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Bond Market’s Silver Lining Playbook: Slicing Next Year’s Taxes

- Record stock market meets worst muni returns since 2013
- ‘Tremendous volume’ of tax-loss swaps, Breckinridge CIO says

Investors see a silver lining in the municipal-bond market rout: Tax-loss swaps.

Thanks to the technique, bondholders are selling securities that have tumbled in value and reinvesting the cash in similar, higher-yielding bonds. The losses that locks in are offsetting gains from a record-setting stock prices, cutting next year’s tax bills.

“There is a tremendous volume of this going on,” said David Madigan, who oversees $25 billion of municipal bonds as chief investment officer at Breckinridge Capital Advisors in Boston. “We are aggressively pursuing what we can get done.”

The rush stems from a financial-market schism that’s widened since Donald Trump’s presidential victory last month, with his pledge to cut income taxes and boost spending on infrastructure stoking speculation that that the Federal Reserve will need to increase interest rates more rapidly.

The Dow Jones Industrial Average of stocks has risen 14 percent this year and is closing in on 20,000. Meanwhile, the prospect of higher rates caused municipal bonds to tumble in November, putting the securities on pace for the first loss since 2013. Investors who bought state and local government debt this summer — when prices reached a record high — have seen the value tumble by as much as 6.3 percent, according to Bank of America Merrill Lynch indexes.

The ability to use such losses to reduce coming tax bills are a rarity for municipal-debt investors. Before 2013, when the Federal Reserve’s decision to wind down its bond-buying spree caused investors to pull out their money, the municipal market hadn’t dropped since the 2008 financial crisis. The last money-losing year before that was 1999, another record-setting time for stocks.

This year, tax-loss swaps are giving investors a money-saving opportunity to adjust their portfolios before Trump takes office, said Kathleen McNamara, a municipal strategist at UBS Wealth Management in New York. The Republican’s election has changed market expectations about inflation, tax policy and the trajectory of federal spending.

“There are so many factors that changed people’s view on how they should be positioned,” said McNamara.

To comply with Internal Revenue Service rules, investors executing tax-loss swaps need to avoid a wash sale, when securities are sold for the purpose of establishing a tax loss but the same or a “substantially identical” security is purchased 30 days before or after the sale.

Complying with the rule is easier in the municipal market, where there are more than 50,000 issuers and more than 1 million outstanding bonds.

Tax-loss swaps make the most sense for investors who bought bonds between May and August, otherwise transaction costs minimize the benefit, Breckinridge's Madigan said. He said his firm has executed $60 million tax-loss swap block trades in the last three weeks.

“It's a rare instance,” Madigan said. “We had a big market rally and then in November we had a big market sell-off, so we actually have losses now that it makes sense to try to capture.”

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