Bond Swapping

Table of Contents

I. An Introduction to Bond Swapping

Fixed-Income investments or “bonds” by their nature tend to appeal to traditionally conservative investors. These investors often buy a bond or portfolio of bonds, place them in their brokerage accounts, and leave them alone until the bonds mature or are otherwise redeemed by the issuer. While bonds are not traditionally “traded” as actively as stocks, there are certainly instances and market conditions when it can make sense to review your fixed-income holdings. A bond swap can be an effective tool for taking advantage of current market conditions, upgrading a portfolio, reducing tax basis, or adjusting to a change in your investment objectives or investment status. This booklet will help explain the basics of the bond swap, common reasons for swapping bonds, some of the rules to keep in mind, and how to get started.

II. Bond-Swap Basics

A bond swap involves two steps. First, you sell a bond or bonds; second, you use those proceeds to purchase another bond or bonds with similar but not identical characteristics. One reason why swaps make sense with bonds or other types of fixed-income securities is that you can often find multiple securities with similar investment features such as maturity, credit quality, interest rate, and price.

III. Why Consider Bond Swapping?

Swapping can help you…

- Lower taxes
- Improve call protection
- Increase yield
- Improve or lower credit quality
- Take advantage of anticipated interest-rate movements

A bond swap should provide your portfolio with benefits that fit into your overall investment objectives. Let your Financial Advisor assist you in reviewing your fixed-income portfolio and determining whether a bond swap could benefit you.

IV. Swapping to Reduce Your Taxes

Reducing taxes is probably the most common reason for bond swaps. Many opportunites to reduce taxes with bond swaps exist. For example, if you own tax-exempt municipal bonds issued in your home state and then you move to another state, you might swap into municipal bonds issued in your new state of residence. This may allow you to avoid paying state taxes on your now "out-of-state" municipal bonds. In addition, any time either the tax laws are changed or your personal tax status changes, there may be an opportunity to review your bond holdings and determine whether a swap would benefit your portfolio. Consult your Financial Advisor for more information on whether a bond swap might fit in with your investment objectives, and consult your tax advisor to determine the implications of any tax-reducing swap for you.

Tax-Loss Swaps

When the fixed-income market declines and your current bond holdings are selling below their amortized or accreted purchase price, you may benefit from tax-loss swapping. If you have realized capital gains from the sale of an asset such as real estate or stocks this year, you will have to pay capital-gains taxes on the sale. If you also own bonds or other fixed-income securities that are currently selling for less than you paid for them, a tax-loss swap can help you reduce your capital-gains tax burden.

Normally, an investor will have to sacrifice something in order to make the swap work. This can include extending maturity, accepting a lower-rated bond or a bond with a lower coupon, or investing additional money. Here is a hypothetical example of a municipal-bond tax-loss swap and its outcome.

SELL—$50,000
Home state Bond A - AAA Rated
Purchased in October of 1998 at 100.00
5.00% Due 7/1/24
Callable 7/1/03 @ 102, 7/1/05 @ 100
Sell Price 93.50
Proceeds—$46,750.00

BUY—$50,000
Home state Bond B - AAA Rated
5.00% Due 5/1/22
Callable 5/1/09 @ 102, 5/1/11 @ 100
Purchase Price 94.157
Cost—$47,078.50

Outcome of the Bond Swap:

- Approximate $3,250 tax loss realized
- Maintained credit quality & income
- Increased call protection
- Shortened maturity by 2 years
- Client must put up $328.50 to make the swap work

By swapping, a “paper” loss has been converted into a real loss that can be used to offset taxable gains without limit* and up to $3,000 in ordinary income annually.

* See Section VIII, Rules for Tax Swapping.

V. Swapping to Increase Yield

Investors often swap bonds to improve the returns on either a taxable or a tax-exempt portfolio. There are many different types of swaps that can improve yield, including extension swaps, quality swaps, and sector swaps.

Extension Swaps

Normally, longer-term bonds will offer higher yields than shorter-term bonds. The higher yields compensate investors for extending maturity. Investors who own portfolios of shorter-term bonds who are looking to improve return might consider a swap out of shorter-term bonds into bonds with longer maturities. This assumes that market conditions are such that long-term bonds are offering higher yields than short-term bonds.

Quality Swaps

Normally, bonds with a lower credit rating will offer higher yields than bonds with higher credit ratings. Depending on an investor's personal tolerance for risk, a quality swap from a higher-rated bond into a lower-rated bond may improve the yield of the portfolio. Of course, if you lower the overall credit rating of your portfolio, you are increasing your risk.

Sector Swaps

At times, different sectors within the fixed-income markets will offer higher yields with similar credit quality because of changes in the market or economy. A sector swap could allow you to take advantage of differences within the fixed-income market to improve the overall yield of your portfolio. A sector swap may allow you to improve your yield among different fixed-income securities. Any fixed-income product or sector should fit in with your overall investment objectives before you consider a purchase.

VI. Swapping to Improve Call Protection

Many fixed-income securities are issued with call or redemption features. These allow the issuer to redeem or "call" the securities at a stated date prior to maturity. The time between the initial purchase and the first "call" or redemption date is known as "call protection." A swap out of a bond with a shorter first call date into a bond with a longer first call date will improve the overall call protection of the portfolio. Call protection can protect an investor from reinvestment risk, the risk of having to reinvest in a less favorable interest-rate environment.

