
WHITEPAPER

FLEX SMAs AND TAX-AWARE LONG-SHORT INVESTING STRATEGIES

WITHIN

ULTRA TAX EFFICIENT WEALTH MANAGEMENT® (UTEWM®)

Executive Summary

Hendershott Wealth Management® now offers a powerful investing strategy in partnership with AQR Capital Management: a tax-aware long-short (TALS) strategy, known as Flex SMA, designed to help high-net-worth investors minimize capital gains tax drag and maximize long-term wealth growth.

This strategy leverages a market-neutral, long-short equity approach in an effort to generate tax losses without increasing portfolio exposure or risk. This is the keystone offering in our broader Ultra Tax Efficient Wealth Management® (UTEWM®) service, and is available for investors with \$1.25M+ in taxable assets who want to minimize tax drag, preserve their wealth, and unlock more financial flexibility.

Key anticipated benefits of Flex SMA:

- Defers capital gains taxes indefinitely, enhancing long-term compounding
- Generates consistent tax losses to offset taxable gains
- Enables flexible rebalancing without triggering unnecessary tax liabilities
- Allows investors to diversify concentrated stock positions while minimizing the impact of large taxable events
- Has the potential to save investors millions in taxes over time compared to traditional strategies



By leveraging tax-aware long-short strategies like Flex SMAs, investors can strategically minimize tax drag, enhance portfolio growth, and preserve more of their wealth for the future.

In addition to comprehensive wealth management, Hendershott Wealth Management® (HWM®) is now offering a tax-aware long-short investing strategy powered by AQR's Flex SMAs to suitable clients with \$1.25M+ in taxable assets.

