

# Portfolio Tactics: Crossing the (Tax-Exempt) Rubicon?

*A Rare Opportunity in Tax-Exempt Municipal Bonds*

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# Introduction

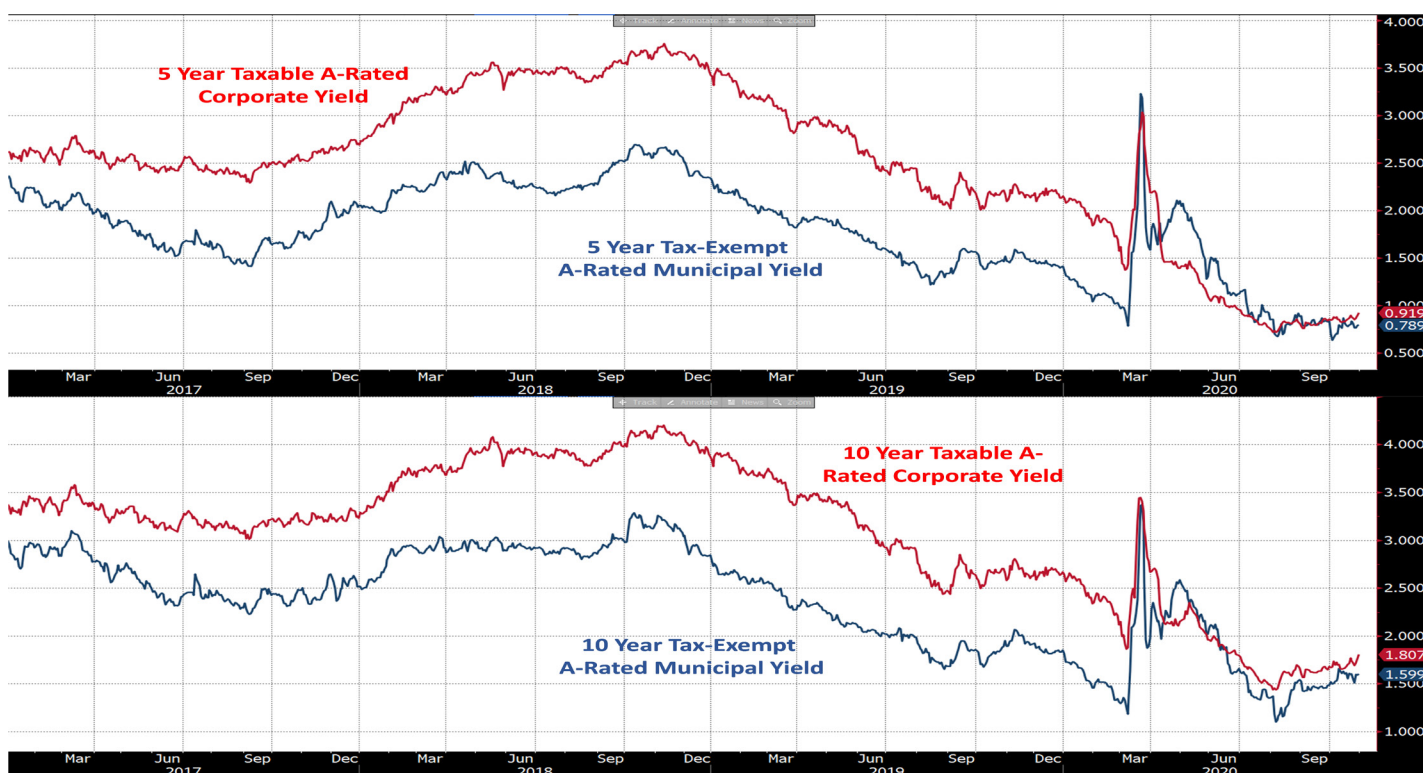
We've recently purchased municipal bonds (munis) in accounts that don't traditionally hold them, such as IRAs, foundations or trusts, which typically have little or no tax liability. Reflecting their tax advantages, munis normally trade with lower yields than comparable taxable alternatives (e.g. corporate bonds).

But the current rate environment is upside-down and we're taking advantage of a rare occasion to add munis at higher yields than corporates. Read on to learn where and why we're seeing these unusual opportunities in the municipal market.

## Unusual Role Reversal

Typically, most municipal bonds carry lower yields than comparably rated corporate bonds because of their tax-advantaged interest income. Specifically, most municipal bond interest is exempt from federal income taxes (and in many cases, state and local income taxes). Therefore, taxable bonds typically trade with significantly higher pre-tax yields than tax-exempt munis. For example, at this time last year, 4-year corporates yielded 2.20% vs. 1.50% for similarly-rated municipals. The gap has traditionally been the same, perhaps even larger, for longer-term maturities. As a result, munis were typically held by highly taxed individuals and corporate bonds by lower/non taxed entities.

