LORD ABBETT

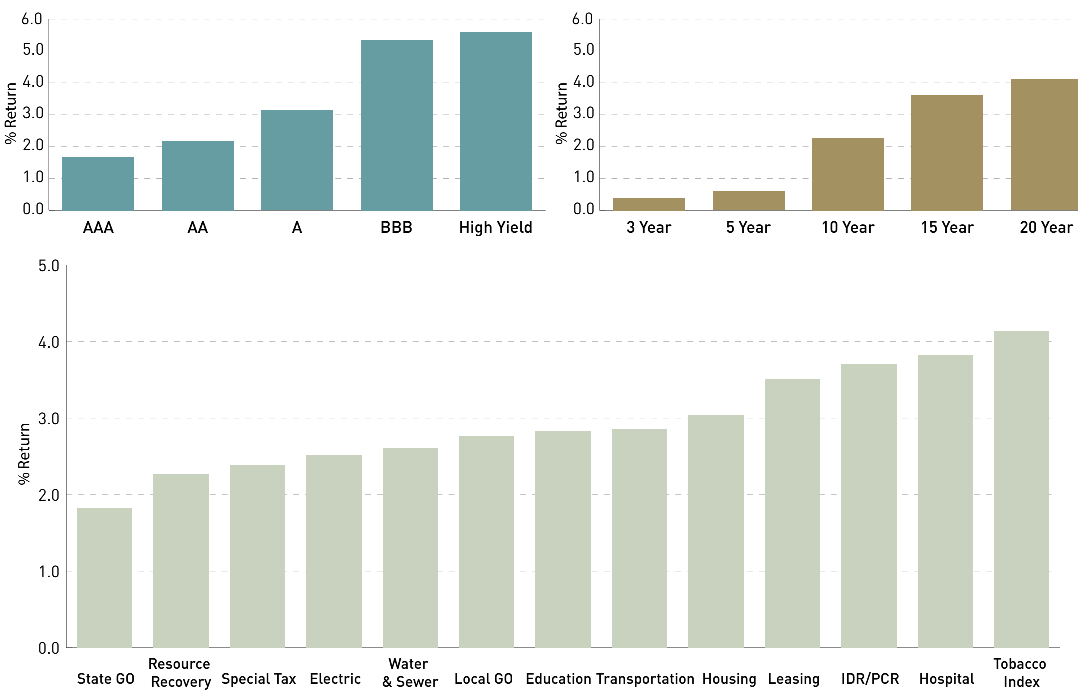
MARKET VIEW

MUNI BONDS: THE ARGUMENT FOR ACTIVE MANAGEMENT

Muni bond investment requires the rigorous analysis of a professional bond manager.

CHART 1. MUNICIPAL BOND RETURNS DIFFER BY QUALITY, MATURITY, AND SECTOR

INDEX* COMPONENTS (12 MONTH-PERIOD ENDED MARCH 28, 2018)



Source: Bloomberg Barclays.

*Municipal bond components as represented by Bloomberg Barclays Municipal Bond Index. The historical data shown is for illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment. **Past performance is not a reliable indicator or guarantee of future results.**

IN BRIEF

- We believe investors in the municipal bond market can benefit in a number of ways from the expertise of experienced portfolio managers and credit analysts.
- Total returns may exceed a traditional buy and hold approach when diligent yield-curve analysis is performed.
- Professional management may mitigate the price impact of rising interest rates.
- Managers closely monitor supply/demand dynamics to identify trends that may affect market performance.
- Credit-spread analysis is an important step in determining relative value.
- Rigorous credit research can help determine which issuers may benefit during periods of expansion and avoid bonds on the path to downgrade, or worse, default.

There are many elements that investors must consider when investing in the municipal bond market. As Chart 1 illustrates, over the last 12 months ended March 28, 2018, different credit qualities, maturities, and sectors have produced very different returns.

In fact, investors are faced with a whole host of questions. For example, what areas of the municipal market may be poised to outperform? Which maturities? Which credit qualities? Which sectors? Which issuers? What macroeconomic or regulatory dynamics might affect the market, and how can the winners and losers be distinguished as a result of those dynamics?

A recent article on lordabbett.com discussed the role that actively managed strategies can play in taxable fixed-income portfolios. We believe there are similar arguments to be made for the tax-free sector. In previous *Market Views*, we discussed a few of the key reasons for hiring a professional municipal bond manager.

