Systematic Tax-Loss Harvesting in Laddered Bond Portfolios

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When it comes to building customized laddered municipal and corporate bond portfolios, the array of options continues to broaden, particularly with the growth of ESG investing. However, one of the most frequently selected customizations remains tax-loss harvesting (TLH).

Systematic TLH is designed to provide investors with a meaningful way to enhance performance by offsetting taxes on realized gains, thereby helping investors stay more fully invested and generate larger compounded returns.

Key takeaways

» Year-round systematic TLH helps identify opportunities to generate capital losses and lower investors' tax bills.

» Custom fixed income SMAs provide TLH opportunities under various interest rate scenarios in ways ETFs and mutual funds simply can't.

» Systematic TLH is a thorough analysis of liquidity, yield, and structure on a bond-by-bond basis intended to capture losses while maintaining a portfolio's risk profile and to avoid triggering potential wash sales.

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Tax-loss harvesting: SMAs can, ETFs can't

While TLH has become mainstream for equity investors, it has remained an elusive benefit for fixed income investors. As this paper shows, systematic TLH can enhance after-tax performance in laddered separately managed accounts (SMAs). In fact, TLH is a powerful tax-mitigation feature available in SMAs that isn't available through traditional passive vehicles such as ETFs or mutual funds. Losses realized in SMAs can be used to offset the account holder's realized capital gains, whereas mutual fund and ETF losses are trapped in the fund vehicle and don't pass through to the investor.

Some asset managers offer a degree of tax management for fixed income portfolios, typically targeting TLH opportunities at year-end. However, most managers remain passive with regard to taxes while being active in their security selection.

Yet the opportunity for TLH in fixed income exists under all interest rate scenarios, whether they're rising, falling, or fluctuating. When interest rates remain flat or decline, loss-harvesting opportunities are primarily isolated and related to credit events. When interest rates rise, loss-harvesting opportunities expand, since fixed income prices in general fall when rates rise.

How systematic tax-loss harvesting works for fixed income portfolios

Systematic TLH involves regular, year-round portfolio monitoring to identify individual tax lots of securities for which a current sell would generate a capital loss. Once the portfolio is fully invested and aligned to its target, the tax-management process can begin. This entails monitoring the holdings regularly for losses as well as undesirable changes in risk exposures. The portfolio manager then executes sell transactions to realize capital losses and acquires suitable replacement securities. This activity is even more valuable when there are realized capital gains elsewhere in the investor's overall portfolio.

The frequency of loss harvesting will fluctuate depending on the market and interest rate environment. A trade is made only if the tax benefit well exceeds the transaction costs. The systematic TLH strategy is intended to capture losses while maintaining a portfolio's risk profile in terms of criteria such as duration, yield, credit quality, and state (where applicable). All trades executed for tax-loss reasons should adhere to applicable trading procedures, including "best execution." Each trade should be executed in the context of current ladders-trading workflows, with proper price-sensitivity considerations in place.

There are significant downsides to approaching tax-loss harvesting on an ad hoc basis in response to investor requests. Investors tend to ask for TLH in December, when the holidays challenge access to liquidity; worse, rates have only been highest in December twice since 1992 (as of June 2022). Furthermore, clients holding the same CUSIPs often submit requests at different times, resulting in the sales of small positions and higher transaction costs. On the other hand, the systematic approach offers the ability to capture losses at the highest rates throughout the year, with maximum access to liquidity and programmatic execution.

The tax benefit varies based on the character of the realized capital loss (short or long term) and the account holder's combined (federal, state, and local) capital gains tax rate. Depending on the investor's goals, specific tax-management techniques for fixed income securities may include:

- Amortizing premiums to reduce the annual taxes due on coupon payments
- Deferring discounts until maturity, when they're recognized as ordinary income
- Offsetting short-term gains elsewhere in the portfolio with realized short- or long-term losses in the laddered bond portfolio

Quantifying the benefit

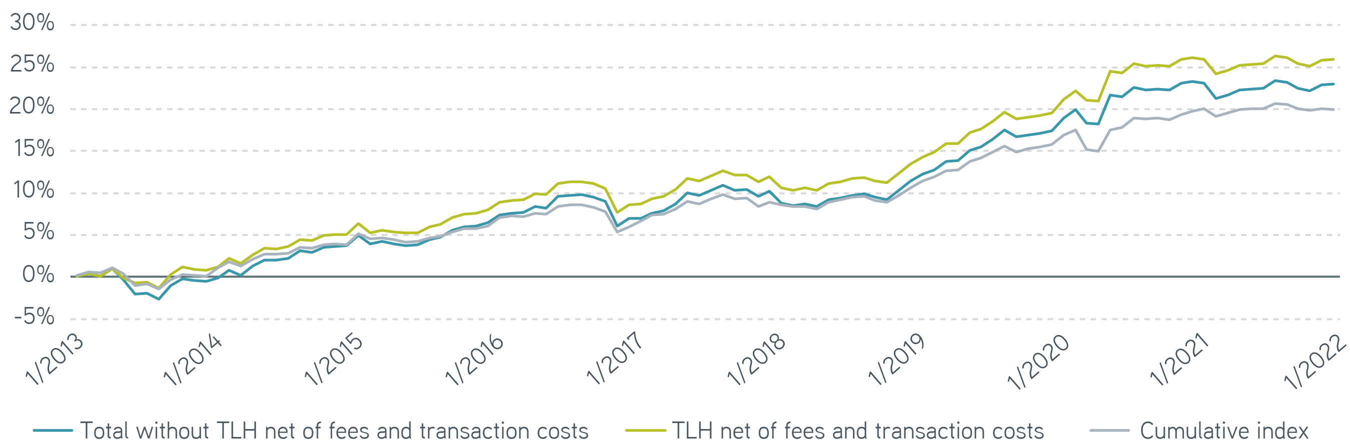
To put some numbers behind the expected alpha generated from systematic TLH, we backtested nine years of performance (2013 through 2021) using a one-to-10-year laddered municipal portfolio as an example (see figure 1), benchmarked against the Bloomberg MM Short-Intermediate 1–10 Year Index. Using the process outlined below, the portfolio generated an additional tax alpha—defined as the excess return generated through techniques that may reduce the investor's taxable income—of 294 basis points (bps), or 33 bps annually.

