LORD ABBETT

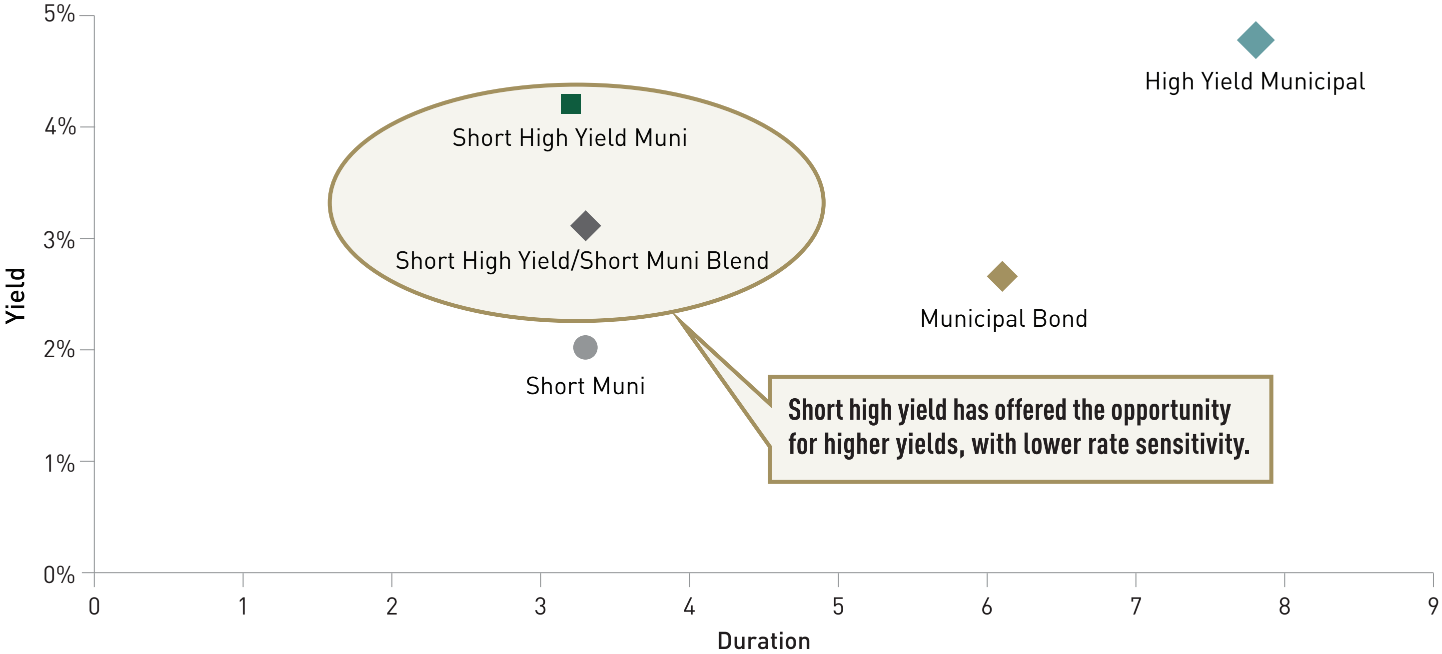
MARKET VIEW

MUNI BONDS: WHERE MIGHT YOU FIND HIGH INCOME WITH LOW DURATION?

A strategy employing short duration, high-yield municipal bonds offers the potential for investors to realize higher income while mitigating interest-rate risk.

CHART 1. SHORT HIGH YIELD: OPPORTUNITY FOR HIGH TAX-FREE INCOME WITH LOWER DURATION

YIELD AND DURATION OF REPRESENTATIVE INDEXES, AS OF JULY 31, 2018



Source: Bloomberg Barclays Indices. Municipal Bond Index=Bloomberg Barclays Municipal Bond Index. Short Muni=Bloomberg Barclays 1-8 Year Municipal Bond Index. High Yield Muni= Bloomberg Barclays High Yield Municipal Bond Index. Short High Yield Muni= Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index. Short Muni/Short High-Yield Muni Blend=A 50/50 combination of the Short Muni and Short High Yield Muni Indexes. Aggregate=Bloomberg Barclays U.S. Aggregate Bond Index.

