



## Where is the Value in the Municipal Market?

By John Smith  
Managing Director & Portfolio Manager  
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The municipal market is one of the most diverse sectors available to fixed income investors. Taxable and tax-exempt issues have maturities encompassing the full range of the maturity curve. Credit quality ranges from non-rated all the way up to AAA. Perhaps you should have some exposure to this asset class, as the municipal sector has something for every investor. The trick is determining what you want to own.

Negative headlines have hurt the municipal market over the past few years. Previous negative comments from financial analysts and hedge fund managers about the credit worthiness of municipals and Detroit's more recent headline-grabbing default have shaken some investors' confidence about the quality of the asset class. Concerns surrounding unfunded pension liabilities within the municipal sector add to quality concerns. While these concerns should be evaluated, it should also be considered that few defaults have occurred in this very large sector. Of the few defaults, most of the credit quality issues (e.g., Detroit) have been well known for a long period of time. Rarely does the credit quality of a municipality fall quickly. We advise against letting a few "bad" municipal issuers deter you from finding value within the sector.

### Characteristics of Municipal Securities

There are two major types of issuances for municipal securities: taxable and tax-exempt. Due to the size and complexity of the sector, our focus for the purposes of this discussion will be on the tax-exempt category. Tax-exempt securities are issued by both large and small municipalities. The most common issues are general obligation bonds (GO bonds), issued to fund the municipality's general operations. Revenue bonds are also issued by municipalities with payments coming from a specific revenue source, such as a water and sewer district. Issues can be non-rated or carry a rating by a nationally recognized rating agency (e.g., Moody's). Very large issuers typically have a credit rating, while small issuers may not consider it cost effective to apply for a rating despite good credit quality.

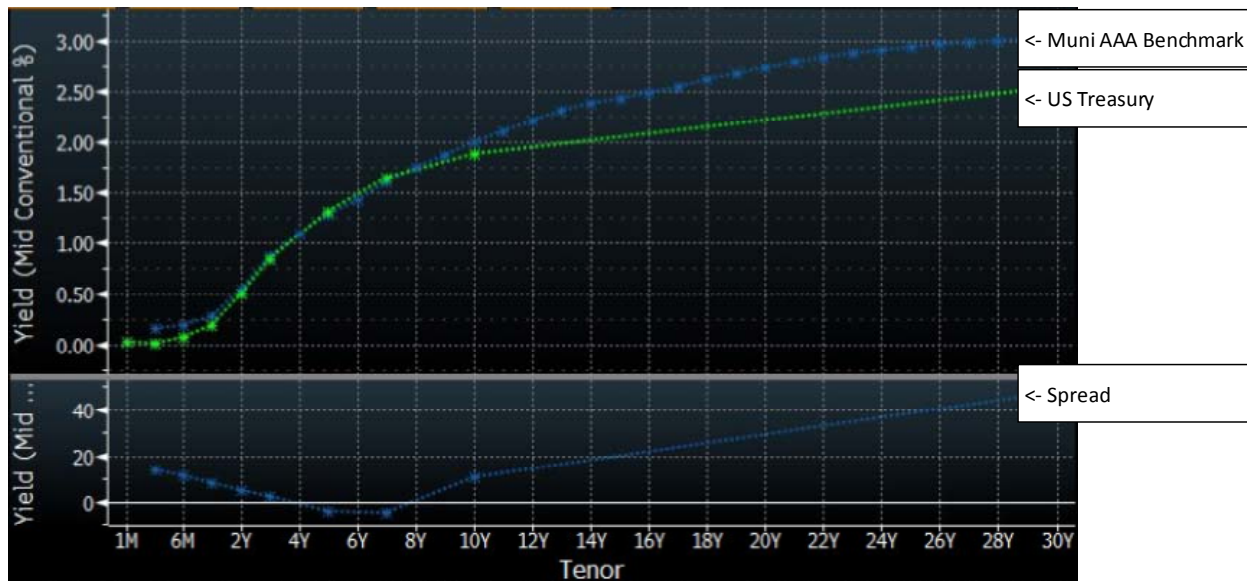
As with most fixed income investment classes, the tax-exempt municipal market is correlated to the Treasury market. Generally speaking, as rates rise and fall in the Treasury market, so do the yields of tax-exempt municipal securities. There are a few major differences that can significantly impact the return to investors, including the:

- credit quality of an issuer,
- tax status of an issuer, and
- tax status of an investor.

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With low interest rates and high investor demand, yield spreads have compressed significantly. As illustrated in the "Yield Curve Spread" graph on the following page, there is little value in the short-term municipal market (5 years and less) for high quality investors as rates are very low. However, the municipal yield curve is steeper than the Treasury yield curve and can provide some real value to a longer-term investor (10 years and beyond) who requires the highest credit quality.