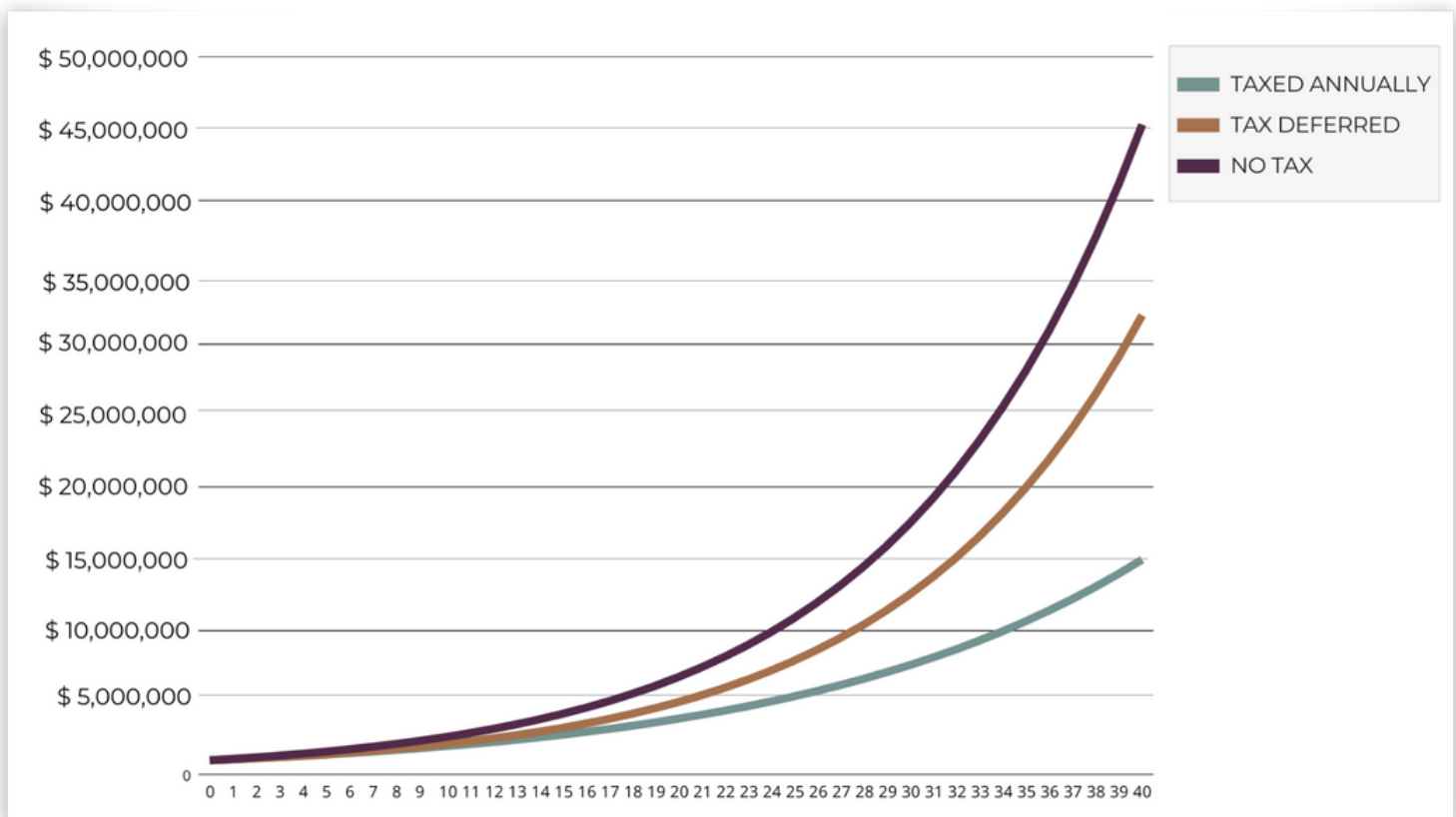
Tax Deferral As A Wealth Building Tool

Tax efficiency matters when building wealth, and there are many strategies investors can use to create those efficiencies.

For example, taxes on capital gains are deferred until an asset is sold. Tax deferral, available to all HWM clients, is a powerful tool for building wealth. As shown below, over a long holding period, deferring taxes (and paying them when the gains are realized at the end of the period) leads to significantly more net worth for investors than paying taxes annually.

THE POWER OF TAX DEFERRAL

\$1m Portfolio: End value over different holding periods
(assumes 10% pre-tax annual return and 30% tax rate)



The graph above is an illustration of mathematical principles used to demonstrate the impact of taxes and compounding on returns. Returns and tax rates are not reflective of any actual or expected investment outcomes or tax rates. Actual results cannot be guaranteed and will vary.

SOURCE: HWM calculations (available upon request)

Deferring taxes magnifies the already powerful benefit of compounded returns over a long period of time.

The Downside of Tax Deferral

The downside of tax deferral is that in order to continue to enjoy the benefits, the assets have to be held over the investor's lifetime—taking rebalancing, reallocation, and the opportunity to enjoy spending your growing wealth off the table.

It would be appropriate to perceive this as an unacceptable cost. Yet most investors have grown accustomed to it because until now, there has been no other way to avoid losing meaningful portions of wealth to taxes.



Tax-Loss Harvesting

Another option, assuming you have multiple holdings in your investment (such as a basket of stocks versus single address real estate), is tax-loss harvesting, which is an important strategy for selling appreciated assets while minimizing the associated tax bill.

Tax-loss harvesting involves selling positions with values below their original cost and using these losses to offset realized gains.

At Hendershott Wealth Management we have employed tax-loss harvesting for years on behalf of our clients when conditions permit.

However, traditional tax-loss harvesting is generally limited to times of market weakness—and by the fact that the stock market tends to go up over time.

Eventually, and sometimes very quickly, we expect all of HWM's client positions to have substantial unrealized gains, eliminating the opportunity to tax-loss harvest altogether.

Tax deferral and tax-loss harvesting are powerful tools for building wealth and increasing tax efficiency, but they have limitations.

That's why we're excited to share that Hendershott Wealth Management is now able to offer our clients a potentially much more effective way to reduce capital gains taxes.

The tax-aware long-short strategy is the keystone offering within our Ultra Tax Efficient Wealth Management® (UTEWM®) services. It is a highly effective, time-tested, systematic investment approach that's implemented by a third party manager in a separately managed account.

Powered by AQR Management's Flex SMAs, the strategy uses long-short equity strategies to allow investors to compound wealth more efficiently, and has been developed over 25 years of investment management research and experience.

Tax-aware long-short aims to generate market-like portfolio returns in a strategy which includes short positions that produce consistent tax losses. The overall strategy is a sophisticated market-neutral, long-short portfolio overlay, including actively harvested tax losses at the security level.

Let's illustrate what we mean by this with a simplified example.

Imagine you made two bets: one \$5 bet that it will rain tomorrow, and one \$5 bet that it will not rain tomorrow. When tomorrow comes, you are guaranteed to win one bet and lose the other.

