Tax-Loss Harvesting:

Seizing Opportunity in Fixed Income

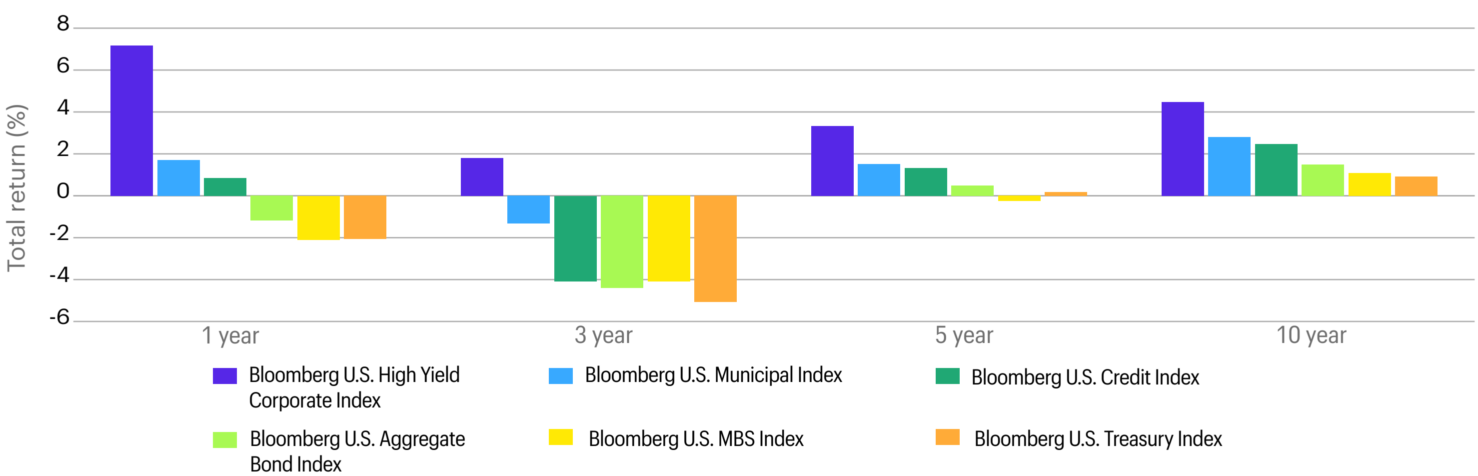
+ Recent performance in the fixed income markets has brought tax-loss harvesting into sharper focus.
+ Harvesting losses now may help investors reduce taxes, increase income, and optimize portfolios.
+ Tax-loss harvesting can be an effective strategy for investors seeking to reduce tax liabilities and enhance overall wealth.

Finding opportunity in 2023

In a year marked by the ongoing impact of the COVID-19 pandemic, the Russia-Ukraine war, and rampant U.S. and global inflation, 2022 became a year that many fixed income investors would like to forget. In an effort to cool an overheated economy and thwart inflation, the Federal Reserve aggressively raised the federal funds rate seven times in 2022. Overall, this had a significantly negative impact on U.S. fixed income markets (Exhibit 1). In fact, in 2022, the Bloomberg U.S. Aggregate Bond Index had its worst year on record by far—declining 13.0% and passing its previous worst calendar-year return on record by more than 10%, or 1,000 basis points (bps; 100 bps equal 1.00%).[1]

Rate hikes continued into 2023 with four additional increases through the end of July. Market impact was mixed, creating an environment of enhanced market volatility. This recent performance may provide greater opportunity to capture losses and reduce taxes.

EXHIBIT 1: KEY BOND INDEX RETURNS



Source: Morningstar, as of August 31, 2023. **Past performance is no guarantee of future results.** You cannot invest directly in an index.

