Asset Bloat in Municipals:
Managing Too Much Money May Lead to Portfolio Underperformance
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C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

C.W. Henderson and Associates, Inc. (CWH) believes that "asset bloat," or managing too much money, may adversely impact a firm's ability to add value in the tax-exempt municipal bond market. Firms that manage too much money are not able to be selective – they are "price takers" and not "price setters." They may be forced to purchase most approved deals, regardless of relative value, otherwise clients will sit in cash - earning minimal returns. Because of asset bloat most large firms are also unable to take advantage of market disparities and cannot efficiently harvest tax losses in client portfolios during periods of rising interest rates.

C.W. Henderson does not have an asset bloat problem. We currently manage about $3.10 billion in high quality, tax-exempt municipal portfolios. We are large enough to have outstanding relationships with the largest brokerage firms on Wall Street, yet we are not too big. Being nimble is one factor that has allowed us to achieve attractive returns for our clients for over 25 years – typically with a much shorter duration and higher credit quality than both our benchmark and peers.

Concerning trends we see in firms that suffer from asset bloat are discussed below.

Purchasing Lower Quality/Longer Duration Bonds

Because money market type vehicles continue to provide near zero returns, investment managers cannot have clients invested in cash. There are not enough high quality bonds to meet demand so larger firms are forced to purchase lower quality securities to stay invested (leases, hospitals, airports, certificate of participation bonds, tobacco bonds, etc.). Credit analysts at these firms have been forced to approve bonds from issuers they might typically avoid. The average credit quality at large firms that manage separate accounts and/or and tax-exempt mutual funds has diminished at exactly the wrong time - when credit spreads are extremely narrow.

CWH's credit quality has actually improved over the last several years as credit spreads have narrowed. Average credit quality is AA+ and we continue to primarily invest in essential service revenue bonds, highly rated general obligation bonds and large private university bonds.

The table below provides a comparison of current quality spreads with those that existed three and four years ago. The differential between AAA and BBB yields exceeded 300 basis points in 2009, but declined sharply in the following years.

	10/31/2016			10/31/2013			10/31/2012		
	AAA	**BBB**	**Spread**	**AAA**	**BBB**	**Spread**	**AAA**	**BBB**	**Spread**
1Yr.	0.71%	1.34%	63 BP	0.17%	1.07%	90 BP	0.20%	1.18%	98 BP
5 Yrs.	1.14	1.93	79	1.07	2.47	140	0.67	2.14	147
10 Yrs.	1.74	2.60	86	2.43	4.06	163	1.72	3.36	164
15 Yrs.	2.16	3.06	90	3.22	4.84	162	2.14	3.85	171
20 Yrs.	2.41	3.31	90	3.71	5.17	146	2.44	4.14	170
30 Yrs.	2.56	3.45	89	4.05	5.40	135	2.83	4.37	154

Spread widening risk exists, and although it may not reoccur for some time, it should be recognized in constructing portfolios. The objective of C.W. Henderson's focus on utilizing only high quality securities with good liquidity characteristics is to reduce the risk of both rating downgrades and spread widening.

In a quest for yield several investment managers have extended portfolio durations - despite a flatter yield curve and interest rates being near historical lows. If municipal rates were to rise, investors will likely be hit with a "double whammy" – both lower prices due to rising interest rates and widening credit spreads that will create even more dramatic principal losses. CWH portfolio durations have been reduced to approximately 3.50 years or 15% short of neutral. We are "playing defense" and believe many investors are not being appropriately compensated for taking on additional credit and/or interest rate risk.

Several firms are even purchasing taxable securities in client municipal accounts, even though they may yield less on an after tax basis or may be lower in quality, due to the lack of available tax-exempt supply relative to total assets under management. CWH does not purchase taxable bonds and does not foresee a time when we will not be able to purchase enough tax-exempt securities to meet client demand.

