Breckinridge
CAPITAL ADVISORS

WHITE PAPER

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MANAGING SHIFTS IN MUNICIPAL RELATIVE VALUE

KEY TAKEAWAYS

- Our Investment Committee evaluates technical and fundamental factors to, in some cases, set strategy to make tactical crossover trades.
- Breckinridge's broad fixed income capabilities, coupled with the close collaboration of our investment teams, make us well-equipped to make relative value assessments.
- Ultimately, the goal for crossover swaps is to improve after-tax income.

Traditionally, tax-efficient investors have focused almost exclusively on the tax-exempt municipal market. While this was usually justified by a higher after-tax yield advantage (particularly in the years following the financial crisis), Breckinridge believes tax-efficient investors now must have a broader focus. The investment landscape in fixed income can change quickly, with the credit quality of municipalities, the risk of tax reform and periodic market imbalances all having the potential to significantly impact the relative value of tax-exempt municipals. Tax-efficient investors need to be aware of these changes and assess them relative to pricing trends in *all* asset classes, including Treasuries, tax-exempts, asset-backed securities (ABS), mortgage backed securities (MBS) and taxable municipals. Focusing solely on tax-exempts could lead to ignoring risks or missing opportunities from not assessing—or incorrectly assessing—anomalies in relative value.

Over the past year in particular, there have been some significant changes in the relative yields of tax-exempt municipal bonds ("tax-exempts") versus the yields of Treasuries and other taxable bonds. When such changes occur, it's important to understand the causes and to assess whether to adjust a portfolio's exposure to tax-exempts. If tax-exempt yields move higher relative to taxable yields, our inclination may be to extend duration, effectively increasing exposure to tax-exempt municipals. Conversely, if tax-exempt yields decline relative to taxable yields, we may reduce exposure to tax-exempt municipals by shortening duration or swapping into taxable bonds, such as Treasuries, agencies, corporates or taxable municipals.

In our view, an awareness of pricing trends across asset classes is crucial for tax-efficient investors. A broader understanding of market factors allows investors to look beyond one fixed income market, and assess whether yields in a particular asset class offer adequate compensation for risks on a relative basis.

Breckinridge is well equipped to make these relative value assessments because of our broad capabilities across domestic fixed income markets coupled with the close collaboration of our investment teams. This paper outlines the process we use for assessing tax-exempt municipal relative value and executing crossover trades into taxable bonds.

HOW WE ASSESS MUNICIPAL RELATIVE VALUE

Just as with other types of bonds, yields of tax-exempt municipal bonds are most often compared to Treasury yields. However, rather than calculating the yield differential (spread) versus Treasuries, the tax-exempt yield is usually expressed as a percentage of the Treasury yield. Using this "yield ratio" is preferable to quoting a spread, because tax-exempt yields are normally *lower* than Treasury yields due to the tax exemption of municipal income.

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The tax exemption is, of course, a very material factor influencing the yield and relative value of most municipal bonds, which makes it important to assess the risk to that exemption. Although remote, there is always the possibility that the tax exemption of municipals could be altered or eliminated at some point in the future—and that risk grows as one looks further into the future. We may feel very certain about the tax advantage of tax-exempt municipals in 2017, but it's much harder to predict what tax advantage there might be in 2037. Someday, there could be no advantage at all. The growing uncertainty of this tax advantage accounts for much of why the yield ratio rises as tax-exempt maturities are extended. For example, a 75 percent yield ratio represents a reasonably fair value for a five-year tax-exempt bond, but the same yield ratio for a 10-year bond would be considered unusually low—meaning 10-year tax-exempt bonds would be considered relatively expensive.

In addition to tax risk, municipal creditworthiness is also a material factor in assessing relative value. All municipalities, even those rated AAA, have some degree of credit risk, which warrants an added yield spread versus the after-tax yield of Treasuries. Just as with tax risk, the future creditworthiness of any municipality is much more certain in the short run than in the long run. Therefore, as investors extend maturities, they assume more uncertainty and credit risk, and this contributes to higher tax-exempt yields and yield ratios on longer-term bonds.

Breckinridge begins any relative value assessment of tax-exempt bonds with the analysis of the combined effects of tax risk and credit risk. We consider these the most important *fundamental* factors impacting the relative value of tax-exempt municipals along the yield curve.