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IN BRIEF

- Short duration, high-yield municipal bonds recently offered higher yields than the broader municipal bond market, with less interest-rate sensitivity.
- Further, they historically have displayed lower volatility than longer-dated, high-yield munis.
- They also have featured low correlation to other muni categories, the broader bond market, and U.S. Treasuries.
- A portfolio blending short-duration high-yield munis with investment-grade short munis potentially may offer a particularly effective means of achieving high tax-free income with less interest-rate risk.

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A number of recent *Market Views* have covered the performance of various segments of the bond market thus far in 2018. While the increase in U.S. Treasury yields in 2018, based on Bloomberg data, has led to negative returns in the broad U.S. bond market (as represented by the Bloomberg Barclays U.S. Aggregate Bond Index, or the Aggregate Index), lower duration, and more credit-sensitive, sectors of the market have outperformed. The same trend holds true in the municipal bond market.

A Closer Look at Munis' Year-to-Date Outperformance

In general, municipals have outperformed the U.S. taxable bond market in 2018, as the broad benchmark Bloomberg Barclays Municipal Bond Index (the Muni Index) is flat on the year (through July 31), compared to a 1.59% loss for the Aggregate Index, as summarized in Table 1. Within municipals, shorter maturities have outperformed, as the less than 10-year maturity portion of the Muni Index has generated positive returns, while longer maturities are in negative territory.

Investors willing to take on some credit exposure have been rewarded, with the Bloomberg Barclays High Yield Municipal Bond Index (the High Yield Muni Index) up 4%. A closer look at Table 1 shows that a specific segment of the high-yield muni space has outperformed this year, and may warrant investor attention: short- duration, high-yield municipal bonds.

TABLE 1. LOWER-RATED MUNI BONDS HAVE ECLIPSED INVESTMENT-GRADE PEERS IN 2018

DATA FOR INDICATED BLOOMBERG BARCLAYS INDEXES, AS OF JULY 31, 2018

INDEX	YTD Return (through 7/31/18)	Average Yield	Effective Duration
Municipal Bond	-0.01%	2.66%	6.1
Short Muni	0.80%	2.02%	3.3
High Yield Muni	4.02%	4.79%	7.8
Short High Yield Muni	5.45%	4.20%	3.2
Short Muni / Short High Yield Muni Blend	3.10%	3.11%	3.3
Aggregate	-1.59%	3.36%	6.0

Source: Bloomberg Barclays Indices. Municipal Bond Index=Bloomberg Barclays Municipal Bond Index. Short Muni=Bloomberg Barclays 1-8 Year Municipal Bond Index. High Yield Muni=Bloomberg Barclays High Yield Municipal Bond Index. Short High Yield Muni=Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index. Short Muni/Short High-Yield Muni Blend=A 50/50 combination of the Short Muni and Short High Yield Muni Indexes. Aggregate=Bloomberg Barclays U.S. Aggregate Bond Index.

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Potential Benefits

As we noted in the June 18, 2018, *Market View*, high-yield municipal bonds may provide investors with the opportunity for high tax-free income, the potential for attractive long-term returns, and portfolio diversification. Those who may find the higher income available in high-yield munis appealing, but may be concerned about the potential duration exposure, or are interested in limiting volatility, may want to consider a strategy employing high-yield muni bonds of shorter duration. Such an approach has the potential to offer.

1. *High tax-free income*: Remember, a 3.0% nominal yield on a municipal bond represents a tax-equivalent yield of over 5.0% for those in the top bracket (40.8%, including the 3.8% Medicare tax).

2. *Lower interest-rate sensitivity*: The lower duration of shorter-maturity high yield munis may lead to better performance during periods of rising rates.

3. *Lower volatility*: Lower duration historically has led these securities to display much lower volatility than the broad high-yield muni market.

4. *Portfolio diversification*: The Short High Yield muni index referenced in Table 1 (the Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index) has very low correlation with the broader Muni Index, or the taxable bond market (as represented by the Aggregate Index), so adding short-duration, high-yield municipal bonds to your portfolio may provide enhanced diversification.

