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The Active Investor: Expanding the Opportunity Set in Municipal Bonds

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In this podcast, Lord Abbett Portfolio Manager Greg Shuman discusses innovative approaches to investing in high yield municipal bonds.

BRIAN FOERSTER: This is Brian Foerster, and welcome to *The Active Investor* podcast, our monthly look at what's happening across asset management, how Lord Abbett's investment leaders are viewing today's markets, and the strategies that can help investors navigate different challenges and opportunities.

In this episode, we're talking about municipal bonds and the evolution and innovation that's happening in the space, both for asset managers and investors. And joining us is Greg Shuman, a portfolio manager and a partner here at Lord Abbett. Greg has been in the investment industry since 2010 and is a CFA charter holder. So welcome, Greg.

GREG SHUMAN: Thanks for having me.

FOERSTER: So, over the next 20 minutes or so, we'll talk about the opportunity in high yield muni [municipal bonds], how that's changed over the last decade, and some of the new approaches and product vehicles that might be helping investors today to access this segment of the market.

But I thought first maybe we'd touch a little bit on your background and how you got into investing. I know you joined Lord Abbett right out of college, I think, in 2010. How'd you get into investing? And then maybe more specifically, into the muni bond market?

SHUMAN: Yeah, sure. Thanks for having me on the podcast.

FOERSTER: Sure.

SHUMAN: Long time listener. First time on the podcast and hopefully it won't be the last.

I came straight out of college in 2010 and was recruited by Dan Solender, who runs the municipal bond department, and has now for over 17 years. And what attracted me to the asset class was the fact that you have municipals, which sits at the intersection of markets and politics, or government policy.

And so those two had always interested me. And I didn't grow up dreaming of being a municipal bond investor. I think very few people even know what municipal bonds are when they're in college. But the fact that it was at the intersection of these two areas of interest that I had throughout my youth in growing up made it really attractive in the long run, and a place where I found it very interesting.

And then second of all, I was sitting in a seat directly next to some great investors who had a long track record, like Dan Solender. And you were just so close in the middle of the activity of growing a business, developing a lot of these different products, and mutual funds, as well as separate accounts. And just being so close to the activity made it really interesting. I still have the notebooks of every trade that we would do over 15 years ago.

FOERSTER: Wow.

SHUMAN: And where things were trading, what the portfolio managers were thinking, asking them, and quizzing them on all the different ideas they had. And so that's been super impactful, just having great mentors around the firm to help develop talent in myself.

FOERSTER: So maybe talk a little bit just about the high yield muni market. I think maybe just demystify it a little bit. What are the types of issuers? What are some of the characteristics of it just at a sort of high level, just to level set?

SHUMAN: Sure. So, when you think about the muni bond market in its entirety, it's about a $4 trillion asset class. Only about $250 billion of that is actually in high yield muni, true below-investment grade, bonds. The interesting thing is that most people, when they think about municipal bonds, they typically think it's a general obligation bond. I'm lending money to a city that's building out their infrastructure.

Well, in the high yield space, it's about 90% revenue bonds. So, there's some specific revenue, whether it be a water and sewer bill or something to that effect, where that specific revenue is pledged to pay you back. And so that's about 90% of what we do in the high yield muni space.

Another interesting fact is that about 70%-- if you look at the Bloomberg High Yield Municipal Bond Index, about 70% of that index is in non-rated securities. So, municipal market participants, like ourselves, who have been around this market for a long period of time, are very comfortable with non-rated securities because maybe the rating agencies, they don't have a criteria or a methodology within a sector because it's not scalable for them.

It's very small. It's a niche part of the market. So, they don't want to do it because it's not a profitable activity for them. But we may have the expertise in-house to evaluate the creditworthiness of that particular part of the market. When you think about the sectors in the market, what we're actually lending to, they're issuers like corporate issuers that are able to access the tax-exempt market for whatever reason through the private activity bond issuances that are available in this country.

They're things like hospital systems that are all throughout the country. There are things like senior living facilities all throughout the country. And then there are things like land development deals, where they're building out the basic infrastructure needs to develop single-family and multi-family housing as well.

FOERSTER: Okay. Interesting, some of those examples you just brought up. What's the default experience for high yield muni bonds? And how does that compare to the corporate market, right, and the default experience for similar credit ratings?

SHUMAN: Yeah. So typically, the default experience within high yield munis, if you look at the actual numbers of defaults on an annual basis are typically somewhere in that 2-3% range when you include non-rated bonds. So, if you were to just look at what is happening defined by Moody's, who runs a default study, that is based on the securities that they're actually rating. So [in] that typically you see high yield munis are defaulting about a third of the rate of [similarly rated] corporate bonds.

