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A TIMELY INTEREST RATE STRATEGY THAT CAN LEAD TO LOWER PORTFOLIO RISK AND GREATER AFTER-TAX RETURNS FOR CERTAIN INVESTORS

To date, the yields on US Treasury notes in the one to five year maturity range have reached their lowest levels since the 1960's. The future may bring unprecedented supply of US debt to the marketplace. It is very reasonable to question if the current rate levels are sustainable. According to Bloomberg, there are over 60 US Treasury issues in this maturity range. Less than five are trading at a discount to par; the rest trade at significant premiums to par.

Timely Investment Strategy – Short Sale of US Treasury Notes: Opportunistic individual investors can implement an investment strategy that will benefit from a normalization of interest rates and the slope of the yield curve. This can be accomplished by shorting US Treasury notes today with the expectation to cover the short position when rates hit higher levels in the future. This investment strategy does not require a substantial amount of capital. It is executed every day by sophisticated investors and has been for decades.

There is an interesting consequence to this investment strategy which may benefit investors with non-deductible capital losses. The strategy should generate both capital gain (the difference between the short sale price and the cost to repurchase the bonds) and net interest expense (the difference between the coupon of the bond and the interest income earned on the short sale proceeds).

Portfolio Construction Implications: Because the strategy effectively converts non-deductible capital losses to currently deductible interest expense, it enables investors to decrease the risk and enhance the after-tax return of their portfolios by altering their asset allocation.

For instance, many investors found their risk profiles to be much higher than they believed in 2008 due to a heavy allocation to equities. As they look to the future they are conflicted. They want to generate high after-tax returns to help "right the ship". But they don't want to make the same mistakes of the past with an overexposure to the equity markets. At the same time, many investors find the yields and spreads of certain taxable fixed income securities, especially high-yield and high-grade corporate bonds, to be extremely compelling at this time and corporate bonds are less risky than common stocks. Such an investor might wish to reallocate a portion of his or her portfolio from equities to a diversified portfolio of corporate bonds. The interest income received on the portfolio of corporate bonds should be "tax-free" because the interest expense generated by the short strategy should be currently deductible against this interest income.

As another possibility, many high net worth investors currently have some portion of their portfolio allocated to municipal bonds. Today corporate bonds yield significantly more than municipal bonds with similar credit risk and duration. Again, because the interest income received on a portfolio of corporate bonds should be tax-free, investors can benefit by swapping out of municipal bonds into higher yielding taxable debt instruments and capturing the higher yield tax-free.

Investors might have other forms of investment income, such as dividends, REIT income, or royalty income which could be offset by the interest expense.

In sum, investors who wish to express the view that the current low interest rate environment is not sustainable given the huge supply of US Treasury debt that is and will continue hitting the market, can establish a short position in US Treasury notes. If such investors have otherwise non-deductible capital losses, those losses should effectively be converted to currently deductible interest expense. Investors can use their new tax profile to both reduce the risk and enhance the after-tax return of their portfolios by effectively converting taxable investment income into tax-free income.

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