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Current market conditions are prime for tax loss harvesting

By Jessica Lerner

The current municipal rally has led to an increase in tax loss harvesting as more investors leverage the strength and pre-holiday liquidity to consider repositioning their portfolios.

This year has seen an increase in and an earlier start to tax loss harvesting after rapidly rising, and then subsequently falling, interest rates and stronger equity market performance.

Most tax-loss swapping typically happens in November and December, as it is a later-in-the-year strategy as investors reassess portfolios, said Sean Carney, head of municipal strategy at BlackRock.

"It's typically something that you have better vision into later in the year. Are my equities going to be positive or negative? Are my longer-duration bonds going to be positive or negative? And then just locking that in while there's still good liquidity in the market," he said.

However, this year's market moves have led to more market participants looking to tax loss harvest earlier, and it's not the first time this year that investors have worked to reposition portfolios.

Tax loss harvesting provides a way to "have an active strategy, which allows you to reduce your overall tax obligation by getting rid of bonds or selling out of bonds that have underperformed and then coming back into the portfolio by purchasing a new bond," said Sean Carney, head of municipal strategy at BlackRock.

Starting in July, there was a massive selloff in USTs, and during that period, market participants realized there was an opportunity for tax loss harvesting , said Bill Buzaid, managing director and head of sales and relationship management at Tradeweb Direct.

"Leading into the summer, people thought 'OK, rates have now kind of peaked. Let's take our losses, let's reset our portfolios,'" said Nick Venditti, municipal bond portfolio manager with Allspring Global Investments. "And then in September and October it was clear rates had not peaked."

From July 3 through Oct. 31, the 10-year UST rose 103 basis points, approaching 5% in late October before settling at 4.887%. The 10-year AAA muni rose 96 basis points to 3.61%, per Refinitiv MMD. This led the 10-year muni-UST ratio to rise from 66% to 74%.

This pushed municipal returns deep into the red in October and moved the asset class into negative returns for the year. Munis returned negative 0.85% in October, pushing year-to-date returns to negative 2.22% by the end of the month.

Muni gains in November have reversed October's losses, as they are now positive 4.20% month-to-date, leading the asset class to return 1.89% year-to-date.

Retail investors have taken notice and "all of a sudden you started to see this rush to sell and capture these losses to offset taxable gains elsewhere," Buzaid said.

Increased tax loss sales mostly happens in years when munis come under pressure, as has happened several times this year, Barclays strategists said in a report.

The last time the market had a down year since 2013 was last year, Buzaid said.

Last year represented the first time in a decade "that folks could actually tax loss harvest and in a broad way," Buzaid said.

The scale of the losses in the muni market was "so large" that many of his clients were playing catch up, both on the retail wealth management side and large institutions, according to Buzaid.

While some investors came into 2023 thinking that 2022 was their once-in-a-decade opportunity to harvest tax losses, this year and the volatility that has occurred has proven them wrong.

"That's why we started to see this increase in bid wanted activity in August and September," Buzaid said. As the selloff in rates accelerated, investors became concerned that the opportunity to take advantage of the right conditions for tax loss harvesting was happening earlier than usual, he said.

Now, bid wanteds are up even further in the fourth quarter of this year so far, with investors putting an average bid of $1.791 billion per day from Oct. 2 through Monday. This is an increase from the average daily bid wanteds in the first three quarters of 2023 — $1.045 billion in Q1, $1.176 billion in Q2 and $1.153 billion in Q3, according to Bloomberg.

Additionally, daily secondary trade volumes this year have averaged $11.4 billion par value, noted Kim Olsan, senior vice president of trading at FHN Financial. But November's activity has surged well above that of the full year level, reaching an average of $13.2 billion par per day.

