunct instructor in the Department of Mathematics at San Diego City College. He has 15 years of investment experience. David received a Ph.D. in Mathematics at the University of California, San Diego, a Master of Science in Applied Mathematics and a Bachelor of Science in Applied Mathematics from San Diego State University. David has published papers in the Journal of Investment Management, Financial Analyst Journal, and Applied Economics, among other financial publications. He has been awarded the "Harry M. Markowitz, Special Distinction Award" from The Journal of Investment Management.

*As of 2/4/2025, EAM Investors, LLC, "EAM" has officially changed its name to The Informed Momentum Company, "IMC". This name change does not impact the integrity or content of the research, reports, or any materials previously published under the old name. All references to "EAM" in past publications and reports now refer to "IMC".