# To Sell or Not to Sell Bond Portfolios: That is the Question

InvestEd | February 2024

## To Sell or Not to Sell

- The current interest rate environment has caused investors to contemplate selling existing portfolios to replace with similar investments at today's high yields.
- Liquidating an existing portfolio and repurchasing substantially the same portfolio at prevailing interest rates may have no net long-term economic benefit.
- Such a restructuring could result in large realized losses in the current fiscal period — which could impact financial reporting — while shifting income from the current period into future periods.

As the U.S. economy emerged from the pandemic, inflation rose from 1% in July 2020 to a peak of 9.1% in June 2022 (as measured by the year-over-year change in the consumer price index, CPI). To fight this bout of inflation, the Federal Reserve (Fed) began a rapid series of rate hikes that raised the target range for the federal funds rate from near zero in early 2022 to 5.25% – 5.50% by the end of 2023. Longer-term interest rates surged in response, rising to their highest levels in 15 years.

As a result, fixed-income securities originally purchased when yields were lower likely have large, unrealized losses and original purchase yields (or yield at cost) that lag current market rates. This has caused some investors to consider selling their existing holdings and reinvesting the proceeds at current market rates, effectively resetting both the cost basis and yield of their portfolios. Below, we will discuss some considerations regarding this potential restructuring.

## Accounting and Reporting Considerations

With interest rates at some of the highest levels seen in quite some time, many clients have considered restructuring portfolios to take advantage of the attractiveness of current yields. As mentioned, securities purchased when yields were lower (relative to current levels) likely have large unrealized losses due to the inverse relationship between prices and yields: as yields rise, the market value of securities falls. In response, some investors have considered selling these lower-yielding securities to purchase new securities at higher current yields. While the use of fair market value accounting on financial statements likely resulted in the booking of unrealized losses in prior fiscal years, those paper losses could be recouped through the passage of time if securities are held to maturity. However, selling securities originally purchased at lower yields may result in substantial losses being realized in the current fiscal year, which would have a material adverse impact on the organization's current and future fiscal year income. In fact, such a strategy could effectively shift investment income from the current fiscal year into future periods due to the impact of the realization of losses.

Selling an entire portfolio and then repurchasing it at current yields may indeed reset (and increase) the portfolio's current yield, resulting in higher investment income in future years. However, the realized losses from selling securities that could be booked in the current year could essentially offset the increase in income that could be received in future years from repurchasing the securities at higher yields. In other words, holding a portfolio of lower-yielding securities to maturity and allowing the unrealized losses to be reversed over time may result in the same economic outcome as selling the lower-yielding securities and repurchasing them at higher yields: any increases in income may be offset by the realized losses. Additionally, shifting income from one period to another in this manner could impact reported financial results.

As an alternative, investors seeking to take advantage of the current rate environment might consider strategically selling specific securities — including those with less earnings potential going forward — in an attempt to improve portfolio performance.

## Execution Considerations

The act of selling and then repurchasing securities contains several risks that must be considered as well. The first is the impact of the "bid-ask spread" when buying and selling securities. Specifically, securities would be sold at lower (bid) prices and higher yields, and then repurchased at higher (ask) prices and lower yields. The differential between the yield at which the security was sold and then repurchased could result in marginally lower long-term earnings.

Another concern is that certain sectors, such as corporates, mortgage-backed securities (MBS), and asset-backed securities (ABS), tend to have wider bid-ask spreads, which would result in increased transaction costs. It also may not be physically possible to source and repurchase similar securities in these sectors as supply is often limited in the secondary markets. As an alternative, there may be opportunities to swap out of certain securities to purchase either longer-dated issues or spread sectors (non-Treasury securities) to aid in the longer-term return potential of the portfolio. An investor's sensitivity to realizing potential gains or losses should be considered as this has implications on the recognition of investment income as discussed above.

## Conclusion

Liquidating an existing portfolio and repurchasing substantially the same portfolio at prevailing interest rates may have no net long-term economic benefit. In the near-term, the investor may book large losses, which could offset any increases in income that could be realized in the long run. This could also shift income into future fiscal years as the higher future earnings in subsequent periods could come at the cost of large realized losses in current periods. Moreover, there may be measurable transaction costs and the loss of bid-ask spreads, which could offset the increase in yield.

If you have been thinking about this type of restructuring, we encourage you to speak with your PFM Asset Management relationship manager, who can work with you and weigh the varying options for your portfolio.