THE BOND BUYER

COMMENTARY

Why Buy-and-Hold Is Dead

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Buy-and-hold is dead as a municipal investment strategy because the opportunity cost has become so high. Why settle for buy-and-hold when you can pick up 35 to 75 basis points of annual return through dynamic tax management? Even better, it's incremental return without additional risk.

Tax management is not new, but here's a different perspective: when you purchase a muni bond you acquire an implicit tax option — the option to sell the bond, recognize a loss, and capture the net value of the tax shield. A strategy of buy-and-hold throws that option away. Actually it throws away more than just a single option, because each time you sell and reinvest, you acquire a new tax option with the replacement bond. You're really throwing away what could be a sequence of options. It's like being a homeowner who stays on the sidelines when he could have profitably refinanced multiple times over the last several years.

While the idea of taking a tax loss seems simple, there are subtleties that demand attention. For example, assume you bought a muni bond at par that is now trading at a discount, and you want to realize the loss. If the tax shield exceeded the transaction cost of acquiring a replacement bond, you might call that a profitable trade. But it's not as profitable as it first seems. Current buyers price the bond knowing they'll owe tax on the discount. But that's a tax you don't owe (because you bought at par). When you sell at the market price in this instance, you're selling below your 'market' value. Your true value — what we term 'hold' value — is critical to the analysis, but you won't find it on Bloomberg or anywhere else. As a result, you could actually lose money on what seemed like a vanilla tax-loss trade, and you wouldn't know it.

Even if a sale produces a net tax benefit, the more complicated question is when to sell, keeping in mind that when you sell and reinvest you're also swapping tax options. That swap in itself can be valuable because you reset the clock, thereby giving yourself another 12 months to realize any potential short-term loss, which is roughly twice as valuable as a long-term one.

You can see that the underlying calculations get tricky very quickly. Nevertheless, the bottom line is simple and the results are remarkable. A holder can pick up about 75 basis points of return on his long-term bonds, assuming he has short-term gains to match against short-term losses. But even if short-term losses are offset against long-term gains the pick-up is still 35 basis points.

There are few lay-ups in muni bond investing, but jettisoning buy-and-hold for dynamic tax management may be one of them.

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