1. Source: Morningstar

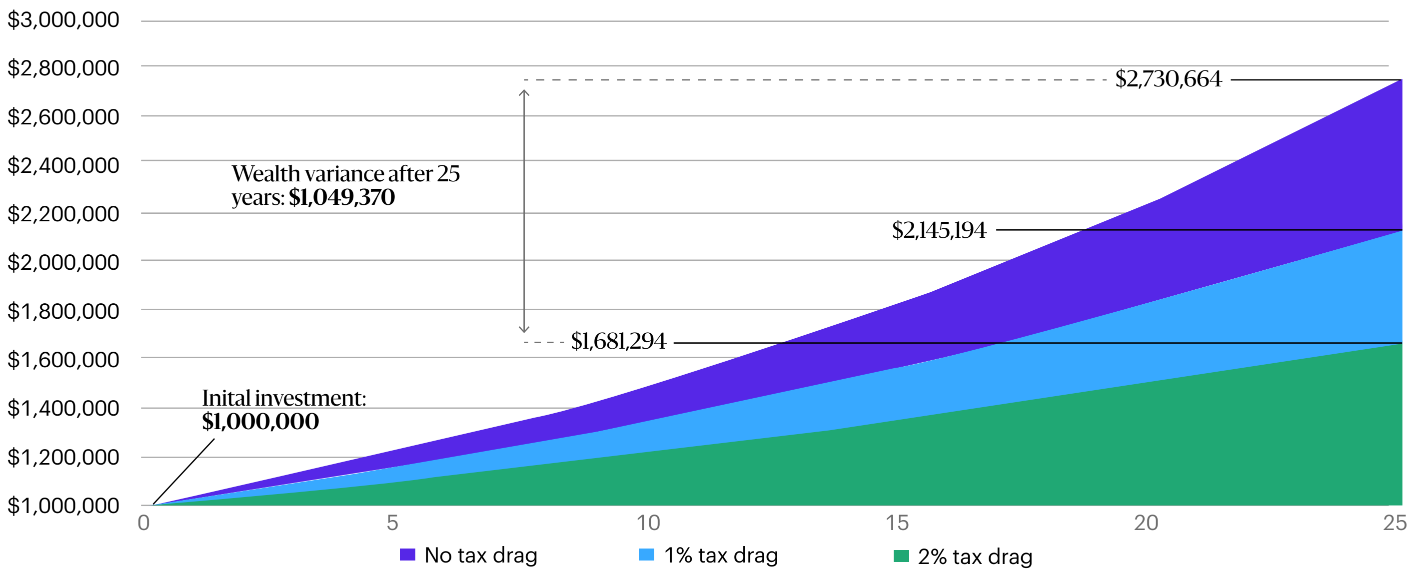
Harvesting losses

Tax-loss harvesting is an effective strategy investors can use to lower their tax liabilities. They can do this by selling investments that have experienced capital losses in order to offset capital gains. By selling underperforming securities and realizing losses, investors can use the losses to offset current or future realized gains from other investments, thereby lowering taxes owed and increasing the net performance of their investment portfolio and overall wealth (Exhibit 2). An investor may use the proceeds from the sale to purchase a similar investment, helping maintain the general composition of the portfolio.

According to the IRS, investors may deduct up to $3,000 annually in capital losses to reduce income or offset realized gains. If realized losses exceed $3,000 in any given calendar year, the difference may be carried forward to future years.

EXHIBIT 2: TAX IMPACT ON WEALTH OVER TIME

HYPOTHETICAL GROWTH OF A $1M FIXED INCOME PORTFOLIO OVER 25 YEARS AT 4.1% PER YEAR



The hypothetical data is not maintained as an actual portfolio. Hypothetical data does not represent actual performance and should not be interpreted as an indication of such. This data is based on knowledge that was available after the fact and thus with the benefit of hindsight. Index returns reflect general market results; do not reflect actual portfolio returns or the experience of any investor; and do not reflect the impact of any fees, expenses, or taxes applicable to an actual investment. Any unauthorized review, use, disclosure, or distribution is prohibited. You cannot invest directly in an index. Hypothetical and past performance is no guarantee of future results.

Source: Allspring

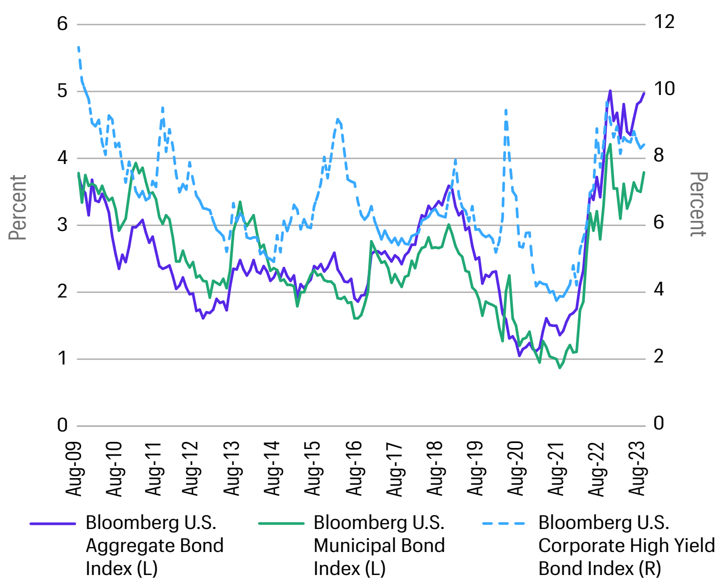
Best practices for tax-loss harvesting

- **Implement throughout the year.** Tax-loss harvesting is often thought of as a year-end exercise but can be an effective strategy throughout the calendar year.
- **Remember the "wash sale" rule.** IRS rules state that an investor may not purchase a "substantially identical" security within 30 days of (either before or after) the sale of a security. It is prudent to seek advice from a tax professional prior to performing a tax swap.
- **Be opportunistic.** In addition to the value-added benefits of tax reduction, investors have the opportunity to replace sold securities with others they may find more appealing.