In the real world, this win/loss would cancel each other out and you'd end up with \$0. But when it comes to taxes, the accounting is done a little differently.

In an investment account, you can recognize the loss and use it to offset wins elsewhere, canceling out the taxes you would have had to pay on those wins—while NOT realizing the gains from your winning rain bet.

Your pair of rain bets broke even, but according to the IRS (assuming you harvest the loss), you lost money.

The simple example of betting on whether or not it will rain would get resolved and paid out almost immediately.

The winning rain bet triggers a “realized gain” that would offset the losing rain bet—you would hand someone a \$5 bill to pay them for your losing bet, and someone else would hand you a different \$5 bill to pay you for your winning bet. Both your bank account and your tax return are unchanged.

But when it comes to financial investments, things are different.



When you own stocks, you generally have winners and losers—and when you have both long and short positions, you are pretty much guaranteed to have winners and losers whether the market is rising or falling.

Flex SMA takes advantage of these perennial market characteristics:

1. Some individual stocks will fall despite a rising market.
2. Most short positions incur losses in a rising market.
3. Many long positions incur losses in a falling market.

Like the rain bet, you are set up to win some and lose some. Unlike the rain bet, you can control when you take both the losses and the gains.

By being extremely tax aware, Flex SMAs allow investors to realize losses quickly while deferring gains indefinitely—and as we saw illustrated in the chart above, tax deferral has a big impact on long-term wealth building.

Let's apply this theory to a hypothetical investor with a \$2 million diversified portfolio in a year where the market goes up 10%.

Ignoring dividends and not selling any positions, this investor is able to defer the \$200,000 gain and pay no taxes—but a tax-aware long-short strategy can do better.

To accomplish the strategy, the third party manager might add a \$2 million long-short overlay to the core \$2 million portfolio. On behalf of the investor, the manager would use leverage to finance a \$1 million S&P 500 ETF short position along with \$1M invested in the 500 individual stocks comprising the S&P 500.

The net result is the account contains the same stocks both long and short. The investor will then hold these two leveraged positions in addition to the \$2 million diversified portfolio (\$4 million in gross positions).

The leveraged long and short positions are “market neutral”, meaning the combination makes zero profit regardless of what happens in the stock market.

If the market goes up, the short sale loses money but the individual stocks make money. If the market goes down, the short position makes money, but the individual stocks lose the same amount.

The market-neutral long-short overlay is designed to have no impact on portfolio returns. Our \$2 million investor still has \$200,000 in gains after a 10% positive year.

There are, however, losses embedded in parts of the overlay, even when the market goes up. If the broad market returns 10%, the short ETF position loses \$100k (offset, of course, by \$100k of profit from the 500 individual long positions).

Further, although the broad market is up, history suggests many of the 500 individual stocks may be down. For the purposes of this example, we are using a 75/25 ratio (positive returns to negative returns), which means within the long overlay, there will be \$150k of profits and \$50k of losses (aggregating to the \$100k gain).



Selling the stocks that have declined along with closing out the short position in this example creates \$150k in losses despite the overall portfolio having a \$200k gain!

Of course, in this tax efficient example the investor's portfolio now has \$350k of deferred gains (\$200k from the core portfolio of diversified mutual funds and ETFs plus \$100k from the long overlay) instead of \$200k—so if the investor liquidates their entire portfolio after a year, there is no tax benefit.

But as we saw in our earlier example, if the investor continues to defer these gains, the effective tax rate falls over time: after 40 years it drops from 30% to single digits. Additionally, the step-up in basis currently available on inheritances makes it possible for future generations to avoid taxes altogether. The effective tax rate is the rate that, if paid annually on investment gains, produces the same value after 40 years as paying 30% on gains all at the end.



In practice, Flex SMAs supercharge this simplified example by using individual positions on both sides of the market-neutral long-short overlay as well as potentially trading in the core portfolio.

AQR's Flex SMA utilizes sophisticated technology that allows investment professionals to closely monitor the separately managed accounts.

There are modest fees associated with financing, managing, and trading the strategy, but for suitable investors, the tax benefits of a well-designed tax-aware long-short strategy may vastly outweigh the costs.

While the strategy has expected fees of roughly 0.6% of the account balance per year, the incremental returns on the long-short overlay are expected to offset the fees and expenses associated with the strategy.