We also backtested nine years of performance (2013 through 2021) using a one-to-10-year laddered corporate portfolio (see figure 2), benchmarking it against the ICE BofA 1–10 Year US Corporate Bond Index. Using the same process outlined above, the portfolios generated an additional tax alpha of 159 bps over nine years, or 18 bps annually.

Conclusion

A systematic process for TLH helps managers efficiently identify appropriate securities and perform a thorough analysis of their liquidity, yield, and structure on a bond-by-bond basis while avoiding triggering potential wash sales. By taking this approach, investors can benefit from improved after-tax performance.

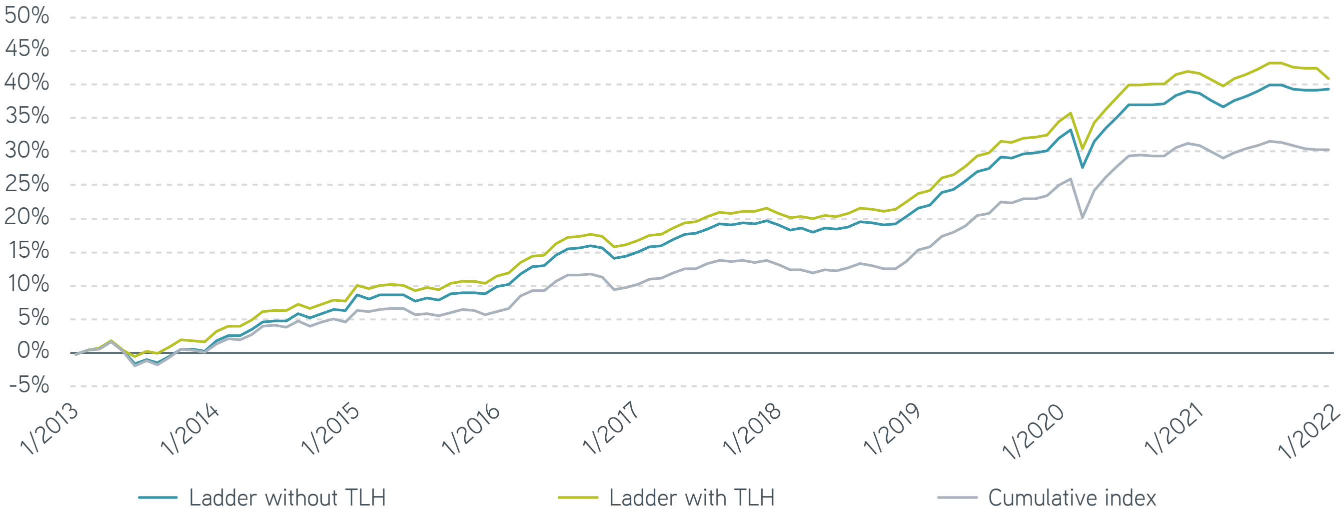
FIGURE 1: HYPOTHETICAL 1-TO-10-YEAR LADDERED MUNI PORTFOLIO VS. BLOOMBERG MM SHORT-INTERMEDIATE 1–10 YEAR, BACKTESTED, 1/31/2013–12/31/2021



Criteria	Assumptions
Minimum bond credit quality	AAA
Investment horizon	Nine years
Portfolio size	$1 million
Portfolio rebalance	Daily
Turnover limit	None
Transaction costs	0.12 bps per year
Management fees	16.00 bps per year
Reinvestment	Coupon payments are reinvested in the ladder; deferred taxes are compounded at the laddered portfolio's return
Tax-loss trigger	1%–2%
Wash-sale rule	Applied at the CUSIP level
Cost basis (premium bonds)	Constant yield amortization of premium (partially offsets coupon income for after-tax performance)
Cost basis (discount bonds)	Discount recognized as income at maturity

Source: Parametric, 12/31/2021. Backtested performance is hypothetical and provided for illustrative purposes only. It does not reflect the experience of any investor and should not be relied on to make investment decisions. Performance is not intended to project any strategy offered by Parametric. Performance is presented net of estimated management fees and transaction costs and reflects the reinvestment of any earnings. Returns do not reflect additional fees that may be charged by a client's custodian or other advisor, which would reduce the returns presented. It is not possible to invest directly in an index. Indexes do not reflect the deduction of fees or expenses. All investments are subject to the risk of loss. See disclosures for additional information.

FIGURE 2: HYPOTHETICAL 1-TO-10-YEAR LADDERED CORPORATE PORTFOLIO VS. ICE BOFA 1–10 YEAR US CORPORATE BOND INDEX, BACKTESTED, 1/31/2013–12/31/2021



Criteria	Assumptions
Minimum bond credit quality	BBB-
Investment horizon	Nine years
Portfolio size	$1 million
Portfolio rebalance	Daily
Turnover limit	None
Transaction costs	0.12 bps per year
Management fees	16.00 bps per year
Reinvestment	Coupon payments are reinvested in the ladder; deferred taxes are compounded at the laddered portfolio's return
Tax-loss trigger	1% to 2%
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