



## *Municipal Bonds A Complex Market that Requires Active Management*

### Insights from the MacKay Municipal Managers<sup>TM</sup> team of MacKay Shields LLC

Municipal bonds can play an important role in a portfolio. In addition to offering investors tax-exempt income, they provide exposure to generally high-quality issuers<sup>1</sup> that historically have had low default rates and low correlation to other major asset classes, as well as diversification. In the past, many financial advisors had a high level of comfort buying individual municipal bonds for their clients. However, the municipal market landscape has been significantly altered over the last several years, making it increasingly difficult to navigate for even experienced financial advisors. As a result, it is our belief that financial advisors and their clients can fully maximize the benefits of tax-free investing by employing the services of an experienced, professional, credit-oriented municipal bond manager. In this paper, we will discuss some of the unique aspects of the municipal bond market, and describe ways that these professional managers can add value for municipal bond investors.

#### **The Municipal Bond Market – Key Distinctions**

The municipal bond market is unique for several reasons:

- The first and most obvious attribute that makes municipal bonds unique is that they offer investors federally tax-exempt income—and in some circumstances this income is exempt from state and local taxes as well.
- Second, individuals, via direct ownership of municipal bonds or through mutual funds or separately managed accounts, make up the largest investor base for the municipal bond market, representing approximately 69% of the market.<sup>2</sup>
- Third, municipal bonds are an over-the-counter market. With roughly 87,000 issuers and no centralized exchange, the \$2.9 trillion municipal bond market is one of the most inefficient and disjointed markets.<sup>2</sup> Compare this to the Treasury market, a market with a single issuer and approximately 400 issues.

Due to a lack of adequate credit information, individuals purchasing municipal bonds directly may struggle to make informed investment decisions. Even those individual investors who possess the skill, time, and financial resources to invest in municipal bonds may run into difficulties given the limited selection of municipal bonds. In addition, less than 1% of municipal bonds outstanding trade on a daily basis.<sup>2</sup> As a result, the number of trade-based price observances is limited. For investors who do not focus on the municipal market solely, it can be difficult to make reasonable relative value decisions. This creates significant advantages for a research-driven asset manager to identify mispricings in the market.

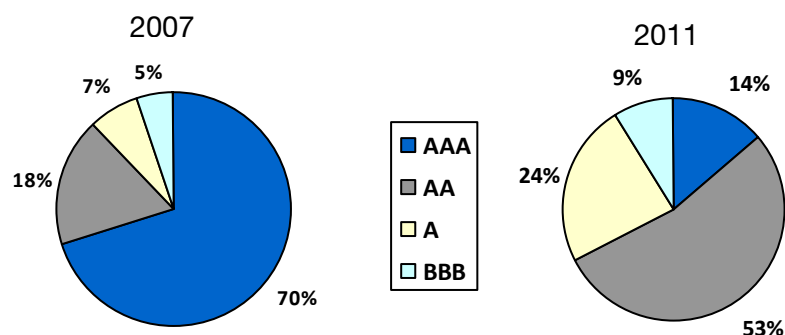
Long gone are the days of a seemingly homogenous municipal bond market consisting of insured bonds. With the decline of bond insurance, today's municipal bond market is a more complex mix of credit stories. In light of these nuances, we believe that credit research oriented professional municipal bond managers are well positioned to consistently identify and capitalize on mispricings and manage risks.

1. Non-Investment grade bonds represent less than 5% of the municipal market, as measured by Barclays Capital as of 10/31/11.

2. Source: Securities Industry and Financial Markets Association (SIFMA) as of 6/30/11.

Income may be subject to the alternative minimum tax (AMT). AMT is imposed at a nearly flat rate on an adjusted amount of taxable income above a certain threshold (exemption).

## A Mix of Credit Stories: Lack of Bond Insurance Has Lowered Municipal Bond Credit Ratings<sup>3</sup>



Source: Barclays Capital. Ratings for 2007 as of 12/31/07. Ratings for 2011 as of 8/31/11.

### **An Active Approach**

In addition to the municipal bond market being quite large and inefficient, there are several other factors investors must consider, such as bond maturity, credit rating, duration, and call features that may impact the cash flow or the price of the bond.

Given these considerations, a laddered or barbell approach to constructing a municipal bond portfolio may be susceptible to certain risks, including deteriorating credit quality, unexpected early redemptions, limited market access, fewer investment opportunities, and high trading costs.

In 2006, more than 60% of municipal bonds issued were insured. Today, only one insurer provides bond insurance and the new issue penetration rate is below 10%. In the past, some investors may have relied on bond insurance as a substitute for old fashioned credit research. With the limited availability of bond insurance, the need for in-depth credit research on municipal bonds is more critical than ever before.

Active managers who employ a disciplined approach using their own credit research are able to look beyond the published bond rating and/or bond insurance to discern value. In managing portfolios, experienced asset managers understand the interest rate environment, rely on internally generated credit analysis, and use their industry experience and contacts to ensure efficient trade execution.