Who is a suitable client for Ultra Tax Efficient Wealth Management®?

Flex SMA is particularly valuable for investors with large, concentrated, and highly-appreciated stock positions that they need to diversify over time.

For example, let's look at another hypothetical investor: an early employee at a successful Silicon Valley startup.

Around the time of the startup's IPO, this investor has \$16m of a single stock that is virtually all unrealized gains—plus \$4m in other financial assets.

The individual's investment portfolio, with 80% in a single stock, is very risky. However, realizing the deferred gains to diversify is very expensive; selling one half of the single stock position could trigger almost \$3m of capital gain taxes in a high-tax state like California—and the portfolio would still be risky!

In these cases, realizing capital gains has a large diversification benefit but sacrifices the large tax deferral benefit.

It seems like you can't have your cake and eat it too... *but you can!*

Flex SMAs provide a path for investors to get the benefits of diversification without bearing the large tax cost from realizing gains.

Remember: The market neutral long-short overlay can be expected to consistently generate realized losses. These losses can be “banked” indefinitely, and used to offset harvested gains that are strategically timed and cancel one another out—the net result being \$0 in tax.

Under reasonable assumptions, in this example a steady, conservative rebalancing has the single stock down to 42% of the investor's portfolio in a decade—with the \$20m portfolio (\$16m in the single stock; \$4m in a diversified portfolio) growing to \$50.3m (\$21m in the single stock; \$29.3m in the diversified portfolio) assuming 10% annual appreciation.



Of course, this hypothetical investor could diversify over time without a tax strategy, sacrificing the benefits to avoid the costs. However, this is likely to produce significantly inferior results.

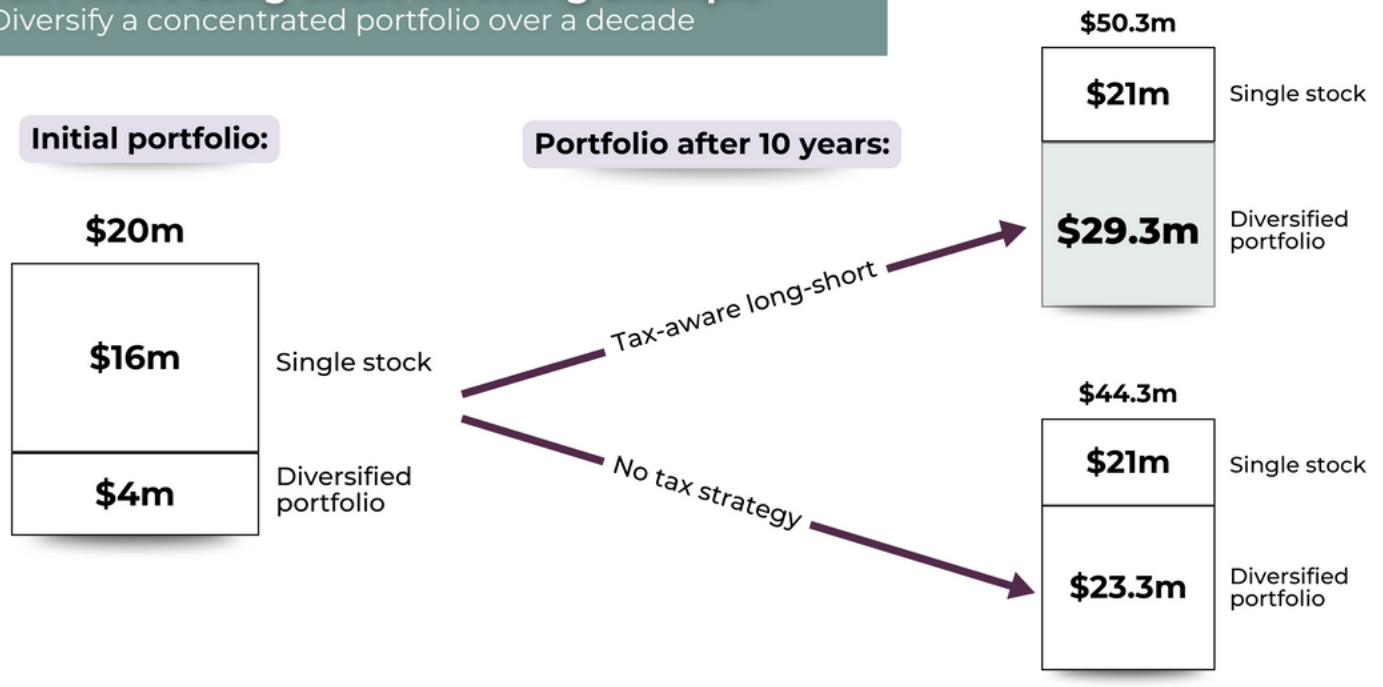
The exact same rebalancing example as above—without a tax-aware long-short strategy—yields a \$44.3 million portfolio (\$21 million in the single stock; \$23.3 million in the diversified portfolio) after a decade.