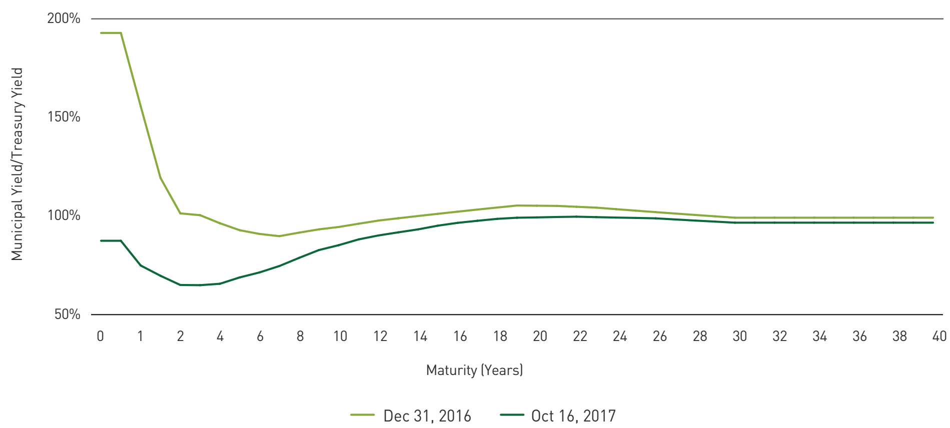
Breckinridge also examines the influence of *technical* factors on the relative value of tax-exempts. Technical factors, such as supply-demand imbalances, can have both short- and long-run impacts. A long-run impact might occur if certain issuers lose some or all eligibility for tax exemption. For example, some legislators have called to limit or eliminate the ability of non-profit (501(c)(3)) colleges or hospitals to issue tax-exempts. Were this to happen, it could substantially reduce tax-exempt supply, and over the long run, we'd expect the tighter supply to cause ratios to move lower.

A short-run impact might occur due to the chronic mismatch between municipal supply and demand. The bulk of the market's municipal supply consists of long-term bonds because municipal bonds mostly back long-term assets (such as buildings and infrastructure).[1] Yet, the largest source of municipal *demand* is from individual investors who tend to favor short and intermediate maturities.

Municipal bond funds, which typically buy long-term bonds, create a bid for longer maturities and partially remedy this mismatch. However, when funds experience redemptions, they're often forced to liquidate bonds, pouring municipal bonds back into the market and *exacerbating* the mismatch, causing yields to rise. This happened in late 2016, when eight consecutive weeks of bond fund redemptions resulted in a significantly oversold market condition, causing municipal yields and ratios to rise and making tax-exempts relatively attractive.

Recently, this technical condition has reversed, as bond funds in the first half of 2017 have had healthy inflows while municipal new issue supply has been light. As a result, yield ratios are now at or near historical lows in short and intermediate securities, and tax-exempts offer a much less compelling value. Figure 1 shows the notable shift in yield ratios that resulted from the change in these technical factors.

Figure 1: Low Supply Has Pushed Ratios Lower in 2017



Source: S&P, MMD, as of October 16, 2017.

CROSSOVER TRADING

When yield ratios are very low, Breckinridge may opt to reduce tax-exempt exposure by selling tax-exempt bonds and replacing them with taxable bonds. On most occasions, such a swap will be for the purpose of boosting the portfolio's after-tax income. This means that even after paying taxes, the taxable bond purchased should offer a higher income than what could have been earned on the tax-exempt bond. The lower an investor's tax rate, the more likely it is there could be an after-tax income advantage from swapping into taxable bonds. For this reason, Breckinridge encourages advisors and consultants to keep us up to date on material changes to a client's tax circumstances.

On some occasions, the swap from tax-exempts to taxable bonds may not offer an immediate after-tax income benefit. Instead, the goal of the swap would be to improve the portfolio's relative value and long-term after-tax total return. Our Investment Committee, which consists of eight senior members of the firm, including representatives from our Portfolio Management, Credit Research, Trading and Investment Strategy Teams, evaluates technical and fundamental factors to, in some cases, set strategy to make tactical crossover trades when warranted for various tax brackets.

Crossover swaps may be performed tactically to improve a portfolio's after-tax, risk-adjusted return.

For instance, if yield ratios were to decline significantly in the absence of any improvement in market fundamentals, we might decide that tax-exempts no longer offer an attractive risk-adjusted return relative to other taxable fixed income investments. This could prompt us to make tactical trades out of municipal bonds and into taxable bonds, such as Treasuries or corporates. Our plan would be to eventually reverse these swaps when yield ratios normalized and tax-exempts offered a more favorable yield and risk-adjusted return relative to taxable bonds.

Thus, the goal for these swaps is to ultimately improve after-tax income by exiting tax-exempts at relatively low yields and reentering once they've moved higher relative to taxable bond yields. Of course, tax and trading costs would be crucial considerations in assessing the merits of such a swap, as the goal is to improve a portfolio's *after-tax*, risk-adjusted return.

A BROADER FIXED INCOME PERSPECTIVE FOR TAX-EFFICIENT INVESTORS

At Breckinridge, we believe that our capabilities across investment-grade asset classes make us better tax-efficient investors. Our investment teams are not siloed; rather, our corporate, ABS/MBS and municipal teams sit side by side, collaborate daily and hold formal meetings weekly. We believe this ongoing communication gives our team a more holistic picture of the fixed income markets, providing the knowledge and judgment necessary to navigate through an uncertain future.

FOOTNOTES:

1. Roughly 12%, 8%, 7% and 11% of bonds issued were of maturities 1.09 years or less in years 2014, 2015, 2016 and YTD 2017, respectively. Source: The Bond Buyer, as of September 29, 2017.