VII. Swapping to Take Advantage of Anticipated Interest-Rate Movements

While predicting changes in interest rates can be difficult, if you expect rates to move in a specific direction, you might want to use an interest-rate swap. Interest-rate swaps are very speculative and their success depends largely on the ability to accurately predict interest rate changes. If the anticipated rate movement does not occur or if rates move in the opposite direction, a decline in the market value of your securities can occur.

In Anticipation of Declining Rates

If you believe that interest rates will decline at some point in the future, an extension swap into bonds with longer maturities can lock in the higher rates normally found in longer-term maturities before a decline in rates. The prices of long-term bonds will fluctuate more with interest rate changes, so if rates decline, long-term bonds generally offer more opportunity for price appreciation than bonds with shorter maturities and similar ratings.

In Anticipation of Increasing Rates

If you believe that interest rates are likely to increase, a swap to shorten the overall maturity of your portfolio might make sense. While short-term maturities will normally yield less than long-term maturities, their prices will also tend to fluctuate less with changes in interest rates. Shortening the overall maturity of your portfolio may leave you less sensitive to price declines when rates are rising.

VIII. Swapping to Improve Quality

From the time a bond is originally issued until the day it matures, its price in the marketplace will fluctuate according to changes in market conditions or credit quality. You may be interested in doing a quality swap if a bond that you own is having problems with its overall credit rating. You may want to sell a weakening credit bond and swap into a more stable or improving credit bond.

IX. Rules for Tax Swapping

As with any strategy involving the Internal Revenue Service, there are many rules and regulations (constantly subject to change) associated with tax-loss swapping. While we will attempt to cover some of the most basic rules, you should consult your tax advisor before you consider any bond swap. Your tax advisor can help you determine both current tax law as well as the personal tax ramifications for you and your portfolio before you consider tax-loss swapping. Among some of the more common rules are minimum holding periods, treatment of original-issue-discount or market-discount bonds, how to report the loss on your tax return, and avoiding a wash sale.

A wash sale is the sale and repurchase within 30 days before or after trade or settlement date of either the same or a substantially identical security. The IRS will not allow a loss generated from a wash sale. Avoiding a wash sale in a bond swap completed within 30 days requires you to buy a security that is not substantially identical to the security you are selling. The term "substantially identical" has not been defined clearly. However, two bonds have not been considered substantially identical if they have different issuers or substantial differences in coupon or maturity.

Most capital losses from bond swaps will be reported on Schedule D of your tax return. Losses will first be used to offset any capital gains you have realized during the year. Whether you have short- or long-term capital gains, the losses from a tax-loss swap will first offset the same term gains: short-term losses will first offset short-term gains and long-term losses will offset long-term gains. Once all the gains in one category have been offset, losses will then be used to offset the other category. Once all capital gains have been offset, any excess can be used to offset ordinary income up to a limit of $3,000. In addition, any excess capital losses can be carried forward to offset future gains and income.

The US tax code can be very complicated and all tax laws are subject to change without notice. The general information presented here is current as of November 2002. You should consult your tax advisor before considering any bond swap especially if you are swapping to reduce your taxes. Your tax advisor can help you evaluate all the ramifications of the current tax laws and how they affect you and your portfolio.

X. Some Things to Keep in Mind

Before you take part in a bond swap check to make sure that it will provide identifiable benefits to your portfolio, and that those benefits outweigh any transaction costs. In addition, remember that because of the spread between the bid and the offer on fixed-income securities, you will often need to make some sacrifice in order to make a bond swap work. This can include extending maturity, purchasing a bond with a lower credit rating, buying a lower-coupon bond, or investing additional money. Your Financial Advisor can counsel you on what is appropriate for your portfolio and your investment objectives and risk tolerances.

XI. How to Get Started

Our firm offers a complimentary program to help you determine whether a bond swap makes sense for your portfolio. To get started, just fill out the Bond-Swap Assistance Form on the next page and return it to your Financial Advisor.

In order to accomplish your investment objectives, are you willing to:

Extend maturity? Yes ❑ No ❑ Invest additional money? Yes ❑ No ❑

Adjust credit ratings? Yes ❑ No ❑ Accept lower income? Yes ❑ No ❑

Please tell us about your current bond holdings. This information is necessary to review your current holdings for possible swap opportunities. If you need additional room, please use additional sheets of paper or make copies of this form.

Face Amount	Issuer & Description	Coupon	Maturity Date	Purchase Cost	Date of Purchase	CUSIP Number

Bond-Swap Assistance Form

Name: ____________________

Address: ____________________

City: ____________________

State, Zip Code: ____________________

State of Residence: ____________________

Home Telephone: ____________________

Work Telephone: ____________________

Account Number: ____________________

Federal Tax Bracket: ____________________

State Tax Bracket: ____________________

Please rate the following in order of importance:

	highest			lowest
Reducing taxes	❑	❑	❑	❑
Improving quality	❑	❑	❑	❑
Increasing yield	❑	❑	❑	❑
Improving call protection	❑	❑	❑	❑

Please comment on any specific investment objectives for your account:

____

____

____

____

55279 11/04

0000571878
(1ea Rev 02)