

# Getting Active

*Municipal bonds have much to offer investors, including a steady stream of tax-free income and portfolio diversification. Investing through an active management strategy can amplify those advantages.*

**A**s an investment strategy, municipal bonds, sometimes referred to as munis, may not generate much excitement. But for anyone looking for an investment that offers a steady stream of income free from federal income taxes, helps with long-term wealth preservation and has a relatively low level of risk, muni bonds can be a very attractive option. An active muni bond management strategy offers additional advantages also worth considering.

## **Advantages of Professional Management**

Compared with a traditional “buy and hold” strategy, a professionally managed bond portfolio can provide:

- Better diversification of bonds and significantly greater liquidity;
- A focus on total return opportunities;
- Dynamic interest-rate and reinvestment risk management; and
- The potential for lower transaction costs or fees per bond.

Investors can reap the benefits of active management through a muni bond fund or a separately managed bond account. An actively managed muni fund pools investment capital from many different investors, and is managed by experienced investment professionals who attempt to maximize the fund’s total returns within predetermined risk guidelines.

Separately managed bond accounts combine the advantages of both actively managed mutual funds and individual bond holdings. Separately managed accounts feature active portfolio management with performance objectives benchmarked to either a specific bond market index or, for larger accounts, highly customized targets. However, unlike bond funds, separately managed bond accounts generally require a \$2 million minimum allocation.

## **More Flexible Risk Management**

Uncertainty is inherent in the stock market, and many investors see fixed income as a low-risk component of their investment portfolio that can help



Chicago's O'Hare International Airport, where municipal bonds provide funding for maintenance of terminals and other facilities.

offset that uncertainty. And while most high-quality fixed-income investments — including muni bonds — have a low default rate, they are not without risk. As with any investment, the best approach to minimizing this risk is broad diversification.

Because of the large number of individual bonds they hold, an actively managed muni bond fund or separately managed account can significantly reduce the effect on the portfolio if a single issuer's credit rating deteriorates or if the issuer defaults. Moreover, because active managers conduct ongoing monitoring of the bonds they hold, they can further minimize these risks by selling vulnerable bonds at the first sign of trouble, before the bond's marketability and current value are reduced.

Active management also can help offset interest-rate risk — the risk that rates will rise and threaten current principal values. "There's interest-rate risk in all fixed-income vehicles," notes Tim McGregor, director of municipal fixed income at Northern Trust. "The goal of bond fund managers is to make sure they're maximizing the fund's return versus that interest-rate risk."

### Flexibility Adds Income Opportunities

Because they are actively managing portfolios of bonds, fund managers have a degree of flexibility available to them that few individual investors can achieve. Bond portfolio managers use this flexibility to find opportunities for adding income to an actively managed bond fund or separately managed account.

One way they do this is by using a bond's duration — its price sensitivity to changes in interest rates — to their advantage. When interest rates are expected to rise, active managers can quickly shorten their portfolios' durations by selling long-maturity bonds in exchange for either high-coupon or short-maturity bonds.

Likewise, if interest rates are expected to fall, an active manager can extend a portfolio's duration in anticipation of the price increase that typically coincides with falling rates.

### Focus on Total Return

The muni bond market is incredibly inefficient, mainly because of its size and the wide variety of projects supported by muni bond issues. Active managers are able to take advantage of these inefficiencies with research focused on finding value anomalies — something that passive investing ignores.

By focusing on total return — the coupon or stated rate of interest income and changes in principal value — active managers can take advantage of gains in principal value that may be lost by following a buy-and-hold strategy with individual bonds.

"A muni bond fund can use the entire spectrum of maturities. This allows managers to add some extra yield," says McGregor. Active bond managers can do this using several strategies:

- **Yield curve positioning** – Normally, long-term interest rates exceed short-term rates. The extent of that difference is referred to as the "steepness" of the yield curve. When active managers expect the



# Tax Advantages of Muni Bonds

Munis are often the best way to fulfill fixed-income asset allocations in taxable accounts. Because the interest income on muni bonds is exempt from federal income tax, and in many cases state and local taxes, munis may be even more attractive to investors subject to higher income tax rates. However, some munis are subject to the alternative minimum tax (AMT), meaning investors should keep the AMT in mind during their investment and tax planning.

“If your effective tax rate is more than 20%, you should consider having municipal bonds as a significant part of your fixed-income portfolio,” says Tim McGregor, director of municipal fixed income at Northern Trust. “It’s clearly an attractive after-tax vehicle for your fixed-income portfolio.”

How much of a difference does the tax exemption make? If an investor is in the 35% federal income tax bracket, a

bond with a 3.77% yield would provide after-tax income equivalent to that of a taxable bond earning 5.81%.

McGregor adds that conditions are currently favorable for investors who are considering adding muni bonds to their portfolios. “With the abundance of new issues in the market right now, yields – the income levels that are available – are higher than they would otherwise be under normal conditions.”

yield curve to flatten or invert (when short-term interest rates match or exceed long-term rates), they may try to boost returns by increasing the number of longer-maturity bonds they hold. Conversely, they likely would move their funds’ investments into shorter-maturity bonds when a steeper yield curve is forecast.

- **Sector allocation** – Active managers also may take advantage of opportunities for higher yields offered by state-, sector- or issuer-specific supply and demand imbalances.
- **Security selection** – Active managers can enhance returns by identifying individual bonds that are mispriced relative to the bonds’ intrinsic value, selling a bond in anticipation of a downgrade in its credit rating or taking advantage of a callable bond’s premium yield after research suggests the bond is unlikely to be called.

## Research and Trading Advantages

Unlike the stock market, where you can purchase shares of a mutual fund that tracks an index, funds tracking bond indices are less exact. To achieve returns that mirror those of a particular index, you need to select the appropriate issues from among the more than \$800 billion in new municipal bond issues made during the past two years. Individual investors simply do not have the necessary depth of research at their disposal to do this successfully.

Pricing is another area where active traders typically have an advantage over individual investors. Because muni bonds are traded in decentralized, over-the-counter markets, they historically carry high trading costs. Bond prices are not centrally set. Instead, they are determined by supply and demand, as reflected in the bid/ask spread (the difference between the bid to buy and the offer to sell). “Because the managers are buying in block size, they’re getting better value than investors buying individually for smaller accounts,” says McGregor.

## An Attractive Addition

With the current influx of new issues to the market, now is a good time to consider taking advantage of the diversification benefits and tax-free income muni bonds can provide your investment portfolio. The greater diversification, potential for higher income through a total return approach and other benefits an actively managed muni portfolio offers may make a muni bond fund or a separately managed account a strategy to consider. ■

## Separately Managed Muni Accounts

If you can allocate \$2 million or more to municipal bonds, a separately managed account might allow you to reap the benefits of active management with a strategy tailored to meet your specific needs. Separately managed muni accounts offer many of the advantages of muni bond mutual funds. And while they typically are not as diversified as muni bond funds, larger-sized separately managed accounts generally are far more diversified than most passive muni portfolios.

You can customize a separately managed account in many ways. Your account manager will help you identify your objectives for the account, including your risk and return goals. Other considerations may include whether you want to take more aggressive positions based on your expectations of changes in interest rates or the yield curve, or if you want to target a particular duration that isn’t available through a bond fund.