Taking advantage of higher yields

Potential opportunities can be found in every phase of the market cycle—especially after a significant downturn. One of the benefits of the recent hyper-aggressive rate hike cycle is that yields are now at or near 15-year-high levels. Investors can now find yields higher than they have been in many years (Exhibit 3), creating opportunity to potentially enhance income levels significantly. Taking advantage of these higher-yielding investments may also help investors outpace inflation if positive real returns are compounded over time. Selling an underperforming investment at a loss and reinvesting the proceeds into a strategy that has higher yields and greater income potential could be a very attractive proposition in the current environment.

EXHIBIT 3: YIELDS ARE AT OR NEAR 15-YEAR-HIGH LEVELS



Source: FactSet, yield to worst as of August 31, 2023

Putting due diligence to work

How can investors determine the best approach to taking advantage of attractive risk/reward opportunities? Besides investing cash or allocating away from other asset classes, fixed income investors may also benefit from swapping out existing holdings. In other words, it provides the opportunity to not only harvest losses and reduce their tax bill but also evaluate other potential investments that may be better suited for their investment goals.

Unrealized losses that may have been driven by the recent rise in interest rates, while unfortunate, can provide an opportunity for investors to realize losses, reevaluate current holdings, and potentially take advantage of a timely tax swap to reposition portfolios.

Remember, investment losses can help reduce taxes today or be carried forward to offset capital gains or even ordinary income taxes in future years. In that case, investors may be able to use up to $3,000 (or $1,500 for married individuals filing separately) of carry-forward losses on a tax return in one year.

Multiple benefits of tax-loss harvesting

Keep more of what you earn.

The most obvious benefit of tax-loss harvesting is the potential to reduce your tax liability, which, in turn, would increase your portfolio's net investment performance and overall wealth.

Rebalance and optimize.

Tax-loss harvesting provides an opportunity to adjust holdings within a portfolio to ensure it stays in line with an investor's long-term goals. It also provides the opportunity to reevaluate portfolio holdings and reallocate to conceivably better investment options.

Leverage flexibility.

Tax-loss harvesting is a strategy that can be opportunistically used throughout the year rather than only as a year-end exercise.

For further information

We want to help clients build for successful outcomes, defend portfolios against uncertainty, and create long-term financial well-being. To learn more, investment professionals can contact us.

Contact details

- For retail clients, contact your financial advisor.
- To reach our intermediary sales professionals, contact your dedicated regional director, or call us at **1-866-701-2575**.

Tax-loss harvesting is the selling of investments at a loss so that losses can be used to offset gains on the sale of other investments—thereby reducing capital gains tax owed. Proceeds from the sale may be used to purchase similar securities to maintain the general composition of the investment portfolio.

INDEX DEFINITIONS

Bloomberg U.S. Corporate High Yield Index
The Bloomberg U.S. Corporate High Yield Index is an unmanaged, U.S.-dollar-denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of $150 million. You cannot invest directly in an index.

Bloomberg U.S. Aggregate Bond Index
The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S.-dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities. You cannot invest directly in an index.

Bloomberg Municipal Bond Index
The Bloomberg Municipal Bond Index is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa. You cannot invest directly in an index.

Bloomberg U.S. MBS Index
The index tracks agency mortgage-backed pass-through securities (both fixed-rate and hybrid adjustable-rate mortgages) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). You cannot invest directly in an index.

Bloomberg U.S. Credit Index
The Bloomberg U.S. Credit Index contains publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be registered with the SEC. Each qualified issuer's exposure is then capped on a market-weighted basis at 3%, and the residual is allocated on a pro-rata basis to all remaining constituents. You cannot invest directly in an index.

Bloomberg U.S. Treasury Bond Index
The Bloomberg U.S. Treasury Bond Index is an unmanaged index of prices of U.S. Treasury bonds with maturities of 1 to 30 years. You cannot invest directly in an index.

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