The municipal market is not only characterized by a wide array of diverse credits and structures, but also by a fairly segmented trading structure. The large number of regional municipal dealers is somewhat inaccessible to the average individual investor. Market access, based on long term business relationships, allows experienced managers to search for investment opportunities across the spectrum of municipal dealers. As a result, they can seek out bonds from a significantly larger investment universe. Active managers can also analyze supply and demand imbalances in the municipal market. This helps identify sector, state, or issuer-specific opportunities based on trends.

*"The municipal market has never been as inefficient as it is today. With current spreads so wide, there are mispricings to uncover and discover every single day. Active management allows individual investors to get access to institutional level execution." Robert DiMella, Senior Managing Director, MacKay Shields*

3. In 2010, Moody's Fitch recalibrated their ratings for U.S. Municipal Bonds to a global ratings scale. The change in ratings does not reflect an improvement in the credit quality of the sectors or securities. The existing credit conditions of the entities will simply result in higher ratings grade when the standards for other asset classes are applied. As part of the recalibration, Moody's concluded that state and local government general obligation debt ratings will increase by an average of two notches. (Moody's Report, March 2010)

It is also important to take into account the political landscape. Active managers keep an eye on pending legislation that may impact taxes and sectors of the municipal market, as well as politics at the state and local level. By understanding the political purpose behind municipal projects, active managers are able to gain additional insight into the support for the issuer's securities should the bonds come under economic pressure (e.g. toll roads, airports, etc.).

Finally, active managers may position portfolios based upon the yield curve by investing in bonds with varying maturities and making adjustments based on relative value opportunities.

The table below looks at the various sources of potential return from our teams' municipal strategies. It's clear that with the right active manager, far more goes into alpha generation in an actively managed portfolio, than in traditional financial advisor-constructed methods such as a laddered or barbell approach.

#### **Potential Sources of Return in Active vs. Passive Investing Strategies**

Potential Return Sources	Mutual Fund	Active SMA Portfolio	Traditional Financial Advisor-Constructed Portfolio
Bond Yield	X	X	X
Duration	X	X	
Yield Curve	X	X	
Credit Research	X	X	
Sector Allocation	X	X	
Quality Allocation	X	X	
Security Selection	X	X	
Trade Execution	X	X	
Active Risk Management	X	X	
Liquidity	X		
Tax Efficiency	X		
Diversification Level	X		
Hedging	X		
Trading Flexibility	X		
Lower Ongoing Operating Expenses		X	X

This chart is for illustrative purposes only. A traditional financial advisor-constructed portfolio refers to either a laddered or barbell approach, which are passive methods of bond investing by which the portfolio is divided to equal parts and invested in individual bonds with different durations and maturities over the investor's time horizon.

#### **Ongoing Risk Management**

Financial advisors and individuals investing in medium- to high-quality, fixed-income investments, such as municipal bonds, naturally consider these among the safer assets in their portfolio. However, despite the relatively strong credit quality and lower historical default rate, investing in the municipal bond market is not without risk. For example, municipal investors can be exposed to deteriorating credit quality, reinvestment risk due to a bond call, or limited liquidity in the future. Now more than ever, active management of municipal bonds is crucial in helping to manage these risks.

In light of the inherent credit risk that now accompanies municipal bond investing, we believe municipal bond investors can mitigate that risk through diversification, which can reduce the impact of any single issuer's credit rating deterioration or default on the overall portfolio. Such diversification is difficult to achieve for individual purchasers of municipal bonds.

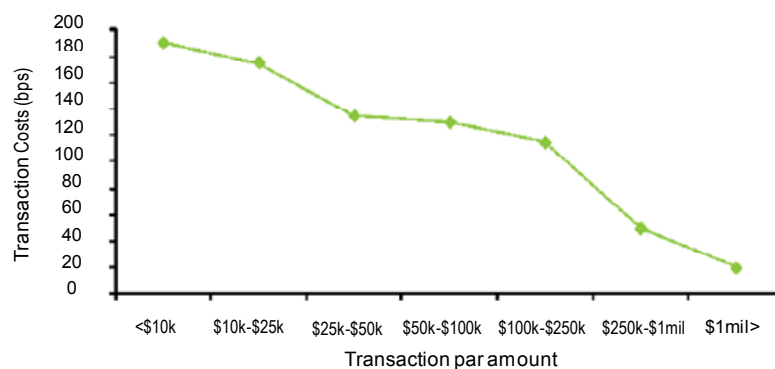
Active managers also manage interest rate risk, the risk that the bond price will drop when interest rates go up. Managers seek to achieve an appropriate risk/return balance by investing in bonds with varying durations.