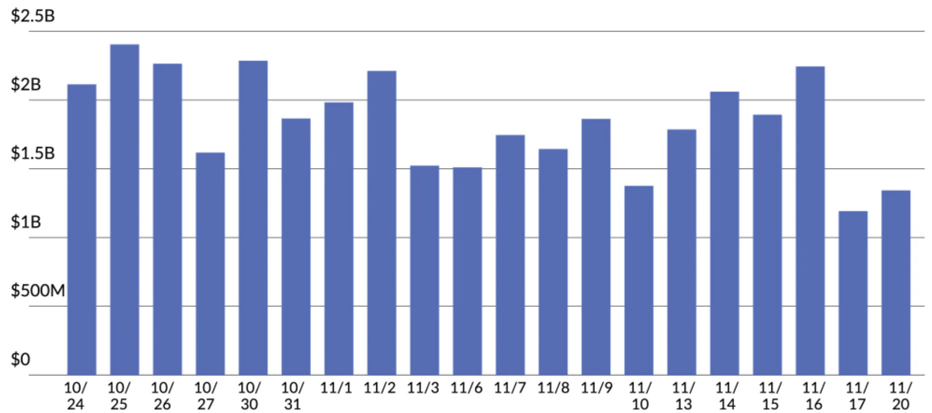
This activity points to the increase in tax loss harvesting. "Higher yields vis-à-vis the lows of 2020/2021 have offered ongoing tax swap opportunities across a range of credits," she noted.

"Stable yields or a further rally could encourage continued tax loss harvesting," she said, adding that the five-year average Refinitiv MMD 10-year yield is 1.86%, "suggesting there is plenty of room to advance toward that objective given a current 3.00%-area level."

Tax loss harvesting provides a way to "have an active strategy, which allows you to reduce your overall tax obligation by getting rid of bonds or selling out of bonds that have underperformed and then coming back into the portfolio by purchasing a new bond," Carney said.

It is an active approach but it's individual in nature, he said.

"Are you simply looking to offset some gains you have elsewhere in the portfolio, or are you truly looking to harvest losses for an upcoming tax liability in the future," Carney said.



In the separately managed account world, he said tax loss harvesting is more of a swap where "clients sell specific line items based on how they have performed and use those proceeds to come right back into the market via a different issuer, and perhaps a different structure, but importantly, remaining fully invested to capture that income component," he said.

Mutual funds are different, though, where "clients or advisors sell out of mutual funds for any number of reasons," such as to avoid a capital gain or because the fund has underperformed, Carney said.

They then that cash into an instrument such as a muni ETF for a period of time, before coming back into the space "via the same or a similar, or perhaps even a completely different mutual fund," he said.

However, it is difficult to "measure the total amount of tax swap selling in any given year, as it is masked by other factors that affect supply and demand: even during 2013 and 2022, both institutional and retail investors put money into the asset class," Barclays strategists said.

"There's no way to explicitly say this much of the market that is tax loss harvesting, but … this isn't just a market movement," Buzaid said. "It pretty clear and based on the anecdotal evidence from talking with clientele, both on the institutional side and on the retail wealth management side, this is tax loss harvesting that's occurring."

Two developments "may help this year to be a particularly beneficial one" for tax loss harvesting, according to a Nov. 15 report from Morgan Stanley.

For one, "tight credit spreads suggest that investors may enjoy smaller 'jumps' to lower yields when swapping to bonds with higher credit qualities," they said, noting that "these differentials can also be offset by modestly extending duration profiles."

Secondly, "the currently inverted yield curve presents participants with opportunities to shorten final maturities while maintaining, or even increasing, yield," Morgan Stanley said.

Such strategies, they said, can "also be accomplished by trading for high-coupon bonds that have longer first-call dates."

However, not all trading periods are opportunistic for tax loss harvesting, according to Morgan Stanley strategists.

"Bid-ask spreads tend to widen during periods of market weakness, as buyers exhibit caution amid the possibility that interest rates may continue to rise," they said.

This same dynamic, Morgan Stanley strategists, is "often apparent when investor interest naturally slows near holidays and weekends."

Investors "often complete these swaps most efficiently during midweek intervals of market strength, particularly when the sessions are outside of seasonally less-active trading periods," they said.

Given that traded par values fell by an average of 21% during the final two weeks of the last 10 years, investors should "leverage the recent period of fixed income strength to consider completing this year's tax-loss harvesting swaps sooner rather than later," Morgan Stanley strategists said.

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