Getting (Re)Familiar with Discount Bonds

Total reading time = 2 minutes

Summary

- Rising interest rates have led to steep price declines in bond markets.
- Some bonds trade at deep price discounts even though their issuer's credit quality remains strong.
- Bonds purchased at a market discount may offer a unique tax-deferral opportunity for investors.

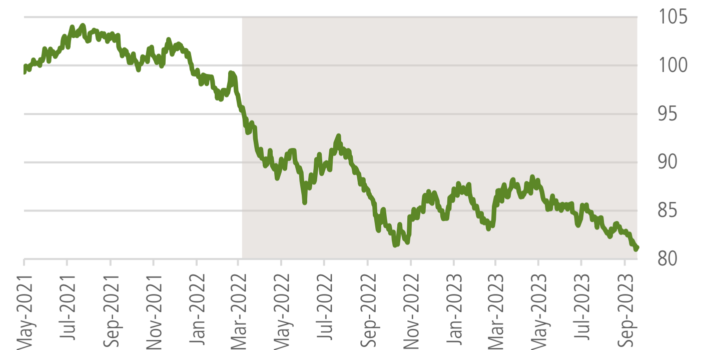
The Federal Open Market Committee (FOMC, the Fed) delivered its recent string of rate hikes at a record pace. Bond prices have fallen dramatically as investors seek out higher-yielding opportunities that reflect the new interest rate regime. Most bonds in circulation, however, are remnants of the low-rate environment that persisted through much of the previous decade. The coupon rates available to investors during most of the post-Great Financial Crisis era, prior to early 2022, pale in comparison to rates available today. This dramatic change in borrowing conditions has led to widespread price discounts throughout fixed income markets. The average bond price has declined to nearly 85 cents per dollar of face value.

Source Bloomberg

Shaded area indicates current tightening cycle.

Before the Fed began its rate hike campaign in early 2022, interest rates had been trending lower for nearly 40 years. Because bond prices move inversely to interest rates, many fixed income investors benefited from a natural tailwind to their total returns between the early 1980s and 2022. Outside the isolated periods of credit market disruption that occurred during the 2008-2009 Great Financial Crisis, two generations of bond investors have not witnessed significant or prolonged price declines in their investment lifetimes. This all changed last year. The broad and deep losses in fixed income assets that occurred in 2022, especially within long-duration bonds like longer-term US Treasuries, have created a different risk-return landscape for bonds. In addition, since it has been such a long time since interest rates have been "normal," combined with the fact interest rates have risen so sharply since early 2022, many bonds are trading at significant discounts to par value. This creates a potential opportunity for taxable investors, many of whom may be unaware of the unique tax rules that apply to bonds purchased at a discount. According to IRS Publication 550, the difference between a bond's market price and its ultimate par value is treated as income, and this income may be tax deferrable to the bondholder.

Between the early 1980s and the present, a steep market discount was often a sign of declining credit quality or some other negative development. Today, however, even highly rated bonds can have market discounts that appear extreme. For example, the US Treasury, a borrower that is generally considered riskless in terms of principal repayment, issued a 10-year bond in May of 2021 with a coupon rate of 1.625%. Today, that same bond trades close to 80 cents on the dollar in the secondary market, a 20% discount from its par value.



Source Bloomberg

Shaded area indicates current tightening cycle.

This bond's price decline is certainly severe, but it is also straight-forward to explain. Interest rates have risen significantly since the spring of 2021. Therefore, the bond's market price has dropped to a level which raises the bond's yield—a return metric which accounts for the return of a bond's principal in addition to its coupon payments—to a level that is in line with more recent US Treasury issues that bear higher coupons. Importantly, the significant discount applied to this Treasury bond does not reflect on the

underlying issuer's quality. It is entirely a function of the movement in interest rates since the bond was issued. A buyer of this 2021 issue today accepts its relatively low coupon rate and expects to generate most of their return from price appreciation; they pay approximately $80 today for every $100 they will receive when the bond matures. Decisions surrounding this price return versus coupon return trade-off should include a consideration of how each revenue source can or will be taxed.

All else being equal, a bond's price approaches $100 as it approaches its maturity date, yet a bondholder does not realize any price returns until the bond matures or is sold. While interest payments are always taxable in the year they are received, IRS rules enable taxpayers to choose between accruing a bond's market discount gradually—and thereby smoothing the associated tax liability—or deferring this type of income until the bond matures or is sold. Flexibility as to when this income is recognized can serve as a valuable planning tool for high-income investors, or for any taxpayer who expects a change to their tax situation. An individual who is retiring soon, for example, might benefit from deferring this income until after their retirement, when their taxable income is likely to have declined and their effective tax rate is therefore likely to be lower.

There are, of course, other factors to consider when selecting a bond investment and certain criteria which must be met for the IRS' market discount rules to apply (outlined in **IRS Publication 550**). Readers who believe they may benefit from this tax strategy should consult with a tax professional and communicate their objectives to their financial advisor.

Our approach emphasizes simplicity, prioritizes quality, and focuses on managing credit, reinvestment, and interest-rate risk. We believe that a low-to-intermediate duration portfolio, managed from the bottom up with a strong value bias, affords our clients the opportunity to generate competitive long-term total return without participating unduly in market volatility.

We welcome your comments and questions at any time!

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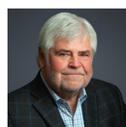

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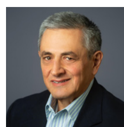

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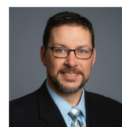

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Disclosures

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The Bloomberg US Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. The US Treasury 10-Year Bond is a debt obligation note by the United States Treasury, that has the eventual maturity of 10 years.

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A Veteran Owned Business (VOB) is a business owned, (51% ownership or greater) by a Veteran who has met the definition of a veteran. The following represents the criteria that the National Veteran Business Development Council (NVBDC) uses in determining ownership:

Ownership: Fifty-one percent ownership by a Veteran or Veterans. The applicant must share in all risk and profits commensurate with their ownership interest.

Control and Management: Proof of active management of the business. Veteran must possess the power to direct or cause to direct the management and policies of the business.

Contribution of Expertise and Capital: Contribution of capital and/or expertise by Veteran owner(s) to acquire their ownership interest shall be real and substantial and be in proportion of the interest acquired.

Independence: The Veteran owner(s) shall have the ability to perform in their area of specialty/expertise without substantial reliance on non-Veteran-owned businesses.

About JAG

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