In the current *Market View*, we further explore the importance of active management in this asset class. We ask such questions as: Are individual investors (or their advisors) analyzing the shape of the yield curve to determine the optimal maturity positioning? Are they monitoring credit spreads to uncover

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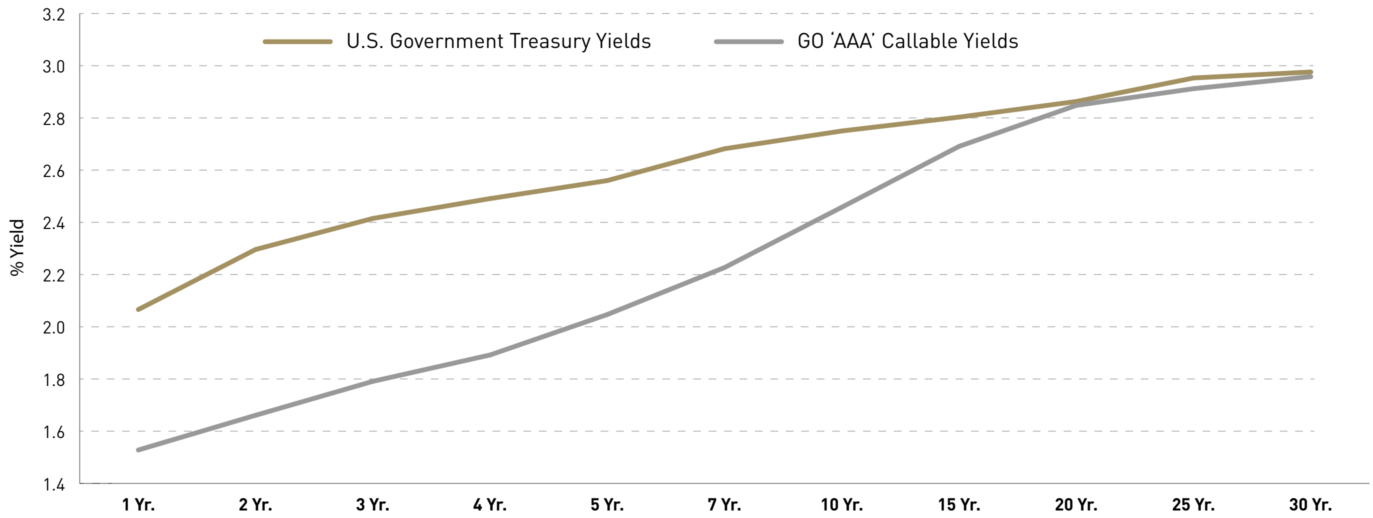
CHART 2. THE MUNICIPAL BOND YIELD CURVE IS TYPICALLY UPWARD SLOPING

DATA AS OF MARCH 30, 2018



Source: Bloomberg.

Past performance is not a reliable indicator or guarantee of future results.

Income from municipal bonds may be subject to the alternative minimum tax. Federal, state, and local taxes may apply. For illustrative purposes only and does not represent any specific portfolio managed by Lord Abbett or any particular investment.

relative value across differing credit quality tiers? Are they performing in-depth credit research at the sector, issuer, or security level? And, finally, are they analyzing bond structures such as callability and how changes in interest rates may affect cash flows?

YIELD-CURVE ANALYSIS

Although it is an important statistic, active managers focused on total return look beyond the yield to maturity of a bond. This is because they often sell the bond prior to maturity. Determining the optimal time to sell is often done by assessing the shape of the yield curve. Simply put, the yield curve is a line graph that plots the yields of bonds with similar credit quality (vertical axis), but different maturities (horizontal axis), from short to long. The municipal bond yield curve is typically upward sloping (see Chart 2), meaning market yields for shorter bonds typically are lower than yields for longer-maturity bonds. Given the bond's yield and the shape of the graphed line, a portfolio manager can estimate what the expected return on a bond may be over the next 12 months, assuming the shape of the line remains constant. If there is high conviction in a potential change in shape, the portfolio manager can incorporate that into the bond's expected return.

All else being equal, the market more highly values a bond that is closer to maturity (same coupon, less risk). Portfolio managers look to capture the premium that has built up in the bond as it nears maturity by selling it before the premium begins to erode and price reaches par value at maturity.

Takeaway: It's important to realize that when diligent yield-curve analysis is performed, total returns may exceed a traditional buy and hold-to-maturity approach.

INTEREST-RATE SENSITIVITY

With rising interest rates on the minds of fixed-income investors, many often inquire about their portfolio's duration. Duration simply is a measure of a bond price's sensitivity to changes in interest rates. The longer a bond's duration, all else equal, the more that bond's price can be expected to fall when market rates and, consequently, bond yields rise. If yields on certain types of bonds are expected to rise, portfolio managers may wish to be more defensive, investing in higher-coupon, higher-priced bonds. Meanwhile, some investors often try to avoid bonds priced at a premium. After all, we are familiar with the intent to "buy low, sell high." So, why do professional managers seek out premium bonds? Because such bonds often come with higher coupons relative to similar, but lower-priced bonds. A higher coupon provides more of a cushion against a negative price impact of rising rates and yields, ultimately resulting in a higher total return (as measured by coupon income +/- price change).

