Active Municipal Bond Management

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INVESTMENT COUNSELORS SPECIALIZING
IN TAX-EXEMPT MUNICIPAL SECURITIES

Ladder Bond Portfolio Construction

Ladder portfolios typically have maturities ranging from one to seven, one to ten or one to fifteen years. Little or no attention and oversight is given to the portfolio until a bond matures – perhaps only once a year. Bonds are generally purchased at prices close to par. This avoids having to explain premium amortization, the difference between current yield and yield to maturity, tax consequences associated with discount bonds, income taker and remainder interests, etc. Call risk is avoided wherever possible to maintain simplicity. Often a preponderance of insured bonds are used to (seemingly) avoid credit issues.

Advantages of Active Municipal Bond Management

Use of non-par bonds increases returns: Strong demand for par bonds tends to cause these securities to trade at rich levels relative to non-par securities. Far better value can be found in premium and discount bonds, often enhancing yields by 25 to 50 basis points. In the case of discount bonds, the enhancement is on an after-tax basis.

Convexity control: Par bonds have poor volatility characteristics. When yields decline, bonds purchased at par appreciate to premium levels where demand lessens and, in the case of longer bonds, price appreciation is restricted by calls. In a rising rate environment, bond prices fall at accelerated rates due to tax consequences – especially when de minimus levels are penetrated and market prices are adjusted to account for ordinary income taxes that must be paid by on the bond's appreciation to par by any new buyer.

Significantly better execution: Bonds purchased from a broker in the secondary market are typically marked up significantly to compensate traders, sales people, etc. For example, each one point (1%) markup on a five year bond at current interest rates represents a yield reduction to the buyer of over 20 basis points. A professional manager that is constantly engaged in the market can generally reduce spreads to one eighth or one quarter of a point (or even less) – both on the buy side and on the sell side.

Constant credit monitoring: In depth credit analysis provided by a professional research staff is a critical component of successful municipal investing. In addition, day-to-day market involvement provides active managers with credit insights and the ability to react quickly to changing circumstances. Credit deterioration can result from changes in a municipal entity's financial condition (i.e. lower tax receipts, a decline in system revenues, unexpected expenses, etc.) as well as from exogenous factors (loss of a major tax paying enterprise, natural disasters, terrorism, required pension and CEPB contributions, etc.). It is important to continuously monitor credit quality and to have a sell discipline to assure that deteriorating credits are expeditiously removed from portfolios.

Ability to look beyond insurance: Insured does not mean guaranteed! We have never relied on insurance in our security selections process, but have focused on underlying credits. Use of second tier credits, (nursing homes, solid waste disposal facilities, local housing authorities, tobacco bonds, etc.) that might possess higher than appropriate credit ratings because of insurance should be avoided. Even with insurance, these securities typically do not have good liquidity characteristics.

Duration control: Forecasting interest rates is at best difficult, but close monitoring of market dynamics does provide insight that can assist in timing market moves. Buying on weakness and selling on strength can add meaningfully to overall returns. Shortening or lengthening duration in anticipation of interest rate moves can also add significant enhancements. Although investors with ladder portfolios often profess that they do not care about volatility as long as they receive a steady flow of tax-exempt income, a ten or fifteen point decline in the price of a relatively short bond can be shocking. If price volatility is to be controlled, short overall portfolio durations are most prudent and should be maintained.

Strategy implementation: Barbell constructed portfolios typically provide enhanced returns with lessened volatility risk. In addition, use of specialized securities (e.g. high coupon bonds with short calls) can provide the returns of ten to twenty year securities with the duration risk of a six-month or one year bond.

Advantageous trading: Changing supply/demand patterns can cause segments of the market to periodically become overvalued and undervalued. We take advantage of these situations by offering bonds at elevated prices to the brokerage community and on internet trading platforms. We can then swap from overvalued securities into other bonds that are trading at cheaper relative valuations. Our objective is to "sell rich and buy cheap" as long as it is tax effective to do so.

Tax-loss harvesting: During periods of rising interest rates it is typical for laddered bond portfolio managers to focus on generating losses in bond accounts only during the last several weeks of the year – exactly when everyone else is attempting to implement similar programs. An active manager monitors gains and losses on a continuous basis and will harvest losses throughout the year whenever advantageous trades can be executed.

Performance monitoring: Most investors with equity portfolios monitor the returns of their accounts relative to an index to determine how their investments are performing. It is prudent to also track performance with a fixed income account. An essential component of active management is the selection of a relevant benchmark that compares the performance of the manger and provides feedback to the investor. Seldom, if ever, are performance comparisons provided for laddered portfolios.

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