Tax-Loss Harvesting:
Balancing Losses, Income and Costs for Muni SMAs

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Key Takeaways

- Harvesting every loss isn't always practical in a municipal bond separately managed account (SMA). Munis trade over the counter and each bond is unique, so replacements can take days or weeks.
- Focus on income. A loss is a one-time tax benefit, while the greater benefit can often come from higher recurring, tax-exempt income for the life of the replacement bonds.
- Manage costs and timing. Bid-ask spreads, odd lots and reinvestment delays can erode the benefit, so we believe each swap should weigh the loss against income and costs.



Loss Harvesting in Muni SMAs vs. Equity Direct Indexing Accounts

Many clients pair a muni SMA with an equity direct indexing account. Losses are more easily harvested in an equity direct indexing account because stocks are liquid, generally trade at tight spreads and have close substitutes. Municipal bonds work differently. They trade over the counter rather than on an exchange, each bond is a distinct issue, and finding a suitable replacement can take days or weeks. For those reasons, harvesting every available loss can often be impractical, and sometimes counterproductive, in a muni SMA.

Tax-Loss Harvesting is a Popular Feature of Muni SMAs

Done well, tax-loss harvesting can potentially raise a portfolio's tax-exempt income while simultaneously realizing capital losses that can offset gains elsewhere. However, more harvesting doesn't always mean better harvesting. Municipal market transactions can carry costs and tradeoffs that don't appear on a year-end tax report, and understanding them can help make client conversations more productive.

Here Are Some *Key Factors* to Keep in Mind When Evaluating Tax-Loss Harvesting in a Muni SMA:

- ## Maintain an income-first mindset.

  In our view, the primary goal of muni tax-loss harvesting should be increasing the client's tax-exempt income. Typically, that means selling bonds acquired at market yields lower than today's levels—such bonds generally trade below cost, all else equal—and reinvesting the proceeds at higher yields. The capital loss associated with selling the initial bonds can provide a one-time tax benefit. However, the greater benefit can often come from higher recurring, tax-exempt income for the life of the replacement bonds.

- ## Transaction costs erode the benefits.

  Bid-ask spreads to trade muni bonds are typically wider than those of other investment grade bonds. Every dollar paid in the bid-ask spread is a dollar that isn't working for the client. It reduces the principal reinvested and the income that comes with it. With small losses, the round-trip cost can exceed the benefit. We believe a professional muni manager is best-suited to gauge this spread and analyze the costs versus benefits of proceeding with a transaction.

- ## Small lots can amplify the trading costs.

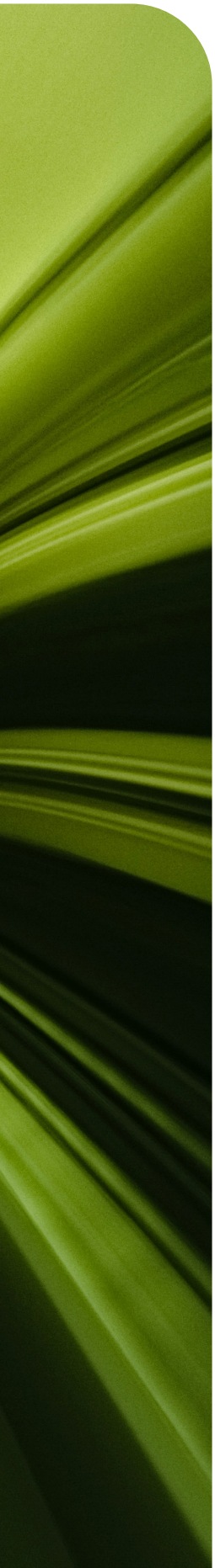
  A relatively small position in a client's account may have been purchased by the manager as part of a much larger block. Like a bulk order, purchases made in these larger institutional-sized transactions may receive more favorable pricing than smaller lots. When a client forces a sale of a small lot to chase a tax loss, it may trade as an "odd lot" subject to wider bid-ask spreads.

- ## Replacement bonds aren't always available right away.

  Finding suitable replacement muni bonds in the primary market can take days or weeks. And rushing to buy replacement bonds in the secondary market can turn the client into a "price taker," further exacerbating the bid-ask spread effect. Uninvested tax-loss harvesting proceeds can create a cash drag in the portfolio. If rates fall before the proceeds are fully reinvested, replacement bonds would enter the portfolio at lower market yields, shrinking the income pickup sought in the swap.

Tax-loss harvesting in a muni SMA is a balance. Each swap weighs the loss realized today against the income, costs and time out of the market that comes with it. We favor a disciplined program that sets clear criteria for each swap, such as minimum loss and position-size thresholds and an expectation that the replacement improves book yield after costs.

Clients who want losses to offset a particular capital gain can share those instructions with their manager, but they should weigh the caveats we describe here. In our view, tax-loss harvesting remains a benefit of a muni SMA, but one with important nuances to keep in mind. The right balance can differ by client, which is why we believe it pays to work with a manager who can apply disciplined criteria consistently and tailor them to a client's goals.



How Loomis Sayles Approaches Tax-Loss Harvesting

The considerations on the previous page inform the guidelines our team applies when evaluating tax-harvesting opportunities. These guidelines seek to balance capital losses against preserving and improving a portfolio's tax-exempt income, while being mindful of transaction costs:

MINIMUM LOSS THRESHOLD

We target positions with losses of at least $1,000. Below that level, transaction costs can consume much of the benefit.

YIELD IMPROVEMENT

In line with our focus on increasing tax-exempt income, we seek roughly 100 basis points of additional yield on a comparable replacement bond (for example, sell a bond purchased at a 3% yield and replace it with a new bond of similar credit quality purchased at a 4% yield).

PORTFOLIO SALE LIMIT

We avoid selling more than 20% of the portfolio at one time. This limits the portfolio's exposure to time out of the market while we source replacement bonds.

SPECIALTY STATE PORTFOLIOS

We apply our guidelines with particular care in state-specific and state-weighted portfolios. Bond supply is thinner in those states, so reinvestment periods tend to be longer.

LOSS-TO-PAR ANALYSIS

Loss-to-par is the realized loss divided by the par amount sold. We use the loss-to-par ratio to identify the opportunities that we believe will generate the greatest realized loss relative to the amount of par sold. This helps us bank meaningful losses while minimizing turnover and trading costs.

BOOK YIELD PRESERVATION

We balance each client's overall investment objectives and loss-harvesting goals against the need to preserve book yield, so that harvesting doesn't come at the expense of the portfolio's long-term income.

Glossary

Tax-loss harvesting: *Selling an investment that has dropped in value to lock in a loss, then reinvesting the money in a similar investment.*

Bid-ask spread: *The gap between the price a dealer will pay for a bond (the bid) and the price they will sell it for (the ask). This gap effectively acts as a trading cost for a given transaction.*

Odd lot: *A small trade, typically $10,000 or less in bond par value.*

Book yield: *The income a bond or portfolio earns based on what was originally paid for it, rather than on the current market price. Selling bonds and buying new ones can change a portfolio's book yield.*

Par: *A bond's face value, which is the amount repaid to the investor when the bond matures. A bond's market price can be above or below par.*

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Market conditions are extremely fluid and change frequently.

Any investment that has the possibility for profits also has the possibility of losses, including loss of principal.

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