Municipal Bonds | Taxes

It's always tax-loss harvesting season

By: Nisha Patel, CFA | May 4, 2021

New York - Investors occasionally look to their municipal bond portfolio for loss-harvesting[1] opportunities that help to reduce the impact of capital gains taxes on portfolio returns. All too often, this occurs only toward year-end. As bonds have limited replacement options and typically wider bid-ask spreads, the tax alpha generated at the end of the year is likely below potential.

We frequently see that the economic loss of selling out of positions at an inopportune time may eliminate any tax benefit. More optimal results can be achieved by partnering with a professional manager and harvesting losses throughout the year, rather than just at year-end.

Why harvest losses year-round?

More favorable liquidity. Historically, the last few weeks of the year experience lower trading volume. Market participants who operate on a calendar year generally reduce activity during this time, and overall liquidity suffers. High liquidity costs can sometimes erode or outweigh the tax benefit of harvesting the loss. Minimizing transaction costs helps maximize tax alpha.

Access to attractive replacements. Typically, issuance slows at year-end as well. Trading throughout the full year may present more opportunities to access the new-issue market when replacing sales. An active new-issue supply helps get cash reinvested more quickly and increases the likelihood of finding bonds with similar relative value to those sold. Access to a wider variety of bonds may also prevent wash-sale rule violations and could ensure that investors maintain portfolio characteristics.

Optimized timing of sales. An optimal tax-loss harvesting strategy monitors positions daily and wastes no opportunity. If tax-loss selling takes place only at year-end, investors may miss opportunities resulting from yield fluctuations throughout the year. Over the past 25 years, the yearly peak in municipal yields has occurred in December only twice: 2020 and 2016.

Efficiency and scale. Not only can year-round loss harvesting boost after-tax total return potential, but it can also increase scale and efficiency for the advisor and client. Opting into professional, continuous monitoring of individual securities eliminates the need for the advisor to make year-end manual requests, which can be time consuming and labor intensive. Clients tend to benefit from the time and attention focused on identifying opportunities and the superior execution a manager can provide.

Ongoing year-round tax-loss harvesting seeks to provide additional tax alpha by looking to minimize capital gains taxes. An active, data-driven tax-loss management strategy aims to maximize loss-harvesting opportunities and minimize costs. Careful analysis of each trade helps ensure that portfolios maintain their structure and characteristics without violating wash-sale rules.

Bottom line: A professionally implemented rules-based tax-loss harvesting strategy may help investors to better capitalize on loss-harvesting opportunities throughout the year, rather than just at year-end. This can eliminate the hassle of year-end manual requests while also seeking to optimize the timing of sales for potentially more favorable liquidity and new-issue volume. A year-round tax-loss harvesting strategy may assist with delivering tax alpha while maintaining desired exposure to the asset class at no additional cost.

1. Tax loss harvesting is a strategy for managing taxes in an investment portfolio. Selling a security that's trading at a loss creates a realized tax loss, which can be used to offset a capital gain realized in the same year.

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Tax-loss harvesting involves certain risks including, among others, the risk that the new investment could perform worse than the original investment and that transaction cost could offset the tax benefit. There may also be unintended tax implications. Investors should consult with their own tax or legal advisor prior to entering into any transaction or strategy described herein.

All investments are subject to risk, including the risk of loss.

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Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risks. The value of most bonds and bond strategies is impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low-interest-rate environment increases this risk.

Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax; a strategy concentrating in a single or limited number of states is subject to greater risk of adverse economic conditions and regulatory changes.

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"Many investors implement a year-end tax-loss harvesting strategy with their municipal bond portfolios. Limiting loss harvesting to year-end, however, can reduce the benefits. It may be time to implement a managed year-round tax-loss harvesting strategy instead."