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Local bonds with global appeal.

In a Q&A, Jim Grabovac, CFA® and Steve Wlodarski, CFA® of McDonnell Investment Management, explain how non-US investors could benefit from allocating to US municipal bonds.

Key Takeaways:

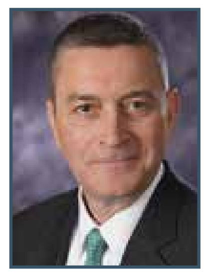
- The $3.83 trillion municipal market provides capital market access to US state and local governments, and to projects ranging from schools, hospitals, roads and airports, to water systems and power plants.
- Nearly 70% of the municipal market is rated AA or higher, compared with just 22% for the corporate market. And munis provide a modest yield pick-up versus corporate bonds and a significant yield uplift over Treasuries.
- For corporates and insurers, munis can be used to match liabilities and there is preferential treatment for munis under Solvency II. In the portfolios of very long-term investors such as pension funds, munis sit between Treasuries and corporate bonds, providing strong capital protection with yield uplift and diversification benefits.

Q. Why should institutional investors be interested in municipal bonds?

A. The US Municipal Market is seeing increased interest from global investors. Long the domain of domestic buyers attracted by the exemption from federal tax, the municipal market began to draw the attention of non-US investors in 2009 with the onset of the Build America Bond Program (BAB), which resulted in a burst of issuance of subsidized taxable municipal bonds designed to help spur infrastructure investment in the wake of the economic downturn. Good quality and yield pickups versus US corporates attracted new buyers to the asset class and that participation has continued to grow.

Q. So what exactly are "munis"?

A. The municipal market provides capital market access to US state and local governments and their agencies. Issuance is broadly categorized as either General Obligation Debt, which is backed by a taxing authority, or Revenue Debt, which is backed by a specific stream of revenues such as tolls, fees and excise taxes. Within these broad categories are issuances for schools, hospitals, roads, airports, water systems, power plants and many other purposes. There is $3.8 trillion in US municipal debt outstanding[1], which equates to somewhat less than half the size of the US corporate market and less than a third of the size of the US Treasury market. In comparison with sovereign debt markets, however, the municipal market would be the third largest issuer after the US and Japan. The municipal market is also highly diverse, with an estimated 50,000 issuers.[2]



Jim Grabovac
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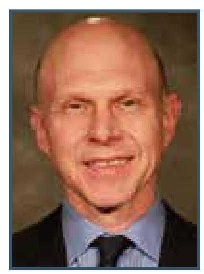

Steve Wlodarski
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Q. How risky are munis compared with corporate bonds?

A. Credit quality across the municipal market is generally high in comparison to the corporate market. Using Bloomberg Barclays indices data as a proxy, nearly 70% of the municipal market is rated AA or higher, compared with just 22% for the corporate market. Meanwhile, only 7% of munis are rated BBB, compared with 44% of corporate issuance.[3] In addition to high average quality, the municipal market also has a much lower historical default rate as well as a higher recovery rate in the event of default.[4] This is not meant to suggest that the municipal market is devoid of credit problems; underfunded pensions and other long-term liabilities represent a significant fiscal challenge for many issuers, particularly those that were overleveraged heading into the credit crisis. But broadly speaking, the market has good fundamental credit quality, which has been bolstered by an eight-year economic recovery. There is some liquidity risk premium, as the market encompasses a large number of small issuers who come to market infrequently. Since the municipal market is dominated by higher rating categories compared to corporate bonds, we view liquidity risk as being low.

Q. How do you pick munis for your portfolio?

A. One of our strengths as a firm is having a research database which tracks about 6,500 individual municipal securities. In any given year, our analysts produce written reviews on over 500 names, which requires both deep credit research resources and cutting-edge credit technology. The analysts issue rating and momentum scores to each issue. The momentum score reflects if fundamentals are improving; we are typically looking to invest in issuers who are moving from a neutral or slightly negative momentum score to a positive score.

Q. How granular is your research?

A. The higher we perceive the risk, the more we research. Larger issuers release financials on a quarterly basis, but smaller issuers often require much greater scrutiny. For a hospital project, for example, we will look at whether financials are released on time; we examine the business model, the strategic plan, the business plan, its relative positioning in the market, its dependence on federal programs such as Medicare and Medicaid, and so on. We will follow up with conversations with CFOs if we think it's necessary.