Takeaway: Monitoring duration and interest-rate movements may translate to portfolio shifts that mitigate price impact from rising interest rates.

SUPPLY/DEMAND DYNAMICS

Another important aspect of municipal-bond investing is monitoring investor demand and issuance. Investor demand, at times, can be concentrated in certain maturity ranges or credits. For example, in recent years, a low-interest-rate environment has caused investors to seek incremental yield in lower-quality credits. Supply is another important factor that can affect bond prices. For example, the fourth quarters of both 2016 and 2017 were characterized by heavy supply. The catalyst for higher-than-normal fourth-quarter 2016 issuance was the anticipated tax and spending effects of a Trump presidency, while issuance in the fourth quarter of 2017 was driven by implications tied to tax reform.

Takeaway: Portfolio managers monitor supply/demand dynamics closely, including expected issuance over the next 30-day period.

CREDIT SPREAD ANALYSIS

Credit spreads represent the incremental yield pickup over less-risky bonds. For example, the yield on a 'BBB' rated bond would be higher than that of an 'AAA' rated bond, all else equal, offering investors a yield "spread" over the 'AAA' bond to compensate for the additional risk. Portfolio managers evaluate credit spreads of various credit qualities and compare them to historical averages. This may uncover value in certain credit tiers relative to others. In addition, it may uncover value in certain issuers, relative to issuers of similar credit quality.

Takeaway: Credit-spread analysis is an important step in determining relative value.

CREDIT RESEARCH

Rigorous credit research is key to developing a deep understanding of sector trends and issuer fundamentals that may affect total return. Even if an investor's forecast is correct of how a specific sector may perform, he or she may face opportunity costs stemming from suboptimal security selection within that sector. For example, in the Lord Abbett Muni Quarterly, our research analysts discussed the higher-education sector. Their analysis showed that many tuition-dependent schools are being forced to offer discounts as affordability remains a concern. What is more, changes to immigration policy may continue to affect enrollment. Both of these factors can be a headwind to revenues of certain universities. On the other hand, schools with large endowments have benefited from stable donation trends and strong investment returns. There also are regional aspects to consider. Demographic shifts favor an expanding market in the Southwest/West Coast markets, and are a headwind for the shrinking markets in the Midwest and Northeast. This insight, albeit very simplified for the purposes of the example, helps distinguish between the winners and losers within the sector.

Takeaway: Rigorous credit research is vital to avoiding bonds on the path to downgrade, or worse, default. In addition, research can help determine which issuers may be more resilient during periods of stress or those that may benefit the most in periods of expansion.

CONCLUSION

Accessing the potential investment opportunity offered by the municipal bond market requires a level of credit expertise that few individual investors have. Professional bond managers and credit analysts perform a valuable service by their diligent monitoring of all aspects of this vital marketplace. ■

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A Note about Risk: The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The municipal bond market may be impacted by unfavorable legislative or political developments and adverse changes in the financial conditions of state and municipal issuers or the federal government in case it provides financial support to the municipality. Income from the municipal bonds held could be declared taxable because of changes in tax laws. Certain sectors of the municipal bond market have special risks that can affect them more significantly than the market as a whole. Because many municipal instruments are issued to finance similar projects, conditions in these industries can significantly affect an investment. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state and local taxes may apply. Investments in Puerto Rico and other U.S. territories, commonwealths, and possessions may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

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GLOSSARY OF TERMS

A **callable bond** (also called redeemable bond) is a type of bond (debt security) that allows the issuer of the bond to retain the privilege of redeeming the bond at some point before the bond reaches its date of maturity.

A **credit spread** is the difference in yield between two bonds of similar maturity but different credit quality.

A **coupon** payment on a bond is the annual interest payment that the bondholder receives from the bond's issue date until it matures.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price.

A **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. The yield curve illustration is built using nonparametric fit of market data obtained from the Municipal Securities Rulemaking Board, new issues calendars, and other proprietary contributed prices. Regarding credit quality, the credit quality of the securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO) such as Standard & Poor's, Moody's or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment grade bonds (junk bonds) involve higher risks than investment grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

Yield to maturity is the rate of return anticipated on a bond if held until it matures. Yield to maturity assumes all the coupon payments are reinvested at an interest rate that equals the yield-to-maturity. The yield to maturity is the long-term yield expressed as an annual rate.

The Bloomberg Barclays Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. The index is a broad measure of the municipal bond market with maturities of at least one year.

Indexes are unmanaged, do not reflect the deduction of fees or expenses, and are not available for direct investment.

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