5 and 10-Year Taxable vs. Tax-Exempt Yields



Source: Bloomberg

However, this paradigm has broken down in today's unprecedented low interest rate environment. Corporate bond yields are trading at all-time lows, with sub-1% yields the norm in shorter-term maturities.

## Nominal Taxable Yields

Maturity	Treasuries	Non-Financial Sector Corporates	Bank/Financial Sector Corporates
1 Year	0.12%	0.20%	0.30%
2 Year	0.16%	0.25%	0.35%
3 Year	0.20%	0.35%	0.45%
4 Year	-	0.45%	0.55%
5 Year	0.37%	0.75%	0.85%

Source: Treasury Partners estimates as of 11/2/20

## “Kickin’ the Tires” on Muni Kicker Bonds

Many of our readers know that we aggressively extended maturities in portfolios when rates spiked earlier this year (see Fixed Income Alert: Market Illiquidity vs. Credit Defaults, published 3/23/20) to capture elevated yields in advance of what we expected to be a significant decline in rates. Now, after the dramatic decline in rates over the last few months, we’re hard-pressed to find attractive opportunities in longer-term bonds. Given the current low yields, our goal is to minimize the amount of interest rate risk (bond price volatility) that’s required for each unit of yield. *As a result, we’re currently finding the most attractive opportunities in short-term municipal “kicker” bonds, a structure that’s unique to munis.*

### Why Do Muni Issuers Refund Debt?

The principle behind municipal refundings is simple; it’s all about locking in recurring cash flow savings.

Imagine a \$100 municipal bond that’s 4 years from final maturity. Originally issued with 5% coupons, the issuer pays 5% in interest every year. Now assume the issuer has an option to immediately call away (refinance) the original bond with new debt that costs only 3%/year. That’s a significant savings – pocketing an extra 2%/year translates into a 6.9% savings over 4 years.

All else equal, longer gaps between a bond’s call date and final maturity translate into higher refunding savings for the issuer. Similarly, the higher an outstanding bond’s coupon rate compared to prevailing market rates, the greater the potential savings.

In theory and practice, muni issuers are always keen to realize any significant savings on their debt. Money saved on debt service lowers total expenditures without cutting into popular spending programs, and helps close budget gaps without raising taxes.

First, a brief explanation of how a typical muni bond issue works. When municipalities issue bonds, the longer-maturities almost always carry an issuer call option, allowing these bonds to be called away from investors prior to the final maturity date. This gives the issuer the future opportunity to refinance at potentially lower rates at or after the first call date. Normally, it’s highly probable the bond will be called, particularly for kickers with relatively high coupons and a large gap between call/final maturity dates. As a result, most muni kickers trade on a yield-to-call basis and not to their legal final maturity.

But while it’s likely this is how everything plays out, it’s not ironclad. Sometimes, the bonds aren’t called immediately and investors end up holding the bond past the call date. In such cases, the math creates an interesting quirk from the investor’s perspective; *the yield increases, or “kicks” higher, to compensate for this uncertainty.*

This isn’t because the bond’s fundamentals have changed - it’s simply the math reflecting the benefit of receiving additional (unanticipated) coupon payments past the call date, which weren’t baked into the bond’s original price. For however long investors wind up holding the bond, this ‘kicked’ yield-to-maturity is usually much higher than the original yield-to-call.

## Some Concrete Examples:

Below are 3 examples of recently-purchased callable muni kickers. The market priced these bonds assuming they'll be called away at the first possible date, between 2022-2025, meaning they priced on a yield-to-call basis. We view these bonds as very attractive alternatives to comparable corporate bonds maturing 2022-2025.

For example, contrast the NY Electric Utilities with a 1.05% yield to its 2024 call vs. 2024 corporates yielding 0.45-0.55%. These muni kickers clearly offer a significant yield pickup. If it takes longer than anticipated for the NY Electric Utilities to be refunded, investors will be compensated for the longer holding period with a yield-to-maturity kick of 3.88% through 2039. As we look at it, whether called or not, investors benefit from this bond structure.

The same comparative analysis holds true for the TX Electric Utilities (0.76% yield to its 2022 call vs 0.25-0.35% for 2022 corporates, plus a potential yield-to-maturity kick to 3.67%) and the Southwestern TX City GO bonds (1.34% yield to its 2025 call vs 0.75-0.85% for 2025 corporates, plus a potential yield-to-maturity kick to 3.19%).

