“Portfolio Choice with Capital Gain Taxation and the Limited Use of Losses”

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Abstract

We study portfolio choice with multiple stocks and capital gain taxation assuming that capital Losses can only be used to offset current or future realized capital gains. We show both numerically and through a back testing analysis that average optimal equity holdings are significantly lower compared to the case typically studied in the literature where the use of capital losses is unrestricted. With low diversification benefits or high embedded capital gains, allocations remain under-diversified even if embedded capital losses are sufficient to offset the gains.

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