



Finding Excess Return in Tax-Exempt Investments

BY RALPH G. "CHIP" NORTON

The total returns from the standard high-quality intermediate maturity municipal bond portfolio have been rather paltry during the past few years. For example, total return for the Lehman Municipal Bond Index during the past three years was just 4.4 percent through August, and that's with a duration of nearly six years. At the same time, short-term municipal cash options have been yielding 3.5 percent with maturities of 30 days. The bottom line is that it's been extremely difficult to generate reasonable returns in the traditional municipal market.

While traditional tax-exempt returns have been low, nontraditional approaches or municipal "alpha" strategies have done quite well. You may be asking yourself if municipal "alpha" is an oxymoron, but indeed these strategies do exist, and in the coming years you will see many more such innovative strategies proliferate, especially for high-net-worth investors.

High-Yield Municipal

One of the most popular nontraditional approaches to municipal excess return has been via the high-yield municipal market. At first glance, many investors associate the high-yield municipal with the high-yield corporate or junk bond market. In reality, these two couldn't be further apart. The default experience for municipals, at all credit levels, is a fraction of that of their distant corpo-

rate cousins. For example, according to Moody's Investors Service, from 1970 to 2005 municipal BB-rated bonds had a default rate of 2.6 percent compared with 19.8 percent for similarly rated corporate bonds. At a B rating, municipal defaults stand at 11.8 percent versus a whopping 46 percent for corporates (see figure 1).

The low municipal high-yield default rate obviously is further limited via active management and diversified portfolio composition. Some suggest that when accessed via a well-managed bond fund structure, the default risk issues are nearly eliminated. What risks remain, of course, are general interest-rate conditions and spread-valuation issues. Today, the average spread between high-quality and high-yield municipals is about 150 basis points (bps). The spread has compressed (to the benefit of investors) from a high of more than 450 bps in early 2003, but it still remains very attractive on a taxable equivalent yield (TEY) basis. For example, a current 10-year AAA municipal yields about 3.75 percent and provides a TEY of 5.77 percent, compared with a high-yield municipal at about 5.25 percent and TEY of 8.08, for a 35-percent bracket investor.

In terms of total return, municipal high-yield products have shown significant outperformance when compared with high-quality intermediate municipals (based on Morningstar average data). Through August, the three-year/five-year trialing total return for high-yield municipal funds versus high-quality municipal funds

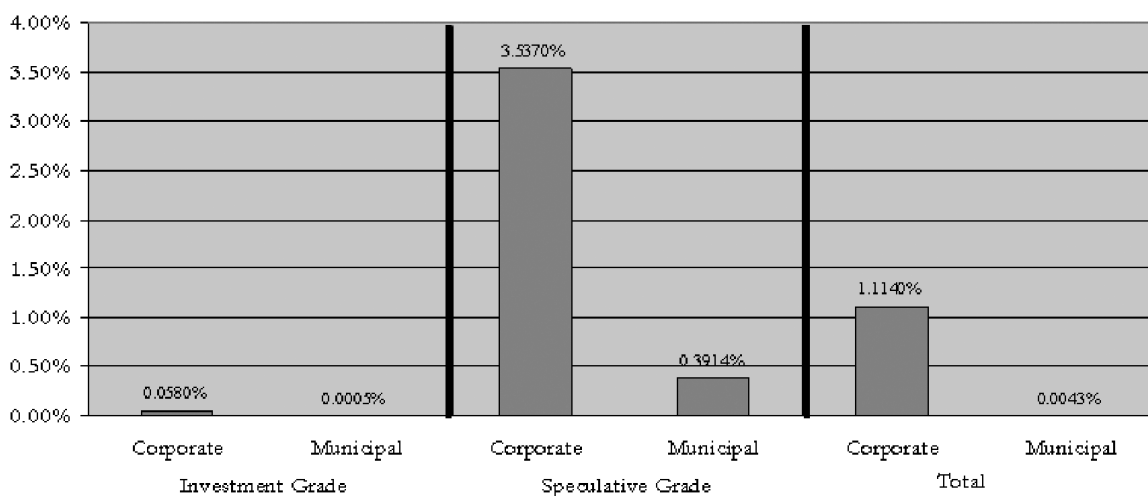
was 7.52 percent/5.82 percent and 3.59 percent/3.75 percent respectively—a big difference. From a risk perspective, the high-yield average three-year standard deviation is 2.78 percent compared with the high-quality intermediate at 3.20 percent. Yes, that's correct: The high-yield municipal funds have had lower return volatility than the high-quality funds—and that's just on average. When you do a bit of homework and identify the category leaders, both the return and risk differentials look even more attractive for high-yield.