FOERSTER: Wow. Okay.

SHUMAN: But within the non-rated segment, it is a little bit more, but you typically see about 1-2% default rates per year. And that's kind of the pace that we're at right now, which is relatively low, versus historical trends.

FOERSTER: Okay. That's very helpful. So, you think about the last decade. You see that dealer inventories are down. You see that banks and insurance companies are less involved. So, what's sort of been the dynamics behind that over the last, say, 10 to 15 years?

SHUMAN: Yeah. So, it's just that in the post-GFC [global financial crisis of 2008–09] world, banks have been backing away more and more from multiple activities. One of them is lending. So typically, they're lending against some secured asset. Maybe it's a piece of real estate. Maybe it's a factory. And typically, they had been very comfortable doing that, particularly the middle-market segment of the market.

So, you think about small banks giving out $20 million, $30 million, $40 million loans to a charter school, and it's secured by a building. Well, what we've been seeing over the most recent past is that a lot of these deals that typically banks would do directly with that charter school are now actually coming as bonds in the municipal bond market.

And so, there is pretty strong security, [i.e., asset backing the debt] and pretty strong prospects for them having the ability to repay that loan. But banks are just no longer doing that type of activity, or don't want to do that type of activity, for capital reasons or balance sheet reasons.

The second thing that we're seeing is banks are less and less likely to provide significant liquidity in the secondary market. And what that means is if you look at over time, and I were to go back to 2006 or 2007, banks were holding somewhere between $50 billion and $60 billion of inventory on their balance sheet of municipal bonds. Whereas if I were to look at that number today, it's somewhere between $5 billion and $10 billion. So, there is a relatively significant reduction in the secondary activity of investment banks providing liquidity.

FOERSTER: Okay. That's very helpful background. So, let's maybe shift now to think about you as an investor and how you think about investing in this space. A lot of what you just described seems like there's a pretty attractive risk-reward trade-off, especially in high yield munis.

Pretty attractive credit quality, especially you talk about the default experience. Obviously, high tax-equivalent yield and some pretty attractive historical returns. So, as you think about being an investor in this space, what are some of the things you look for? And just maybe just your overall approach to investing.

SHUMAN: Sure. So, let's start here. The single most important thing when you're investing is your starting yield. Historically, based on what you're going to earn, is most likely going to look like your starting yield. If you look at it from a long-term perspective and you're looking five, ten years down the line, your starting yield is the single most important thing. Today, the starting yield on the high yield municipal bond index [the Bloomberg High Yield Municipal Bond Index] is about 5.9%. That's about a 10% taxable equivalent yield.

FOERSTER: Wow.

SHUMAN: The historical volatility of that asset class, and I compare a 10% taxable equivalent return or yield to other asset classes, that is extremely attractive, right? One of the things that's holding people back is if you look at the AA-rated bond index [the AA-rated portion of the Bloomberg Municipal Bond Index], it's about 3.8%.

So, you're getting about 210 basis points of excess yield for buying a below investment-grade bond, versus buying an AA-rated municipal if you're looking sort of apples to apples. And the issue that people are having is, they're saying, "Well, credit spreads are tight."

But what I would say is that yields haven't been this high in over 10 years. So, you are getting a wonderful opportunity, and that opportunity is based on yields and historical returns that you've received. So, I'm very excited about the prospects for future returns for investors in the asset class today.

FOERSTER: Got it. Why does that exist? That sort of 210 basis point spread that you talked about. When we talk about that much better default experience in the muni market than, say, in the corporate market, right? So, is there just a mispricing that's persistent? Or is it investor behavior? Why do you think that exists?

SHUMAN: Yeah. So, I think that the premium exists because when you think about munis as an asset class, demand is very segmented, right, and fragmented. So, if you think about who holds municipal bonds, it's predominantly about 70% of the market either through mutual funds, ETFs [exchange-traded funds], or separately managed accounts, or directly owning individual securities--it's about 70% individual investors.

And those individual investors can move about the market in very fragmented ways. And they tend to act together. So, when you think about the high yield muni space specifically, it's a very niche market. And most of the individual investors own municipal bonds for stability and for income.

And so, they focus predominantly on that short and intermediate part of the yield curve, predominantly in the high-quality segment of the market. And so, because you have this fragmented demand profile, you end up with what I think are wonderful opportunities in the high yield space because people usually come into munis not to take risk, but to stay away from risk.

FOERSTER: Got it.