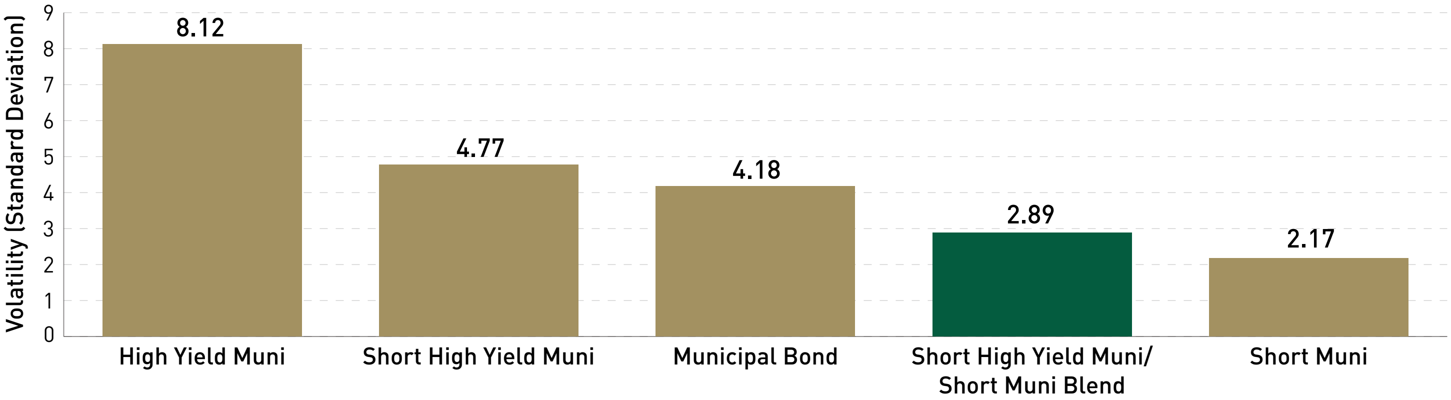
A Diversified Approach

While short high yield munis have many merits, a diversified approach which blends short-duration high-yield with short investment-grade municipals may be a prudent approach for many investors. This blend may enhance diversification and liquidity relative to a pure high-yield strategy. As illustrated by the 50/50 blend featured in Chart 1, this blended strategy could provide a higher yield than the broad muni market, with about half the duration exposure.

The benefits of this diversified approach are evident when examining volatility, as measured by standard duration (see Chart 2). The Short High Yield Index historically has had lower volatility than the broader High Yield Muni Index. Indeed, as of July 31, 2018, the Short High Yield index had a 10-year standard deviation of 4.77, versus 8.12 for the High Yield Muni Index. However, a blended approach combining the Short High Yield Index and the investment-grade Short Muni Index further limited volatility, bringing the standard deviation down to 2.89.

CHART 2. SHORT HIGH-YIELD MUNIS HISTORICALLY HAVE HAD LOWER VOLATILITY THAN LONGER-MATURITY COUNTERPARTS

TEN-YEAR STANDARD DEVIATION OF INDICATED INDEXES, AS OF JULY 31, 2018



Source: Bloomberg Barclays Indices. Municipal Bond Index=Bloomberg Barclays Municipal Bond Index. Short Muni=Bloomberg Barclays 1-8 Year Municipal Bond Index. High Yield Muni=Bloomberg Barclays High Yield Municipal Bond Index. Short High Yield Muni= Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index. Short Muni/Short High-Yield Muni Blend=A 50/50 combination of the Short Muni and Short High Yield Muni Indexes.

