Federated Hermes CW Henderson Municipal SMAs

Federated Hermes

Opportunities beyond tax-free income

Proactive loss-harvesting and tax-efficient portfolio management may add value for tax-sensitive investors

- Tax-loss harvesting opportunities occur throughout the year, not just at year-end.
- Strategic loss-harvesting can generate significant "tax alpha" that is not reflected in reported performance numbers.
- Internal bond swapping helps to maintain market exposure and can be more efficient than trading in the secondary market.

Recent market volatility, including a period of historic losses for bond markets in 2022, focused attention on tax strategies as many investors repositioned portfolios to realize losses and adjust asset allocations. Regardless of market conditions, however, tax-loss harvesting is often reactive, meaning trades are only executed if a client requests it, or left to the end of the year as tax season approaches. In addition, tax-loss trading in the municipal market is typically done in the secondary market, with bonds being sold on the "bid" side and replacement bonds purchased back on the "offered" side. This approach adds bid/offer spread costs to the transaction and subjects client accounts to market risk and income loss if replacement bonds are not purchased immediately. Moreover, dealers typically anticipate a pick-up in this activity toward year-end, which is reflected in the prices they offer investors that are seeking to transact, often resulting in less favorable trade execution.

Given these dynamics, and the fact that municipal bond investors are tax-sensitive, Federated Hermes CW Henderson takes a more pro-active approach to harvesting tax losses in our clients' municipal separately managed account (SMA) portfolios. Waiting for a dramatic change in interest rates, a client request or until the end of the year, may not be the most efficient approach.

Loss-harvesting opportunities occur throughout the year

Opportunities for tax-loss harvesting occur throughout the year (see table below) when interest rate and market volatility create unrealized losses (typically short-term) which can be used to an investor's advantage. At Federated Hermes CW Henderson, we constantly monitor portfolios for loss harvesting opportunities in an effort to maximize this benefit for our clients.

- Rate volatility, seasonal factors, macroeconomic events and central bank actions can all generate short-term swings in bond prices.
- Capitalizing on these dislocations can generate tax-losses that may be utilized to offset realized gains and income taxes, reducing clients' overall tax burdens. Losses can be carried forward indefinitely.

Bloomberg Muni Inter-Short 1-10 Index					**7 out of 10 years with losses in Q1-Q3**	**2 out of 10 years with losses in Q4**	**8 out of 10 years with positive returns**
Calendar year	Q1 return	Q2 return	Q3 return	Q4 return	Q1-Q3 down quarters	Q4 down quarters	Full year return
2013	0.5	-1.6	0.7	0.4	**Yes**	No	0.0
2014	1.3	1.4	0.7	0.4	No	No	3.9
2015	0.8	-0.4	1.2	0.6	**Yes**	No	2.2
2016	1.1	1.2	-0.1	-2.3	**Yes**	**Yes**	-0.1
2017	1.5	1.2	0.6	-0.4	No	**Yes**	3.0
2018	-0.6	0.8	-0.1	1.5	**Yes**	No	1.7
2019	2.0	1.5	0.7	0.9	No	No	5.2
2020	-0.6	2.7	1.0	0.8	**Yes**	No	4.0
2021	-0.2	0.5	0.0	0.1	**Yes**	No	0.4
2022	-4.5	-0.6	-2.3	2.9	**Yes**	No	-4.5

Source: Bloomberg
This is for illustrative purposes only and is not representative of any specific investment. Past performance is no guarantee of future results.

The Federated Hermes CW Henderson approach

A key benefit of SMA portfolios is their potential for tax-advantaged outcomes by retaining one's own cost basis in individual securities and eliminating the influence of other investors' cash flows, such as in pooled vehicles. With an active approach to tax-loss harvesting built directly into our daily investment process, we can create "tax alpha" by generating losses in client portfolios for use toward offsetting gains. Tax alpha is not reflected in reported total returns but can be highly valuable to tax-sensitive, high net worth investors. In the chart below, most losses are assumed to be short-term, consistent with our historical loss-harvesting experience.

Hypothetical tax alpha based on a $2,000,000 portfolio

Loss harvest value		Long-term losses (15% of total)		Short-term losses (85% of total)		Total tax alpha (%)*
%	$	%	$	%	$	
0.50%	$10,000	0.08%	$1,500	0.43%	$8,500	**0.19%**
1.00%	$20,000	0.15%	$3,000	0.85%	$17,000	**0.38%**
1.50%	$30,000	0.23%	$4,500	1.28%	$25,500	**0.57%**
2.00%	$40,000	0.30%	$6,000	1.70%	$34,000	**0.77%**

*Assumes a top rate of 40.8% (37% top Federal income tax rate plus 3.8% tax on net investment income) for short-term gain offsets and 23.8% (20% top long-term gains rate plus 3.8% on net investment income) for long-term gain offsets. This analysis does not incorporate state income taxes. Tax alpha = 23.8% x (% of Long-term losses) + 40.8% x (% of Short-term losses). Actual client results will vary based on specific circumstances such as tax-bracket, state of residence and timing of investments and cash flows.