SHUMAN: And so that creates, in my view, a long-term opportunity for investors in the [municipal] credit space.

FOERSTER: So, one last question for you, Greg. I mentioned in our intro just some of the evolution and innovation happening at the product level in this space. Can you talk a little bit about what the potential benefits are of investing in a semi-liquid structure in the high yield muni space?

SHUMAN: Yeah. Absolutely. So, when you think about the concentration of assets in the high yield muni space, it's predominantly concentrated among 10 mutual fund family managers. And so, what we're able to do there is create a more concentrated, focused portfolio with our best ideas, okay? We're able to provide creative financing solutions that maybe don't fit in a daily liquid vehicle or, for whatever reason, are not well understood by the market. And then we're able to more effectively deploy leverage through the tender option bond market, which can be a very attractive part of the market, particularly when you have a very steep yield curve, as you do in the municipal bond market today. And so those things allow you to perhaps pursue a little bit higher returns, a little bit higher yields in the market than you would traditionally be able to get through an open-end mutual fund.

FOERSTER: Yeah, no. Imagine as well the ability to be a buyer as flows are going out [i.e., outflows from municipal bond funds], as opposed to sort of being beholden to investor flows. That's probably a benefit as well.

SHUMAN: Yeah. That's a wonderful aspect to a semi-liquid vehicle as well. If you look typically over long periods of time, some of the best returns have come out of periods where you've seen the larger outflows in municipal bond open-end mutual funds. And so typically, going against the grain has afforded investors very, very well. And having a semi-liquid vehicle allows you to kind of take advantage of that flow cycle that we typically see.

FOERSTER: Right. All right, great stuff. Thanks, Greg, for joining us, and hope to have you back here again.

For investors wanting to learn more about Lord Abbett's views on the markets, please visit the "Insight" section of LordAbbett.com. We have a number of papers on municipal bond investing that touch on a lot of what we discussed here today.

If you have any comments on today's episode or ideas for future episodes, email Podcasts@LordAbbett.com. We welcome your thoughts and would love to hear from you. So, we'll leave it there. This has been Brian Foerster with *The Active Investor* podcast. Thank you for listening.

GLOSSARY OF TERMS USED IN THIS BROADCAST

A **basis point** is one one-hundredth of a percentage point.

An **exchange-traded fund (ETF)** is an investment fund that holds multiple underlying assets and can be bought and sold on an exchange, much like an individual stock. ETFs can be structured to track anything from the price of a commodity to a large and diverse collection of stocks.

General obligation (GO) bonds are backed by the "full faith and credit" of a government and are issued by entities such as states, cities, counties, and school districts. **Revenue bonds** are backed by revenues from specific projects or facilities (such as toll roads, water/sewer systems, or airports).

Liquidity: Daily liquidity vehicles, like mutual funds, allow investors to buy or redeem shares at the end of each day's net asset value (NAV). A quarterly liquidity vehicle refers to an investment structure that offers investors the opportunity to redeem their shares on a quarterly basis. Highly illiquid investments, such as Limited Partnerships (LPs) or private funds, may require investors to wait for a specific event or a longer period to exit their investment.

Private activity bonds are municipal bonds that are used to attract private investment for projects that have some public benefit.

In fixed income, the **secondary market** refers to the sale and purchase of securities after they have been issued in the primary market. Investors buy from other investors rather than from issuing companies.

Spread is the percentage difference in current yields of various classes of fixed-income securities versus Treasury bonds or another benchmark bond measure. A bond spread is often expressed as a difference in percentage points or basis points (which equal one-one hundredth of a percentage point).

Tender option bonds are special purpose trust investments that create leverage by borrowing primarily from money market funds or other cash-like investors to invest in high quality municipal bonds.

Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. **Yield-to-maturity (YTM)** represents the expected return (expressed as an annualized rate) from the bond's future cash flows, including coupon payments over the life of the bond and the bond's principal value received at maturity. **Yield-to-worst** refers to the lesser of a bond's (a) yield-to-maturity or (b) the lowest yield-to-call calculated on each scheduled call date.

The **tax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of the tax-exempt yield on a municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond to see which bond has a higher applicable yield.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. A normal, upward-sloping (steep) curve means that long-term securities have a higher yield, whereas an inverted curve shows short-term securities have a higher yield.

The **Bloomberg High Yield Municipal Bond Index** is an unmanaged index consisting of noninvestment-grade, unrated or below Ba1 bonds.

The **Bloomberg Municipal Bond Index** is a rules-based, market-value-weighted index engineered for the long-term, tax-exempt bond market. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two ratings agencies.

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