Overpaying for Bonds to Receive an Allocation

Demand for municipals has outpaced supply for a considerable amount of time. As of 10/24/2016, tax-exempt mutual funds had inflows in 55 of the last 56 weeks. Some firms have attempted to purchase entire deals to adequately invest client cash. This can lead to them "overpaying" for securities. Larger firms that do not overpay for bonds have clients invested in cash and earn essentially nothing. C.W. Henderson does not have this problem. See below:

Indiana State University (ISU) and Stephen F. Austin University (SFAU) both recently came to market. Both issuers are rated A1/AA- and were approved by our internal credit staff. ISU bonds maturing 4/1/17 were priced at 0.70%. The SFAU bonds maturing 4/15/17 were priced at 0.77%, or 10% cheaper for a comparable credit. We only purchased the SFAU bonds (buying 3.085 million for clients) and avoided the ISU bonds because they were too rich in our opinion. CWH can be much more selective than our larger peers. This selectiveness, and incremental yield enhancement, adds significant alpha generation and improves portfolio performance over time.

Inability to Effectively Harvest Capital Losses

Firms that manage too much money are unable to effectively tax-loss harvest in client portfolios. For a legal "tax swap" in the municipal space, according to IRS rules, two of the following three bond characteristics must be altered when executing a swap or cross trade: coupon, maturity date or issuer. Properly executing cross trades is extremely labor intensive. CWH firm policy requires obtaining a pricing service evaluation, a firm price evaluation and independent price evaluations from three brokerage firms. So, ten evaluations are required for each transaction. The SEC has approved our policy for cross trading in regards to tax loss harvesting. Most large firms do not have the capacity to execute tax loss cross trades across all client portfolios. The alternative: selling bonds in the open market on the "bid side" and purchasing different bonds on the "offered side" would likely eat up all the tax savings when compared with SEC approved "crossing" internally.

Although of significant value to our clients, the after tax benefit of the tax losses CWH harvested in 2008, 2011, 2013, 2015, etc. are not included in our performance calculations. We monitor gains and losses on a continuous basis and will harvest losses throughout the year whenever advantageous trades can be executed. Loss harvesting during periods of rising interest rates is a major differentiator for CWH compared to large firms.

Unlikely to Purchase "Matchers"

Larger firms typically do not focus on matching blocks of bonds or "matchers" – at least not proactively. In fact, many firms will not look at offerings of less than one million. The practice of purchasing smaller blocks of bonds does not significantly enhance returns for firms with $10 to $20 billion, or more, in AUM. We can utilize smaller blocks and add to positions when we find additional bonds in the secondary market.

At $3.10 billion in assets under management, CWH is an aggressive buyer of matching blocks of bonds and, over time, is able to meaningfully enhance returns. For example, we may purchase a block of 250,000 California Water bonds in the secondary market. Assuming a large maturity and frequent secondary market activity for a CA Water bond, we can add 50,000, 100,000, 200,000, etc. at much cheaper valuations than a round lot of CA Water bonds. Over time our original block of 250,000 bonds may grow to perhaps 10 million – making it worth considerably more. Essentially, we often purchase securities at "odd lot" prices and are then able to sell positions at "round lot" prices – assuming it is tax effective to do so.

Limited Duration Control and Lack of Advantageous Trading

Larger firms that suffer from asset bloat often manage laddered portfolios that 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. They are essentially "index neutral"- which means they typically do not shift portfolio duration in response to market opportunities.

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. In fourth quarter 2008, when 10 year prime municipal/Treasury yield ratios exceeded 170%, CWH was able to react swiftly to the market dysfunction and take advantage of the tremendous buying opportunity. We were aggressive in extending Intermediate Product portfolio durations from a neutral duration of 4.00 years to a more aggressive 5.00 years. When municipal rates declined several years later we rather easily shifted back to a more defensive posture – remaining cognizant of the tax ramifications involved in a portfolio restructuring. As described, segments of the municipal market may periodically become overvalued and undervalued. Our size and "nimbleness" allows us to take advantage of such situations.

In summary, asset bloat is an often overlooked aspect of the municipal bond portfolio management landscape. Investment performance is often inversely related to asset growth. Clients should understand the risk in a manager's swelling AUM, as often times a firm's ability to enhance returns erodes as they become too large.

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