Compare these identical diversifying single stock sales over time with the Flex SMA strategy, which produces a more well-diversified portfolio that is \$6 million larger after 10 years (*after accounting for incremental annual costs and ignoring the incremental return the strategy is designed to provide*).

When diversifying a concentrated stock portfolio, the benefits of executing a tax-aware long-short strategy can be expected to greatly exceed the costs.

Tax-Aware Long-Short Investing Example

Diversify a concentrated portfolio over a decade



Example assumes 10% appreciation on investments and a 37% tax rate on realized capital gains. Tax efficiency is a function of market conditions - the example savings cannot be guaranteed. The Tax-Aware Long-Short Investing example includes 90bps in annual costs covering financing, management and trading. Returns and tax benefits are not actual or promised investment outcomes or tax regimes. Actual results will vary with market conditions and cannot be guaranteed.

The graph above is an illustration of mathematical principles used to demonstrate the impact of taxes and compounding on returns. Returns and tax rates are not reflective of any actual or expected investment outcomes or tax rates. Actual results cannot be guaranteed and will vary.
SOURCE: HWM calculations (available upon request)

Further, these benefits compound over time: continuing the same approach and assumptions, the concentrated stock is completely sold after 18 years with no net realized capital gains—that is, no capital gains taxes paid.

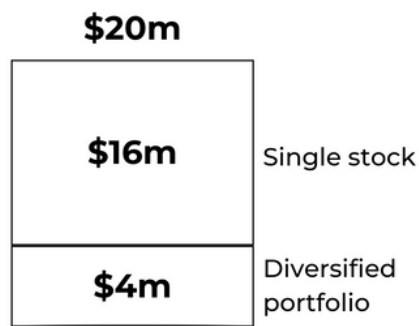
At this point the investor in our example has a \$102.6 million diversified portfolio using Flex SMA versus having a \$78.3 million diversified portfolio without a tax strategy.

These results are as if the investor saved over \$24 million in capital gains taxes over time!

Tax-Aware Long-Short (TALS) Example

Fully diversify a concentrated portfolio over 18 years

Initial portfolio:



Portfolio after 18 years:

Tax-aware long-short

No tax strategy

\$102.6m

\$78.3m

Example assumes 10% appreciation on investments and a 37% tax rate on realized capital gains. Tax efficiency is a function of market conditions - the example savings cannot be guaranteed. The Tax-Aware Long-Short example includes 90bps in annual costs covering financing, management and trading.

The graph above is an illustration of mathematical principles used to demonstrate the impact of taxes and compounding on returns. Returns and tax rates are not reflective of any actual or expected investment outcomes or tax rates. Actual results cannot be guaranteed and will vary. SOURCE: HWM calculations (available upon request)

Tax-aware long-short overlays can also benefit diversified, highly-appreciated stock portfolios.

While there are other strategies for accessing the value of an appreciated stock portfolio without generating a large tax bill (for example, borrowing against securities) none offer the efficacy of Flex SMAs—particularly at current interest rates.

Further, Flex SMAs add a powerful tax planning dimension for other forms of capital gains like selling a business or highly-appreciated real estate.

Each of these situations calls for somewhat different tax strategies. We're here to help you find the one that fits your circumstances—and keeps your money in your accounts.

Implementation & Lifecycle: How Flex SMA Works in Practice

While the tax-aware long-short strategy used in Flex SMA is grounded in sophisticated portfolio construction, the experience for investors is designed to be straightforward—and personalized.

