Municipal Bond Investing

For a Rising Rate Environment

CRAWFORD
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Over the past four months, we have seen a sharp rise in overall interest rates, including interest rates for intermediate term municipal bonds. Interest rates for 10 year maturity high quality municipal bonds have increased 100 basis points from the lows we observed at the beginning of May. This is attributable to concerns of the Fed tapering its bond purchases which caused a rise in Treasury yields and the reversal of municipal bond mutual fund flows from positive to negative. We have received several calls from clients indicating concern about the possibility of portfolios losing value in this rising rate scenario. We felt it would be a good time to address the issue of what, if any, changes need to be made in order to mitigate the effects of rising interest rates.

A Defensive Investment Style

First, we should point out that our interest rate forecast at Crawford Investment Counsel is one of a modest rate increase for 2014 as the economy continues to grow and the Federal Reserve begins to taper asset purchases. However, we do not foresee an accelerating inflation problem in the United States for the next 12 to 18 months due to high unemployment and our forecast for economic recovery is at a lower than normal rate. The risk of a substantial rise in interest rates is not high in our opinion. However, our overall management style for municipal bond investing is one that attempts to be defensive in nature. We invest the portfolios in a manner which has helped mitigate the effects of rising interest rates. Municipal bonds typically represent our client's safest assets, and preservation of principal is paramount in our investment process. Historically, our investment returns have consistently outperformed our benchmarks in periods when interest rates are increasing and prices of municipal bonds are falling.

We invest portfolios in a manner which has helped mitigate the effects of rising interest rates.

We will illustrate how we invest in a defensive manner and how this may help to insulate the portfolio market value in a rising-rate environment. First and foremost, all municipal fixed income is not created equally from a quality and structural perspective. In 2008, we learned that high-quality fixed income can deliver solid returns even in an environment of extreme uncertainty. However, any deviation from high quality, such as AAA-rated bonds based solely on insurance, was punished severely in this same time period. Our investment philosophy emphasizes the underlying credit quality of the individual bonds we purchase and does not rely on bond insurance. Therefore, this tends to be a more defensive way to posture a municipal bond portfolio, no matter what interest rate forecast you assume.

We believe the structural aspects of an individual bond will also be a significant determinant of that bond's defensive characteristics. For instance, a "plain vanilla" structure such as a 10-year maturity non-callable par bond will exhibit far greater price deterioration in a rising-rate environment than a 10-year non callable high coupon premium bond. A 10 year maturity high coupon premium bond with a five year call feature will exhibit even less price deterioration in a rising rate environment. Other structures of municipal bonds will also offer additional yield and defensive price characteristics. These are the structures we seek for our client portfolios no matter the outlook for interest rates, because we are an income-oriented defensive style manager.

Income or Total Return

Despite our defensive style, in a rising interest rate environment our portfolios will experience a temporary drop in value. At this point the investor needs to determine if he/she owns a municipal portfolio for the consistent income it produces, or for the potential for price appreciation or total return. If the initial allocation to municipal bonds was for income, we suggest monitoring the portfolio during a period of potentially rising rates.

Our typical municipal portfolio at Crawford has a three year average effective maturity. Generally speaking, if interest rates for municipal bonds increase one full percentage point (100 basis points) from existing levels, the price of our holdings will drop approximately 2.8%. This is the current market value, not the value if held to maturity. Our intermediate term bond portfolios are constructed of individual municipal securities that can be held to maturity if desired. The seasoning of a portfolio is critical in a rising rate environment. As a bond inches closer to the final maturity, it will naturally migrate toward face value. This is an advantage of a separately managed bond portfolio over a bond mutual fund that manages to a constant maturity date. The benefit of an intermediate-term maturity, separately managed portfolio is the visibility and certainty of the final maturity.

We also stagger the maturity dates of our portfolios to mitigate the effects of rising interest rates. Commonly referred to as "laddering", this portfolio management technique ensures that the portfolio will provide sufficient liquidity by having bonds mature in each year or range of years. In a rising-rate environment, the practice of laddering enables us to reinvest maturing bonds at higher and higher interest rates. This in turn allows the portfolio yield to increase, and self adjust to the overall higher rate environment without having to liquidate securities to raise funds for purchase.

Tax-Free Return While Preserving Capital

Finally, the tax treatment on capital gains for municipals is a difficult hurdle to overcome. For instance, many of the municipal bonds purchased over the past 5 years were acquired at a higher yield than is available today. If we forecast that rates are going to increase, and subsequently make the determination to sell our current holdings to preserve the value, we will be realizing capital gains on the disposal of the assets. Those capital gains are taxed at a rate of 23.8% at the federal level. By selling, we have effectively converted future tax-exempt income into a current taxable gain. This is simply the bond math involved with the disposal of above-market yield municipal securities.

If your municipal bond fixed income investment goals are to earn a reasonable tax free return while preserving capital, we offer an excellent solution regardless of the interest rate forecast. We endeavor to exceed your expectations through our security selection process and portfolio construction characteristics. As always, if you have questions or a concern, feel free to contact anyone on the fixed income team at Crawford Investment Counsel.

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