Municipal Hedge Funds

Over the past year municipal hedge or "arbitrage" strategies have garnered market attention. The *Wall Street Journal* published a spotlight article about these strategies in late June 2005 that received much attention because it suggested that many multistrategy hedge funds were adding them to their list of "alpha" generators. *Worth* magazine also ran a three-page feature in October 2006.¹ The bottom line is that most of what's been written about these products has scratched only the surface of both the rewards and risks of this strategy for high-net-worth investors. Like any good alpha enhancer, the approach can be complex and is being implemented in a variety of ways.

Unlike some esoteric proprietary hedge fund strategies, the strategies employed by the municipal hedge firms are well-known, utilize high credit-quality debt, have transparency, and are utilized by the

FIGURE 1 Mapping of Moody's U.S. Municipal Bond Rating Scale to Moody's Corporate Rating Scale and Assignment of Corporate Equivalent Ratings to Municipal Obligations—June 2006



Source: Moody's

institutional side of nearly every major investment firm. The goal of nearly every firm is the same: Deliver an annualized return between 9 percent and 12 percent that is nearly all tax-exempt over a five- to seven-year period, has low correlation to traditional municipal and equity investments, and has a risk profile far lower than equities. This is quite attractive, given other investment choices these days.

Traditionally, municipal leverage was accessed via closed-end municipal funds that provided leverage via preferred stock offerings. That has become expensive and the spreads have narrowed considerably. Today's strategies take a different approach.

A Natural Positive Carry. There are two central components of the municipal hedge or "arb" strategy. The first is leverage, the second is hedging. The leverage associated with the municipal hedge strategies is a traditional debt carry trade where the fund borrows at the short-end of the maturity spectrum at a floating rate and then invests in longer-maturity fixed-rate securities. The spread between short (borrowing) and long (investment) rates is the positive

carry. The municipal spread trade remains positive because of the continued (historic) steepness of the municipal curve. In addition, the near-elimination of credit risk by firms leveraging with AAA and AAA-insured municipal bonds helps focus risk into smaller compartments.

While there are several ways to gain leverage (borrow) via the capital markets, the preferred method is a municipal leverage trade facilitated by a tender option bond, known as a TOB trust. In its most simple form, the TOB trust separates a high-quality municipal bond into two components. The first is the floater. The floater pays variable rates based on the Bond Market Association (BMA) swap rate and resets on a very short-term basis (seven-day, 30-day, some longer). Money fund and cash managers use these products in their funds as they par reset, which keeps up with short-term rate-hike movements in the market. The other side of the TOB is called the "residual" or "inverse floater." This portion keeps the fixed coupon but pays the market-driven variable rate to the floater. Obviously, the spread between the two is the key consideration. TOBs

can be complex with respect to what are called "trigger" events that can terminate the trust, such as quality downgrades or pricing levels. Most major Wall Street debt shops, including Morgan Stanley and Lehman Brothers, offer TOBs.

Leverage Varies. Leverage via the TOB trade ranges from 3x to 10x with most municipal hedge managers. The minimum leverage is about 3x. There are, however, many funds that invest in the TOB trade with no hedge to gain straight income generation; this is the most risky approach.

This is how it works: If a current 10-year municipal is yielding 4.0 percent with a cash borrowing rate at 2.5 percent, a positive carry spread of 150 bps in yield (or 230 bps in TEY) is created. Leveraging 5x brings the yield to more than 11.5 percent. This is an extremely attractive yield when compared with nominal unleveraged bonds. But of course, nothing is free. Along with the big income stream comes duration multiplied by the leverage. In this example, the duration may be four years on the 10-year municipal, which when leveraged 5x brings the

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investment duration to 20 years. Any rate increase in this scenario could be very detrimental to the position value. Now imagine leverage at 10x—clearly, a risk tool is needed. Enter the hedge.