Here's how it works:

Account Setup & Strategy Activation

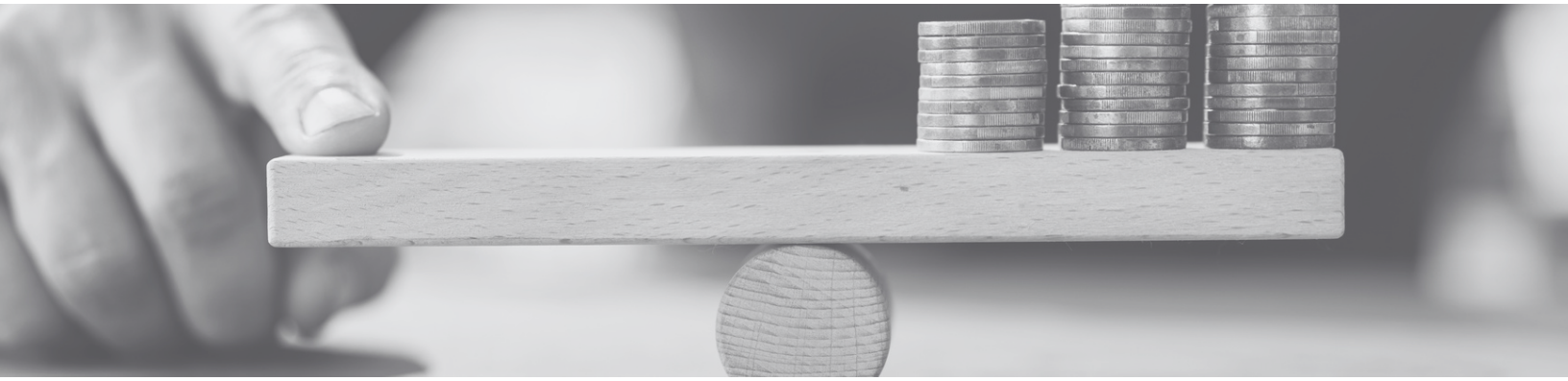
When a client elects to use Flex SMA, Hendershott Wealth Management® opens a separately managed account (SMA) on their behalf, typically at Fidelity. The portfolio is then implemented by AQR Capital Management, the third-party institutional asset manager who designed and oversees the strategy.



The SMA includes:

- A long overlay, created by purchasing individual stocks
- A short overlay, using a distinct set of individual stocks intended to lag those in the long overlay
- Tax-aware trading rules that continuously harvest losses from individual positions in both overlays

These components are engineered to work together in a market-neutral, rules-based way, minimizing risk while maximizing tax efficiency.



Selecting the Right Amount of Leverage

Unlike traditional strategies where leverage decisions are made behind the scenes, Flex SMA offers a customizable range of leverage—typically between 0.5x and 2x the investor's base portfolio. This decision is made collaboratively between Hendershott Wealth Management and you, the client.

Factors that influence leverage selection include:

- Timing and size of capital gains (e.g., from a business sale, equity comp, or real estate event)
- Tax bracket and exposure
- Cash flow needs and future liquidity events
- Risk tolerance and long-term goals



We may adjust the leverage throughout the year depending on when the gains occur and how much tax offset is needed. For example, an investor who sells a business in January may benefit from more aggressive leverage early in the year, then gradually scale down.

The Lifecycle: From Setup to Legacy

The power of Flex SMA lies in how it performs across the full lifecycle of an investor's financial plan—not just in a single tax year.

Year 1–3: Tax Offset & Transition

- Flex SMA generates realized losses while core holdings are carefully transitioned or rebalanced.
- Capital gains are offset strategically, helping investors diversify without triggering large tax bills.

Years 4–10: Long-Term Deferral & Growth

- Losses are “banked” for future use.
- Gains continue compounding without triggering taxation.
- Flex SMA continues to harvest tax losses—even in up markets.

Beyond Year 10: Legacy & Liquidation

- Investors can realize gains in a tax-managed way.
- Tax loss reserves may be used to offset RMDs, gifting, or portfolio rebalancing.
- Heirs may benefit from step-up in basis and legacy tax efficiency.