Q. What experience do you have managing municipal bond portfolios?

A. All our resources are focused on fixed Income; that's our business. Two-thirds of the assets we manage are munis. In terms of skills and organization, we're different in that our portfolio managers and research analysts work as an integrated team, whereas in many firms, research is seen as an inhouse ratings agency. We currently have 11 credit research analysts on staff, which is significant for our $11bn in AuM. These analysts, many of whom have 20 or more years of experience, allow our process to be research-driven across credits, markets and portfolios. They also serve as the core of our strong risk control culture and allow us to evaluate opportunities across the new issue market, which totaled $445B in 2016[1], the secondary market and the entire yield curve.

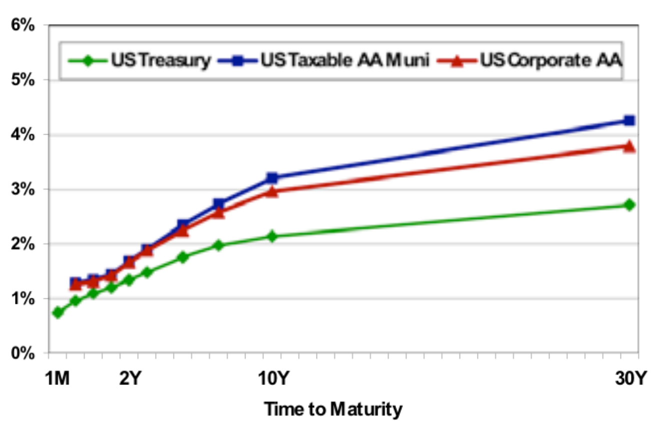
Q. What yields can investors expect?

A. The municipal liquidity give-up tends to result in a modest yield pick-up versus comparably-rated corporate bonds and a significant yield uplift over Treasuries in the long-term, as the chart below shows.[5] The level of return depends on the specific strategy. A boutique like McDonnell is uniquely positioned to exploit the trading inefficiencies of the market. We are large enough to have a significant market presence, but not so large as to limit our ability to be flexible and selective.

Q. How attractive are munis to non-US investors?

A. There is strong interest among US individuals because municipal interest income is usually exempt from federal taxes. But take-up by non-US investors in taxable issuance – which attracts higher yields - is increasing steadily. According to the Federal Reserve, non-US holders had accumulated $90.4B of munis (as of Q1-2017), or 2.3% of outstanding issuance.6 This represents an increase of 25% from the end of 2010.

YIELD CURVES AS OF 6/23/2017



Source: Bloomberg

Q. What kinds of investors should be interested in munis?

A. For corporations and, in particular, insurers, munis are increasingly used to match liabilities. In contrast to most segments of the fixed-income market, municipal issuance is typically comprised of a combination of serial and term bonds, with maturities staggered from one to 30 years. As a consequence, investors are afforded opportunities to invest in the 10- to 20-year portion of the yield curve.

For property and casualty insurers, durations of around five years can be used to match medium-term liabilities. Meanwhile, life insurers require longer duration bonds. Given the fact that munis are used to finance US Infrastructure, many insurance companies use them as a diversification to their infrastructure investments.

In the portfolios of very long-term investors such as pension funds, munis sit somewhere between Treasuries and corporate bonds, providing strong capital protection with yield uplift and diversification benefits.

Q. Can you sum up the opportunity for investors?

A. The US municipal market is a pure credit market. Although the market possesses strong average quality, the divergence between individual issuers can be profound. While historical default experience is low in comparison with similarly-rated corporate bonds, chronic underfunding of long-term liabilities is a challenge for many state and local issuers. We believe that while good opportunities for global investors remain, prudent investment in munis begins by accessing a partner dedicated to investment in the sector, and with strong capabilities in fundamental credit, portfolio and market research.

1. http://www.sifma.org/research/statistics.aspx
2. http://www.msrb.org/msrb1/pdfs/MSRB-Muni-Facts.pdf
3. Bloomberg Barclays Indices
4. Moody's Investor Services: US Municipal Bond Defaults and Recoveries, 1970-2015, May 31, 2016
5. Bloomberg
6. https://www.federalreserve.gov/apps/fof/DisplayTable.aspx?t=l.212

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