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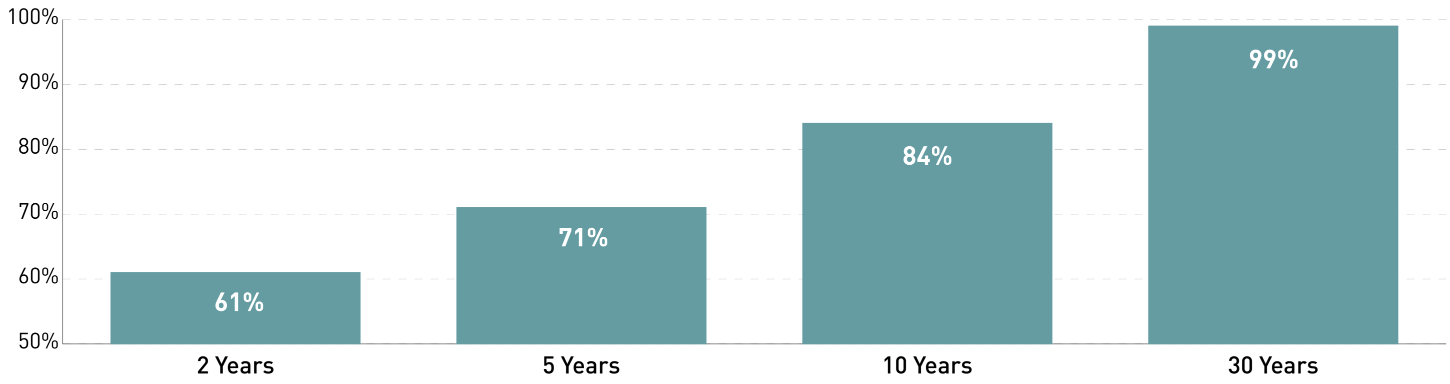
The potential diversification benefits offered by short high-yield munis on their own are evident when examining their correlation with other muni-bond categories, the broader bond market (the Aggregate Index), and U.S. Treasury securities (see Chart 3).

CHART 3. SHORTER-DATED HIGH-YIELD MUNIS OFFER THE OPPORTUNITY FOR EFFECTIVE PORTFOLIO DIVERSIFICATION

TEN-YEAR CORRELATION WITH THE BLOOMBERG BARCLAYS 1-8 YEAR HIGH YIELD MUNICIPAL BOND INDEX, AS OF JUNE 30, 2018



Source: Zephyr StyleADVISOR. Municipal Bond Index=Bloomberg Barclays Municipal Bond Index. Short Muni=Bloomberg Barclays 1-8 Year Municipal Bond Index. Short High Yield Muni= Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index. 10-year Treasury=Citigroup 10-Year U.S. Treasury Bond Index.

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Summing Up

The better tax-equivalent yields available in the muni market certainly have appeal for income investors. But, as Lord Abbett Partner and Director of Municipal Bonds Dan Solender pointed out in a recent *Muni Matters* column, investors have poured money into shorter-dated munis to reduce interest rate risk. As a result, the muni curve has become much steeper relative to the Treasury curve, according to data from Thomson Reuters MMD. Those muni investors wishing to emphasize shorter-duration securities may find themselves in a bit of a quandary, as the strong demand for very short, high-quality bonds has made them less attractive on a relative value basis. Thus, investors seeking less interest-rate sensitive muni securities may find that the lower rungs of the credit-quality ladder may offer better opportunity.

For those seeking to reduce interest-rate risk, a strategy employing short duration, high-yield municipal bonds, in tandem with short-dated investment grade munis, may prove particularly appealing, as it has the potential to lower overall interest rate risk, while still providing the opportunity for attractive income and total return. ■

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Diversification does not ensure a profit or protect against a loss in a declining market.

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Correlation is a statistical measure that describes the strength of relationship between two variables. It can vary from 1.00 to -1.00.

Duration is the change in the value of a fixed-income security that will result from a 1% change in market interest rates. Generally, the larger a portfolio's duration, the greater the interest-rate risk or reward for underlying bond prices. **Effective duration** is calculated using the approximate duration formula for a bond with an embedded option, reflecting the expected change in the cash flow caused by the option.

Standard Deviation (Risk) is a statistical measure of the historical volatility of a portfolio; the higher the number, the greater the risk.

Yield is the annual interest received from a bond and is typically expressed as a percentage of the bond's market price. The **average yield** is the market-value-weighted average yield to maturity of a portfolio of bonds. **Tax-equivalent yield** is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond in order to see which bond has a higher applicable yield.

The **Bloomberg Barclays High Yield Municipal Bond Index** is an unmanaged index consisting of noninvestment-grade, unrated or below Ba1 bonds. The **Bloomberg Barclays 1-8 Year High Yield Municipal Bond Index** is a maturity-specific component of the index.

The **Bloomberg Barclays Municipal Bond Index** 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. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. The Bloomberg Barclays 1-8 Year Municipal Bond Index is a maturity-specific component of the index.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

The **Citigroup 10-Year Treasury Bond Index** is a broad measure of the performance of the medium-term U.S. Treasury securities

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