When the Taxman Comes Knocking

April 15th, Tax Day, is our annual reminder of how challenging the tax environment has become. As Municipal investors, we are often asked about the topic of tax efficiency since Municipal bond owners are among the most averse to paying taxes on their investments. In this commentary, we describe how tax considerations intersect with our investment approach.

We consider ourselves tax-aware, not "tax-minimizing," as we seek to generate *attractive after-tax returns* while protecting our clients' capital. Clearly, we cannot satisfy our return objective without being thoughtful on the subject of taxes, an all too real cost. While we seek to safely grow our clients' wealth, success does not necessarily mean avoiding taxes altogether. Tax liabilities generally arise from four sources: a bond's state of issuance, tax status, purchase price, and trading activity.

Municipals differ from the other major fixed income sectors in that households constitute the majority of the investor base, rather than institutions. Many individual investors simply do not want to pay taxes on their Municipal bonds under any circumstances. This preference often limits investment opportunities to bonds issued from the client's home state or the triple-tax-free debt of the U.S. territories. This comes at a cost – both from a valuation and credit perspective. Typically the demand from residents of high tax states often reduces the number of good values in that state. Second, the quality of US territory debt, particularly Puerto Rico, often fails to meet our uncompromising credit criteria. Our value-oriented approach is best executed with broad potential opportunity set. We usually find that we can overcome the impact of state taxes with the wider range of opportunities presented nationally. Typically, state concentrations in our managed portfolios stay below 10%-15%.

We have also observed that a smaller buyer base exists for bonds that are subject to the Alternative Minimum Tax (AMT) and bonds that are discount-priced (i.e. purchased below par) securities, which frequently leads to attractive investment opportunities. AMT bonds, also known as private activity bonds, are Municipal bonds whereby more than 10% of issuance proceeds are earmarked for private business use. AMT bonds typically finance facilities such as airports, solid waste projects, and housing. When the American Taxpayer Relief Act (ATRA) was enacted in early 2013, it not only raised the top marginal tax rate, but it also incorporated both personal exemption and deduction phase-outs in the regular tax code. The ATRA also indexed AMT income exemption thresholds for inflation, reducing the tax's footprint significantly. Prior to this "fix", the AMT would regularly capture a wide swath of taxpayers. As a result of these changes, the ATRA significantly reduced the relevance of the AMT, yet opportunities remain.

Federally tax-free Municipals bonds are subject to some tax if they are purchased below par (excluding original issue discount bonds). With the introduction of the Revenue Reconciliation Act of 1993 (1993 Act), the accretion back to par was subject to tax at ordinary income rates. The 1993 Act also established a "de mininis" threshold, allowing capital gains treatment for bonds that were purchased modestly below par. This threshold is equal to ¼ of 1% per year multiplied by the bond's remaining years to maturity. We have highlighted a few examples in the table below:

Taxation of a Discount Bond's Accretion

	Purchase Prices		
Tax Treatment	**5-Year Maturity**	**10-Year Maturity**	**30-Year Maturity**
Capital Gain	98.75 to 100	97.5 to 100	92.50 to 100
Ordinary Income	Below 98.75	Below 97.50	Below 92.50

Just as with AMT bonds, we do not shy away from purchasing discount-priced securities, but we are careful to model the prospective tax impact when assessing each bond's value.

Turnover is another driver of tax-related liabilities. A passive buy-and-hold strategy won't generate any tax liabilities for regular Municipal bonds purchased at par or higher and serve as a good example of a popular "tax-minimizing" strategy. However, we view a carefully executed active strategy as superior given the wide range of credit and structural opportunities present in the Municipal bond market.

Active management does not necessarily imply a high degree of trading. When we get our hands on an attractive long-term opportunity, we don't like to let go. Our average historic turnover has been roughly 20-25%, implying average holding periods of 4-5years.

There are four primary reasons why we will sell a position:

1) A credit concern
2) A better opportunity
3) Valuation
4) Administrative

First, our focus on capital protection demands that if our credit thesis is challenged by new developments and breaks down, we sell, irrespective of the tax consequences. Tax costs pale in comparison to the potential of principal loss. For the three remaining reasons, we always evaluate the known tax consequences of a sale against the credit, structural, and interest rate risks of a security. We will sell an existing position if we can identify a more attractive long-term opportunity. We will sell if another investor or broker-dealer wants to overpay for any of our bonds. Lastly, and more mundane, we will sell for administrative reasons, such as a redemption request.

We seek to own a limited number of durable credits, purchased at attractive yields. Municipal bonds have never been renown for their liquidity. Since the Financial Crisis and the enactment of multiple regulatory reform measures, market liquidity has deteriorated further. Bid-ask spreads are wide and frequent trading often leads to high transaction costs, in addition to tax consequences. We find that the many good values in Municipals are limited in size, and we would face a material risk of not being able to reestablish a position if we sold for purely tax-driven reasons.

The tax consequences of investing in Municipals are multifaceted and unfortunately cannot be represented by a single statistic. As we have discussed, tax-minimizing strategies are often inferior from an investment perspective. We seek to achieve our investment objectives by investing wherever opportunities emerge, even if the bonds are subject to tax. We only transact selectively, so when the taxman comes knocking, our investors know that we have carefully considered the tax implications of our overall strategy in order to deliver superior after-tax results.

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