Hedging Duration. To counter the impact of the leveraged duration as discussed above, most managers actively hedge their portfolios. The cost of the hedge reduces the municipal income stream. The result to the client then is the leveraged TOB return minus the hedge costs and associated limited partner (LP) and structure costs. The biggest challenge for managers is the lack of a perfect municipal market hedge. This forces the managers to use a variety of taxable hedge products. Theoretically, the municipal market should trend exactly with the taxable market over longer periods of time because pricing on both is a direct result of interest-rate changes. The reality is that the hedge process is not perfect and basis risk (i.e., the risk that the hedge moves out of sync with the primary security), can and does vary. For most strategies the basis risk becomes the most critical aspect of the strategy.

There are natural times when the basis risk increases due to the taxable and municipal markets moving out of sync with each other. For example, during periods of high municipal volume (which drives yields higher), municipals can show a significant underperformance relative to taxables. This can result in short periods of time with losses in the funds. Unexpected events also have skewed the basis. The biggest was just after 9/11 when a flight to quality to Treasury bonds caused Treasuries to outperform municipals and created a significant downturn in municipal hedge funds due to the basis risk; indeed, some funds were off more than 10 percent in September 2001. Clearly, the risk profile is not that of your good old municipal bond.

Nevertheless, a typical standard deviation on a municipal hedge fund is more than 10 percent compared with just 3 percent for a traditional municipal intermediate high-quality fund. The good news is that the hedge funds have shown very low correlation (about 0.20) to high-quality intermediate funds. This lines them up as worthy candidates for carefully allocated, balanced portfolios.

Risks. As with any investment worth its salt, municipal arbitrage strategy has a number of risks beyond basis risk. Here are but a few of the gems one encounters with this approach, a list that points out why these funds normally are open to only high-net-worth “qualified investors”:


- Credit quality deterioration on the underlying TOB bonds
- Counterparty risk of the TOB trust
- Carry trade economics (curve flattening and squeezing out positive carry trade)
- Basis risk from persistent decoupling of the hedge
- Legislative risk that the value of federal and state municipal bond income exemption may be challenged
- Legislative risk to TOB tax structures
- Legislative risk to simple lowering of tax brackets
- Manager implementation risk (because this is a complex trade that requires a high level of knowledge to execute reliably)

Portfolio Construction

When municipal high-yield or municipal hedge funds are added to a traditional municipal portfolio allocation they can provide significant alpha to the account. Correlation data on municipal hedge funds is very low to both traditional high-quality municipal and high-yield as well as equity market products, which provides an added layer of risk management. While municipal high-yield products have higher correlation to high-quality, the total return differential is signifi-

cant. However, it remains important to balance these strategies with traditional fixed income. As an enhancement to the fixed income allocation bucket, these strategies should be held to 30 percent or less. With respect to the total portfolio, exposure should be held to 10 percent to 15 percent.

Due Diligence

When any investor moves into non-traditional investment choices, the role of careful and comprehensive due diligence is paramount. For example, simply buying a high-yield municipal bond for a short period of time just to chase the high yield can be a dangerous proposition because it ignores the credit issues and potential short-term return volatility. Similarly, investing in municipal hedge funds requires an intimate knowledge of whatever strategy the fund utilizes, whether it's leverage ranges or hedging techniques, as well as market conditions and trade metrics. In the bond world, yield always is the price of risk. So when one is receiving nearly twice the tax-exempt return, knowing your investment product and, more importantly, the folks managing that money, is key. In addition, due diligence in this space, as in many others, only begins with the first investment. Ongoing monitoring of performance as well as subjective factors such as management status is a big job, but it's one where a good adviser truly adds value. 

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Endnotes

1. See John Ferry, “Municipal Arbitrage,” *Worth* (October 2006): 84–86.