We typically execute swap trades between client accounts, rather than transacting in the secondary market, potentially improving the efficiency of the tax-loss harvesting process.

- By swapping bonds across accounts, the bid/offer spread is reduced providing better execution.
- Losses are immediately harvested, and clients remain invested without delays.
- Account level characteristics (quality, duration, yield, etc.) remain largely unchanged.

Hypothetical example of loss harvesting with a bond swap

Our investment team actively monitors client portfolios for loss harvesting opportunities and has decades of experience executing swap transactions across accounts. We identify securities with embedded losses that have similar (not identical) characteristics across issuer, coupon, yield and structure. Each individual account must benefit from the swap transaction. For example, assume Client A owns bond A and Client B owns bond B, each at a loss and with similar rating, yield and structural profiles. We "swap" Client A from bond A into bond B and vice versa. The portfolio characteristics of each client are largely unchanged, but each realizes a tax loss on the bond they swapped from and importantly, maintains market exposure by remaining invested. Swap execution prices are based on reliable and independent third-party price data.

Hypothetical bond swap for loss harvesting

Market values based on a $2,000,000 portfolio

Account	Issuer	Market value	Maturity date	Coupon	Purchase price	Yield to worst	Price after 50 basis point rate increase**	Yield to worst (Post rate move**)	Market value after 50 basis point rate increase	Unrealized loss - recognized for TLH	Loss harvesting value (% of total portfolio)
Client A	Muni Bond A	$115,079.00	2/15/2036	5%	$115.08	3.03%	$111.00	3.53%	$111,002.00	$(4,077.0)	0.20%
Client B	Muni Bond B	$115,999.00	2/15/2036	5%	$116.00	2.92%	$111.88	3.42%	$111,883.00	$(4,116.0)	0.21%

**Assumes an instantaneous 50 basis point rate shock.

For illustrative purposes only, not to be deemed a recommendation for a specific security or sector.

Conclusion

Rate volatility and falling bond prices can be driven by many factors including elevated market supply, weaker seasonality and Federal Reserve policy decisions. A proactive and efficient approach to tax loss harvesting throughout the year can help to maintain portfolio stability while creating an improved tax position for individual clients.

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Effective 9/30/22, CW Henderson & Associates, Incorporated was acquired by Federated Hermes, Incorporated and renamed Federated Hermes CW Henderson, a division of Federated Investment Counseling.

Bond credit ratings measure the risk that a security will default. Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality and the lowest category of investment grade; credit ratings of BB and below are lower-rated securities; and credit ratings of CCC or below have high default risk. Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

This should not be construed as a recommendation regarding tax information. Consult your tax professional for more information.

Separately managed account portfolios strategies are only offered to certain qualified investors.

The amount of public information available about municipal securities is generally less than that for corporate bonds. Special factors, such as legislative changes and local and business developments, may adversely affect the yield or value of municipal securities.

Credit ratings do not remove market risk.

Income from municipal securities may be subject to the federal alternative minimum tax and state and local taxes.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.

Duration is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

Bloomberg Municipal Intermediate (5-10 Year) Bond Index: Is an unmanaged index of long-term, fixed-rate, investment-grade, tax-exempt bonds representative of the municipal bond market. The Bloomberg 5-Year Municipal Bond Index is the 5-year (4-6) component of the Bloomberg Municipal Bond Index. Bloomberg 7-Year Municipal Bond Index is an unmanaged index of municipal bonds issued after January 1, 1991 with a minimum credit rating of at least Baa, been issued as part of a deal of at least $50 million, have a maturity value of at least $5 million and a maturity range of 4-6 years. As of January 1996, the index also includes zero coupon bonds and bonds subject to the Alternative Minimum Tax with maturities between nine and twelve years. The Bloomberg 10-Year Municipal Bond Index is the 10-Year total return subset of the Bloomberg Municipal Bond Index.

Tax alpha in the example presented is a hypothetical representation of tax savings as a percentage of portfolio value, based on the assumptions shown for the breakdown of short and long-term capital gains and tax brackets. Does not factor in state taxes. Results will vary based on each investor's specific account details.

Indexes are unmanaged and cannot be invested in directly.

50986 (6/23)
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