Issuer	TX Electric Utilities	NY Electric Utilities	Southwestern Texas General Obligations
Issuer Description	Austin, TX public electric utility	Long Island, NY public electric utility	General obligation of a large city in southwestern TX
Coupon	4%	5%	4%
Ratings	A1/A/A+	A2/A/A	-/AA/AA
Final Maturity	5/15/2043	9/1/2039	8/15/2041
First Call Date	5/15/2022	9/1/2024	8/15/2025
Yield to Call Date	0.76% (to 5/15/22)	1.05% (to 9/1/24)	1.34% (to 8/15/25)
Yield to Final Maturity	3.67% (to 5/15/43)	3.88% (to 9/1/39)	3.19% (to 8/15/41)
Effective Duration	0.9	2.5	3.6

Source: Treasury Partners purchases week of 10/26/20

We've also captured yield opportunities in two attractive sectors of the muni market: toll roads/turnpikes (particularly established large systems) and major-hub airports. We view these as irreplaceable transportation infrastructure assets with impossible barriers to entry. They offer additional spread because they're out-of-favor sectors due to pandemic-related impacts. We have a contrarian view and have identified select issuers who retain fundamentally high-quality credit characteristics with attractive pricing. Below are a couple of recently-purchased examples: both the PA Toll Road Revenues, with a 1.83% yield to its 2024 call, and the Major Mid-Atlantic Airport System Revenues, with a 1.26% yield to its 2024 call, compare very favorably. vs. 2024 corporates yielding 0.45-0.55%.

Issuer	PA Toll Road Revenues	Major Mid-Atlantic Airport System Revenues
Issuer Description	Major PA toll road system	Multi-airport system serving mid-Atlantic states
Coupon	5%	5%
Ratings	A1/A+/A+	Aa3/A+/AA-
Final Maturity	12/1/2044	10/1/2028
First Call Date	12/1/2024	10/1/2024
Yield to Call Date	1.83% (to 12/1/24)	1.26% (to 10/1/24)
Yield to Final Maturity	4.18% (to 12/1/44)	2.97% (to 10/1/28)
Effective Duration	2.6	2.5

*Source: Treasury Partners purchases week of 10/26/20*

## Something Else to Consider

Adding municipals brings a higher level of diversification to portfolios. Depending on the issuer, munis are often affected differently by changing economic conditions than corporate bonds. The primary reason is that many of the underlying credit fundamentals behave counter-cyclically, typically lagging shifts in the broader economic cycle. Since there's normally a significant yield penalty in adding tax-exempt munis compared to taxable corporates, we rarely added them in the past. But in today's rate environment, we're picking up both the higher yield and the increased issuer diversification benefit at the same time.

## The Value of Flexibility and Thinking Differently

In our current ultra-low yield climate, we're pursuing outside-the-box ideas by placing short-term muni kickers into nontraditional accounts. Our internal trading and portfolio management structure enables us to cross asset classes in managing portfolios when attractive opportunities arise. Importantly, we achieve this flexibility while conforming to existing client Investment Policy (IP) parameters.

To be sure, favoring short-call muni kickers vs. bullets isn't a riskless strategy – there's always the possibility that at least some of these bonds remain outstanding longer than the anticipated call date, adding uncertainty to the timing of a portfolio's maturity profile. In addition, while munis can diversify a traditional corporate bond portfolio, they add another layer of issuer risk. However, we believe the additional yield pickup compensates for these uncertainties. The alternative of simply accepting the much-lower yields in exchange for a defined maturity date isn't very appealing at these rock-bottom levels.

We recognize that our nimble approach and willingness to take advantage of unusual relative value opportunities will sometimes cause us to “stray from the herd”. But this isn’t the first time we’ve pursued an out-of-consensus strategy. We’re empowered to take these actions by leveraging two vital factors:

- Our ability to efficiently and nimbly navigate between taxable and tax-exempt markets in search of relative value; and
- The trust in us that you place via the leeway and flexibility permitted in existing IP parameters.

## Work-From-Home Update

This historic pandemic has caused us to chop our daily commutes down to just 20 seconds, or the time it takes to move from the bedroom to our laptops. For all the pros and cons that arise from this unprecedented work-from-home environment, one good result is that we’re spending more time than ever in monitoring credit developments and searching for market opportunities. Our eyes remain wide open throughout the process.

We appreciate the continued trust and confidence you place in us to manage your investment assets. We hope you and your family remain safe as we wait for further development of a medical solution to the crisis.

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