Throughout this entire process, Hendershott Wealth Management serves as your strategic advisor and implementation partner. While AQR manages the day-to-day execution of the strategy, our team stays closely involved in:

- Reviewing annual tax returns
- Managing leverage and timing decisions
- Coordinating with estate planning and charitable giving strategies
- Helping you make informed, tax-aware decisions for decades to come

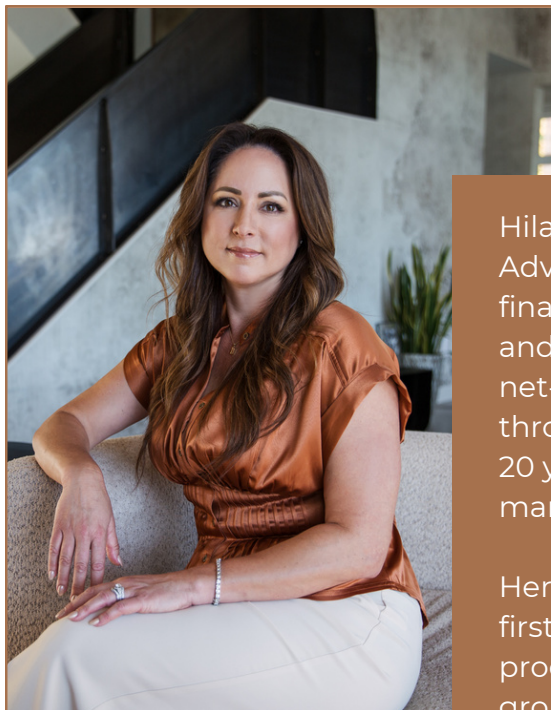
These services are part of our Ultra Tax Efficient Wealth Management® suite, available to all Hendershott Wealth Management clients.

To find out if you're a suitable client for tax-aware long-short strategies within UTEWM®, [get in touch](#).



At Hendershott Wealth Management, we're happy to consult on how this powerful, tax-optimized approach that the super rich have been using to build wealth for nearly a decade can work in your situation.

SCHEDULE YOUR INITIAL CALL TODAY

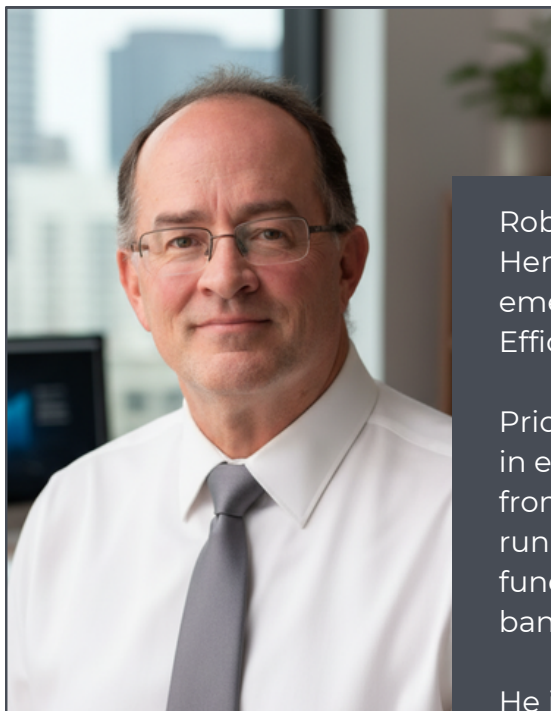


HILARY HENDERSHOTT®, MBA, CFP®

Founder & Chief Advisor

Hilary Hendershott, MBA, CFP®, is the founder and Chief Advisor at Hendershott Wealth Management®, a fee-only financial advisory firm specializing in empowering women and couples to achieve financial freedom and helping high-net-worth clients take a tax-aware approach to investing through Ultra Tax Efficient Wealth Management®. For over 20 years, Hilary has helped clients simplify money management, reduce financial stress, and grow their wealth.

Her obligation as a fiduciary places her clients' best interests first, minimizes conflicts of interest, and is void of proprietary product sales or insurance commissions. Her approach, grounded in evidence, expertise, and compassion, centers on making the complex world of finance accessible and actionable, and has led to a 93.96% retention rate of her high-net-worth clients over the last 5 years.



ROBERT HENDERSHOTT, PH.D.

Chief Investment Officer

Robert Hendershott is the Chief Investment Officer at Hendershott Wealth Management®, having recently emerged from partial retirement to support the Ultra Tax Efficient Wealth Management® initiative.

Prior to that partial retirement, he put his bachelor's degree in electrical engineering from Stanford and PhD in Finance from The Ohio State to work for 26 years founding and running a series of successful private equity and hedge funds. He has published finance papers based on research in bank consolidation, venture capital, and real estate.

