SPECTRUM
Asset Management

Qualified Dividend Income: Less May Still Be More

Components to President Biden's tax plan seek to eliminate the long-term capital gains tax benefit for wealthier investors and the Qualified Dividend Income (QDI) benefit, as a result. We summarize the risks to the proposal below, which as written would:

- Raise the top marginal income tax rate from 37% to 39.6% percent, on income over $452,700 for single and head of household filers and $509,300 for joint filers.
- Raise the long-term capital gains tax and the tax on qualified dividends by taxing both as ordinary income for taxpayers with taxable incomes over $1 million -- this essentially means that there would no longer be a "qualified dividend" available for wealthier some taxpayers. The change would result in a top marginal tax rate of 39.6% -- and when the 3.8% Net Investment Income Tax (NIIT) for Obama Care is included, the top marginal rates on long-term capital gains and dividends would increase to 43.4% from 23.8%.

Clearly, this tax hike could cut many investor's income benefits on "qualified dividends" available in preferred stock and some contingent convertible capital securities. In the table below, we highlight a sample of after-tax yields available with the existing tax law by observing the ICE BofA benchmark yields for preferred stock (p0d0) and contingent convertibles (cdlr) and comparing these to investment grade corporates (cy42) and high yield bonds (h0a0) – the after-tax economics are viewed relative to 5yr Treasury Inflation Protected Securities (TIPS) to illustrate how much the Fed is bullying interest rates by forcing inflation adjusted yields (i.e., real yields) well below zero (e.g., -1.53% on the 5yr TIPS) – in effect, this is inflation's "burn rate" on capital invested the US Treasury 5yr note. We then look at the after-tax differences on our chosen credit sector alternatives to ascertain how much of this burn rate can be offset to at least generate some nominally positive real growth in purchasing power, after-tax. Under existing tax law, CoCo paper places #1, followed high yield #2 and preferred stock #3 with IG corporates coming just short of the podium in 4th place (and still burning purchasing power). If the tax law changes as explained, then high yield would flip to #1 and CoCo paper would slip to #2:

	ICE BofA Pfd. Stk.	ICE BofA CoCos	ICE BofA 3-5yr Corp	ICE BofA US HighYld.
	p0do	cdlr	cy42	h0a0
Yield-to-Worst (%)	2.36	3.48	1.42	3.97
Spread vs. US Govt. (bps)	162	274	77	329
Modified Duration	3.4	3.3	3.7	3.6
Price	$107.77	$108.00	$108.44	$104.82
Coupon (%)	4.98	6.51	3.73	5.84
Composite Rating	BBB2	BB1	BBB2	B1
Existing Tax Law[1] (QDI = 23.8%; Ordinary Income Tax = 40.8%; LT Capital Loss = 20.0%):				
QDI? (Y/N)	Y	Y	N	N
After Tax YTW (%)	**1.89**	**2.90**	**0.35**	**2.29**
5yr UST TIPS (Real ROR%)	-1.53	-1.53	-1.53	-1.53
After Tax Pickup (%) vs. 5yr TIPS	3.42	4.43	1.88	3.82
Less 5yr B/E Inflation Rate (@2.38%)[2]	1.04	2.05	-0.50	1.44
Proposed Tax Law[1] (QDI = 43.4%; Ordinary Income Tax = 43.4%; LT Capital Loss = 39.6%):				
QDI? (Y/N)	N	N	N	N
After Tax YTW (%)	**1.37**	**2.12**	**0.69**	**2.40**
5yr UST TIPS (Real ROR%)	-1.53	-1.53	-1.53	-1.53
After Tax Pickup (%) vs. 5yr TIPS	2.90	3.65	2.22	3.93
Less 5yr B/E Inflation Rate (@2.38%)	0.52	1.27	-0.16	1.55
Adjusting for Default Assumptions:				
Average Annual Default Risk[3]	**-0.11**	**-0.11**	**-0.04**	**-2.57**
Default Assumption After-tax	-0.07	-0.07	-0.02	-1.55
§ Credit to Real ROR, net net	0.45	1.20	-0.18	0.00

(1) Taxation on incomes >$1mm; includes Obamacare's net investment income tax rate of 3.8%

(2) Less 5yr B/E Inflation Rate (@2.38%) = Spread to 5yr USTsy note yield, absolute after tax

(3) Source = Moody's and Spectrum Asset Management

(§) Credit to Real ROR, net net = After tax, after assumed default risk; pickup in purchasing power, relative to 5yr UST note

Memo:	Pfd. Stk.	CoCos	3-5yr Corp	US HighYld.
Real ROR for credit sector, Atx	-1.01	-0.26	-1.69	0.02

The reasons for high yield bonds surpassing CoCos under the proposed tax law changes are that existing QDI paper would lose a 19.6% stream of annual income margin but pick up a 19.6% margin on a unit of long-term loss, such as a premium paid above par. On the other hand, non-QDI paper like IG corporates and high yield would lose ("just") a 3% margin of annual income stream while picking up a 19.6% tax-loss benefit on a long-term capital loss. Therefore, the proposed tax law changes would detract more comprehensive value from QDI paper and could add

comprehensive value to premium non-QDI paper if capital losses can be offset by capital gains.

Though there is no doubt that wealthier QDI investors have the most to lose from the Biden plan, when we consider default risks and inflation break-evens (remembering that inflation is an after-tax cost to purchasing power), CoCos and preferred stock can still win the day as better economic choices than either investment grade corporate bonds or junk bonds. In fact, CoCos and preferred stock, score #1 and #2 when adjusting yields for historical default experience – they also offer credits (e.g., 120bps and 45bps, respectively) to real returns that are negative which help to fight back against the bond bully (i.e., the Fed) who compels you to save later and spend now by keeping real investment returns negative (well, for now). Basically, CoCos and preferred stock can turn the temperature down on the Fed's burn rate against your capital, but IG corporates and junk bonds may not – especially when considering default histories.

The Fed's confidence in its flexible average inflation targeting policy appears to be a bit suspect of late with its hawkish concerns communicated from its committee meeting last week. The Fed is now giving conflicting signals of insisting it will wait for desired economic outcomes to manifest "significant further progress" before it lifts the zero federal funds rate, yet it appears oddly nervous about inflation (i.e., its goal) even though it has gone to great lengths in describing current inflation as merely "transitory". We still view the risks being skewed to higher long-term rates especially against the backdrop of a taper powered by ongoing fiscal stimulus that may challenge "transitory" inflation narratives. One way to hedge against inflation is to do the best you can to earn the Fed's inflation target of at least 2%, after-tax. QDI paper can give fixed income investors more opportunities to do that when fairly risk adjusted by historical default experience even if QDI is taxed more to yield less. Indeed, less may still be more because everything in bond land is relative!

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