## Trading - Pricing and Market Access

Active managers have significant advantages when compared to individual investors in terms of trading municipal bonds. In general, active managers can access the market quickly and efficiently – which is essential to their ability to capitalize on the opportunities they identify. Individual investors only have access to the bonds their broker/dealer has access to, which may limit their ability to properly diversify their portfolio.

In addition, trading spreads are normally very tight for institutional investors such as mutual funds. Individual municipal bond purchasers typically do not benefit from these tight trading spreads or the economies of scale that can be achieved in a mutual fund. Another factor to consider is that transaction costs for individual municipal bond purchases have escalated over the years. Bond spreads of approximately 2% are a routine fact pattern for retail investors. Higher spreads may also occur. Investors served by managers with institutional presence pay only a small portion of the trading costs associated with individual bond portfolios. Finally, there is greater liquidity in a mutual fund or separately managed account because managers are trading often, unlike an individual purchaser's buy and hold strategy.

### Municipal Bond Transaction Costs



Source: Journal of Financial Economics, July 2007

***“Both wrap fees and commissions on agency trades are small relative to the dispersion we observe in the prices retail investors pay.”***

*Richard C. Green, Burton Hollifield and Norman Schurtoff from “Dealer Intermediation and Price Behavior in the Aftermarket for New Bond Issues,” Journal of Financial Economics, July 2007*

### **Not All Active Municipal Managers Are Created Equal: MacKay Municipal Managers™**

It is important to note that active managers vary widely in experience, investment philosophy, and approach. The MacKay Municipal Managers™ team possesses the following key attributes, differentiating the team from its peers:

**Experience:** The team has an average of 20 plus years of experience and the co-heads have worked together for more than 17 years.

**What We Are:** MacKay Municipal Managers™ is a relative value manager (much like a value equity manager), relying heavily on deep credit analysis, yield curve positioning, and sector rotation with the goal of uncovering mispricings in the market. Rather than seeking maximum yield regardless of price, the team looks for credits with an attractive yield and a compelling price. As a result, the goal is to not only earn attractive tax-exempt income, but also generate strong total return.

**What We Are Not:** MacKay Municipal Managers™ is not a passive buy and hold manager and does not invest based solely on interest rate forecasts. Unlike many of our peers, we do not currently employ leverage. We believe that there is significant value in the market and the added volatility that accompanies leverage is not necessary.

*“MacKay Municipal Managers offers investors the experienced management of a larger complex, with the benefits of a small, nimble boutique that can capitalize on opportunities of all sizes.”*  
*Robert DiMella, Senior Managing Director, MacKay Shields*

**Cash Flow Positive:** MacKay Municipal Managers™ is one of a select few managers who have experienced positive cash flow in 2011. This creates a much more favorable, proactive investment dynamic versus those managers with heightened focus on meeting cash flow needs due to outflows.

**Investing Side-by-Side with Our Investors:** To further demonstrate that the managers' interests are well-aligned, MacKay Municipal Managers™ believes it is very important for all members of the investment team to have their personal wealth invested in the products we manage.

Below is a before and after look at a portfolio that has shifted from a traditional advisor-constructed approach, to an actively managed mutual fund or account.

	Municipal Bond Portfolio A - "Before" Active Management	Municipal Bond Portfolio B - "After" Active Management
Diversification	Highly concentrated, position weights often in excess of 6% to 7%	More diversified, position weights typically targeted to be $\leq$ 3.5%
Maturity distribution	Typically short to intermediate, often laddered	Invested along entire maturity range, with maturity bucket under/over-weights reflecting relative value view
Credit quality	Typically very high quality, AAA and AA rated only	Invested along entire quality spectrum, targeting an A/A+ average credit quality, 20% max BBB
Trading activity	Minimal, typically buying bonds and holding them until maturity	Actively managed and traded to capture relative value opportunities
"Philosophy"	Passive, income oriented	Active, total return oriented with a focus on income
Structure	Typically par bonds	Varies along curve. Coupon and maturity structure reflect relative value decisions and risk management
Research support	Typically minimal, at purchase only and reactive	Investment process built entirely on using internally generated research to identify opportunities in the market. Ongoing surveillance employed to support proactive approach to managing credit and other risks.
<b>The Outcome: A more liquid, efficient, and diversified portfolio in terms of issues, maturity, and credit quality with strict risk control measures.</b>		

Source: MacKay Municipal Managers™

## Conclusion

The municipal bond market has changed dramatically over the past five years and has become increasingly complex and difficult to navigate for the individual investor. At one time, constructing a bond portfolio of high-quality general obligation bonds was a reasonable task for experienced financial advisors and individual investors. However, a lack of municipal bond insurers, coupled with a growing municipal tax-exempt and taxable market and increasing economic pressure on municipalities has made credit research in this space more crucial than ever. It would be highly unusual for most individual investors to have the time, experience, and resources to successfully perform the same analysis on their own. Experienced active managers are well positioned to capitalize on opportunities as well as navigate new risks in today's municipal bond market.

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