He is a tenured professor of 30+ years at Santa Clara University, albeit in a reduced role, and is now thrilled to leverage both his education and career experience to champion HWM clients supercharging their wealth building.

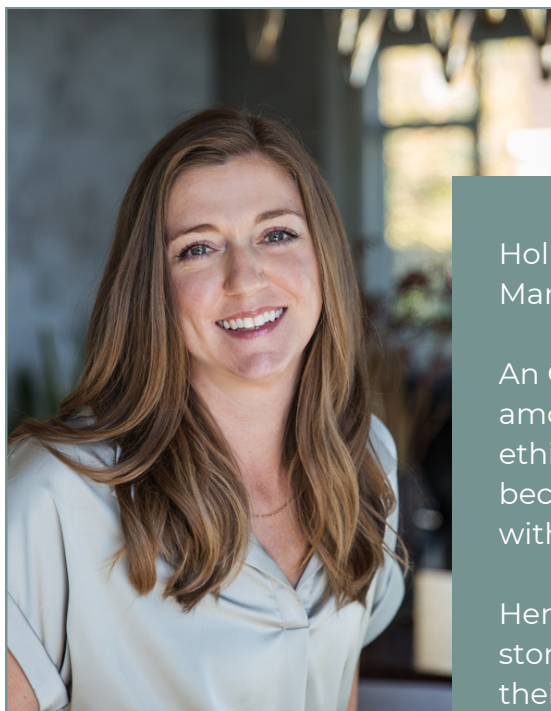
**JEN RUPP, CFP®**

Senior Financial Advisor and Director of Financial Planning

Jen Rupp is Senior Financial Advisor and Director of Financial Planning at Hendershott Wealth Management®.

The first female to graduate from Bethel College with her particular degree in Economics and Finance with a minor in Accounting, she spent 12 years serving clients through an independent wealth management firm in Indiana before joining the HWM team in 2017.

Her expertise in numbers and passion for being the conduit for positive financial outcomes in people's lives had led her to impact countless clients' lives through strategic financial planning.

**HOLLINA WADSWORTH, CFP®, MSFS**

Lead Advisor

Hollina Wadsworth joined the Hendershott Wealth Management® team as a Lead Advisor in 2024.

An Oregonian born and raised in a town of 1,000 people amongst seven siblings, she learned the importance of work ethic at a young age, putting herself through college and becoming a CERTIFIED FINANCIAL PLANNER® professional with a Master's of Science in Personal Financial Planning.

Her fascination for—and expertise in—finances centers clients' stories and personal goals in creating financial plans that suit their best interests.

Disclaimer:

All investing involves risk, including the potential loss of principal. There is no guarantee that any investment plan or strategy will be successful. Advisory services provided by Hendershott Wealth Management, LLC ® ("HWM ®"), an investment advisor registered with the U.S. Securities and Exchange Commission. Registration does not imply a certain level of skill or training.

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All examples in this document are strictly illustrations of mathematical principles, not actual or hypothetical returns. These illustrations have many inherent limitations, some of which, but not all are described herein. No representation is being made that any fund or account will or is likely to achieve profits or losses similar to those shown herein. In fact, there will likely be sharp differences between these illustrations and actual results subsequently realized by any particular trading program. Illustrations do not account for market volatility or the impact of financial risk that is experienced during actual trading.

The realized tax benefits associated with the tax-aware strategy may be less than expected or may not materialize due to the economic performance of the strategy, an investor's particular circumstances, prospective or retroactive change in applicable tax law, and/or a successful challenge by the IRS. In the case of an IRS challenge, penalties may apply.

There is no guarantee, express or implied, that long-term return and/or volatility targets will be achieved. Realized returns and/or volatility may come in higher or lower than expected. There is a risk of substantial loss associated with trading commodities, futures, options, derivatives and other financial instruments. Before trading, investors should carefully consider their financial position and risk tolerance to determine if the proposed trading style is appropriate. When trading these instruments, one could lose the full balance of their account. It is also possible to lose more than the initial deposit when trading derivatives and using leverage. All funds committed to such a trading strategy should be purely risk capital.

Shares of appreciated assets cannot be restricted and must be unencumbered. Security must have a minimum market cap of \$1B and be a constituent of the Russell 3000 Index. Investment minimums apply. The investment strategy and themes discussed herein may be unsuitable for investors depending on their specific investment objectives and financial situation.