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# Slightly below par

The post-September interest-rate rise has pushed the price of many a short-dated, fixed-income security into the high nineties from par—and therein lies opportunity.

The opportunity is related to the U.S. Tax Code's advantageous treatment of capital gains earned over a holding period of 12 months or longer. The patient investor is taxed at 20% as opposed to the 37% rate applied to ordinary income in the highest federal bracket—including interest income. These two tax facts point to the relative appeal of high-grade bonds trading at a discount to par compared with like securities quoted at or above par. No tax experts are we, but 20% is better than 37%.

Not quite stranded, perhaps, are the high-quality bonds with tiny coupons that came to market around the time of the 2016 lows in yields. The rise in rates has trimmed their market value while enhancing their after-tax value.

"In particular," relates colleague Fabiano Santin, "these bonds present an opportunity for investors who are willing to lock up capital for more than one year and earn capital gains at maturity, or in the near future when the prices of their bonds ascend towards par. The proposition becomes even better for investors in jurisdictions subject to higher state and local taxes. Investors should consult their tax advisors [we have exhausted our tax expertise with the observation above] to understand the precise rates to which they are subject."

"Take the 18-month Treasury note [trading near 98 cents on the dollar]," Mikhial Pasic, vice president and fixed-income portfolio advisor at Toronto-based RBC Dominion Securities, Inc., tells Santin. "It basically acts like a strip bond given the low coupon, but it is taxed more efficiently." Pasic, who advises individuals subject to the 53.53% Ontario income tax (and capital gains taxed at half of that), says the 2.2% pre-tax yield on the Treasury's ¾s due August 2019 becomes 3% on a tax-equivalent basis (for Ontario investors), compared with par-priced bonds whose gains come from ordinarily taxed interest income.

American tax arithmetic is different, but the concept is the same. Thus, U.S.-based investors may consider the single-A-minus-rated Wells Fargo & Co. 2.1s of 2021, which trade at 96 cents on the dollar for a yield to maturity of 3.3%. At the above-referenced maximum federal rates, the blended capital gains and ordinary tax bite would leave about a 2.3% after-tax return. Compare with the iShares iBoxx Investment Grade Corporate Bond ETF (LQD on NYSE Arca), which yields 3.84%, or 2.4% after tax. The duration of the LQD, 8.4 years, is much higher than that of the Wells security, 3.0. Then, too, the ETF holds 45% of its assets in (barely investment-grade) triple-B-rated securities.

Another possibility is the triple-B-plus-rated Morgan Stanley 2½s of 2021, trading at 3.28% to maturity, or 2.2% on our hypothetical after-tax basis, a 63 basis-point pickup over comparable Treasurys. Still another: the double-A-minus-rated Amazon.com, Inc. 1.9s of 2020, quoted slightly below 98 cents to yield 2.7% to maturity, or 1.88% after tax, a tax-adjusted pickup of 40 basis points over the comparably dated Treasury.

There's no such thing as a bad basis point of investment return, but the lightly taxed ones are better.

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