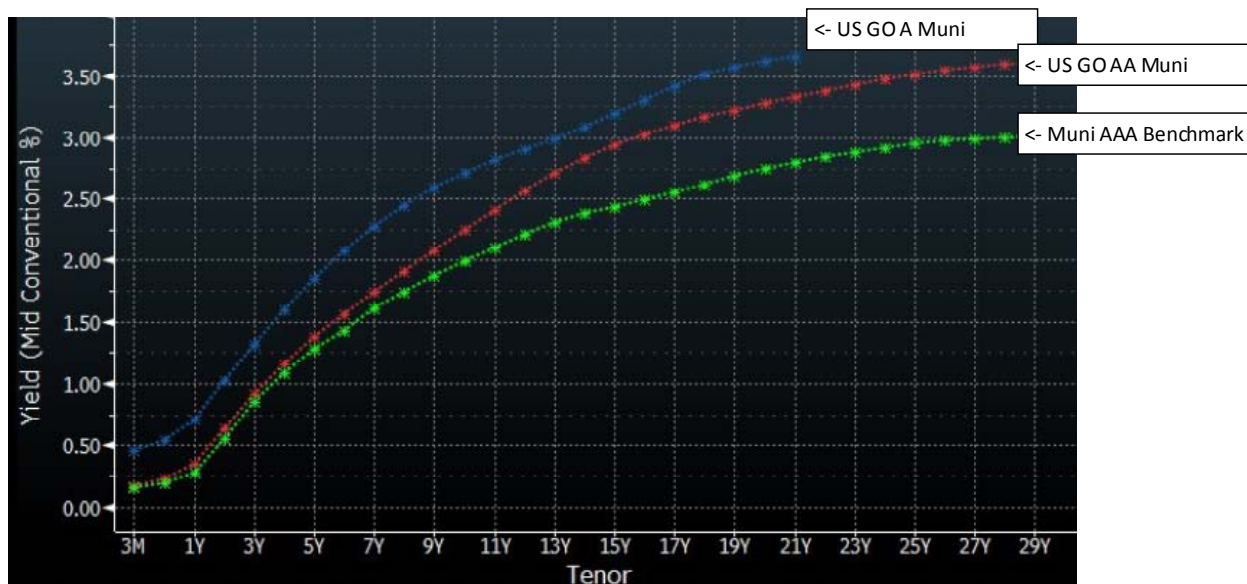
## Yield Curve Spread - Municipal AAA Benchmark vs. US Treasury



\*Bloomberg (04/15/2015)

Additional yield pickup is also available as the investor moves down the rating scale, as evident in the chart below.

## Municipal Yield Curve - Various Ratings



\*Bloomberg (04/15/2015)

Extending maturity in a low rate environment seems risky, but there is one significant advantage to a tax-exempt investment over a taxable investment. The tax-exempt feature helps to reduce taxes, but also provides market value protection if and when rates do ultimately rise. The market value of a tax-exempt issue has historically experienced approximately two-thirds of the price decline of a corresponding taxable issue when rates rise. Tax-exempt issues are more defensive in a rising rate environment and provide more initial after-tax income – a very powerful combination. For these benefits, an investor concedes some liquidity and takes on the risk of changes in tax law.



Value can also be found in the municipal market for those investors willing to do a little credit work. Smaller issuers may not find it economical to pay for a nationally recognized credit rating or their ratings may be lower due only to size. The underlying credit may still be very good. Without a high credit rating or any rating at all, the pool of potential buyers becomes much smaller. A smaller pool of investors leads to higher yields for those willing to analyze the credit metrics of the issuer.

### **Other Factors for Consideration**

There are a few special factors that must be considered by our bank investors specifically when purchasing municipal securities. While ultimately dependent on the conditions within the institution and the portfolio, the decision of whether to place the purchase in available-for-sale (“AFS”) or held-to-maturity (“HTM”) will impact future liquidity and the ability to sell prior to any perceived market movements. Placing a small, local, non-rated issue in the HTM portfolio can be justified, as the probability of sale and finding a buyer is minimal. Placing rated issues with some marketability in the AFS portfolio is often the best decision, as it allows for managing the risk of higher rates, effective tax planning, and the need for liquidity.

Bank investors could also be impacted by a changing TEFRA penalty (Tax Equity and Fiscal Responsibility Act of 1982). Low interest rates are causing the TEFRA penalty to remain low. The TEFRA penalty will increase as a bank’s cost of funds increases in a rising rate environment. Longer maturity purchases are more susceptible to the negative impact of the higher penalty.

Every investor has unique circumstances that ultimately impact investment decisions. Tax status, tolerance of credit exposure, and willingness to accept market value volatility impact an investor’s decision matrix. A diverse municipal market offers something for everyone, particularly in an environment where the search for income is very difficult. While the municipal purchase process may seem daunting, our team is available to assist with the required due diligence, evaluation of fit within your portfolio, and proper classification when purchased.

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