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May 2021

Adapting to a Changing Municipal Landscape

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Individual investors and financial advisors building municipal bond portfolios on their own face challenges such as heightened credit risk, limited access to bonds, large markups, and volatile interest rates. Those who take this route often wind up with poor investment performance that is exacerbated by lingering uninvested cash balances.

At the same time, new state and local tax deduction caps and changing tax rates have increased investor interest in tax-exempt interest income. This paper explores the reasons it's important for investors to examine their tax-exempt allocations and explains how a professionally managed laddered approach to municipal bonds provides structure that can reduce risk and combat rising interest rates.

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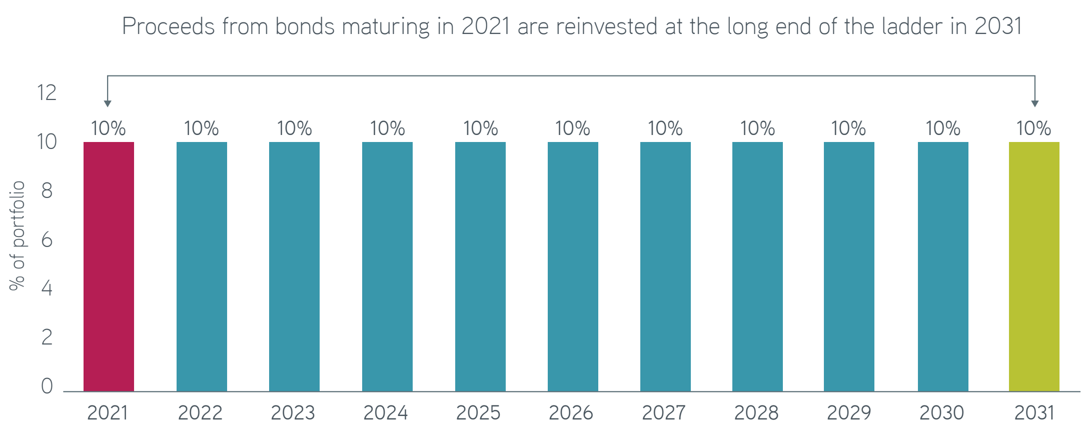
What is a laddered investment strategy?

A laddered approach may provide the benefits of municipal bonds—predictable, tax-exempt interest income and price performance that's relatively uncorrelated with equities—while also delivering the customization needed for each investor's unique circumstances. Laddering a municipal bond portfolio involves equally weighting maturity exposure over a specified portion of the yield curve. A constant percentage of bonds mature, or roll out, each year. As displayed in figure 1, the proceeds are reinvested on the longer end of the ladder as each bond rolls out.

Equally weighted ladders may also be defensive in a rising rate environment. As shorter bonds roll out of the lower-ladder range, the proceeds may be reinvested at the higher-yielding upper-ladder range, assuming a positively sloped yield curve, which is the norm in municipals. This has the potential effect of raising the yield of the portfolio. The result can be positive income and total return—even in rapidly rising rate environments.

Figure 1: Laddered municipal portfolios with reinvested proceeds at higher rates



Source: Parametric, 2021. For illustrative purposes only.

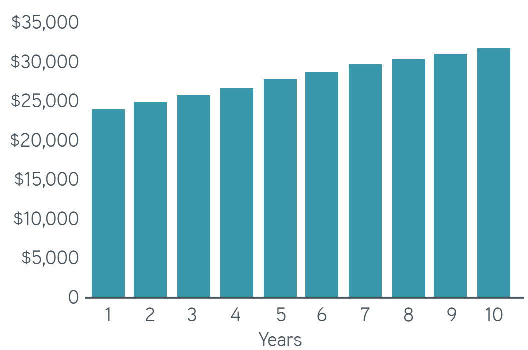
Using ladders to combat rising rates

Figure 2 expands on the concept of using laddered municipal bonds for reinvestment purposes. The laddered portfolio experiences an increase in estimated annual income and annual return, even as interest rates rise over a five-year period.

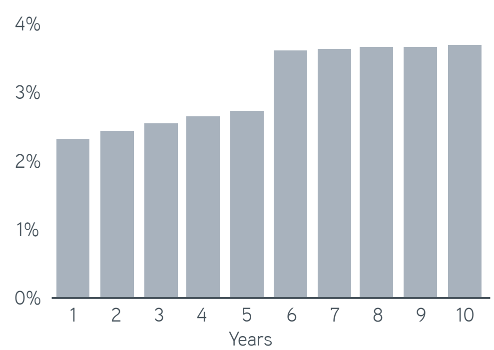
Figure 2: Laddered income and total return in rapidly rising rate environments (hypothetical)

	Starting investment $1,000,000	**Minimum credit rating AA**	**5–15 year maturity**	**National portfolio**
Starting averages	Duration to maturity 8.78 years	Maturity 10.00 years	Tax-free yield 2.40%	Taxable-equivalent[2] yield 4.06%
Tax summary[1]	Federal rate tax 37.00%	State tax rate 0.00%	Health care tax 3.80%	Effective tax rate 40.80%
Rising rate scenario = 0.50% over 5 years (0.10% per year)				
Cumulative data	5-year cumulative income (gross) $129,423		5-year cumulative total return (gross) 13.25%	

Estimated annual income



Estimated annual return



The information and illustration presented in the scenario tool are for hypothetical and illustrative purposes only. Results may not represent the experience of individual investors, and should not be construed as tax or legal advice. An investor should consult a financial and/or tax professional concerning their specific situation before making any financial decisions. Any references to future returns should not be construed as an estimate of the results a client portfolio may achieve. Yields, cumulative income, and total return shown do not reflect the effect of fees imposed by an investment manager, nor do they reflect the impact of taxes. Fees and taxes will reduce the value of a client's portfolio. Past performance, actual or simulated, is no guarantee of future results. The chart presented does not represent the results that any particular investor actually attained nor the results of any Parametric product. The information presented is based, in part, on hypothetical assumptions. No representation or warranty is made as to the reasonableness of the assumptions made or that all the assumptions used in achieving the returns have been stated or fully considered. Simulated results have many inherent limitations, and no representation is made that any account will or is likely to profit similar to those shown in the scenarios. Actual performance results may differ, and may differ substantially, from the simulations. Changes in the assumptions may have a material impact on the hypothetical results presented.

This estimated annual income increase can be particularly helpful to investors who want to achieve an attractive total return regardless of the interest rate environment but who also want to avoid price and reinvestment risk. While there may be price fluctuations over time, matching maturities of the bonds to an investor's time horizon may help with the primary goal of capital preservation. In the event of price declines, investors can choose to allow the ladder to mature. This perspective allows investors to maintain a long-term view on short-term price movements with less worry.

The potential land mines of professional credit oversight

After the 2008 financial crisis, navigating the municipal market has become a greater challenge for individual investors. The elimination of the AAA insurer guaranty reinforces the need for continuous credit analysis of the underlying issuers. While balance sheets of municipal issuers are generally improving, the threat of unfunded pension liabilities and strained budgets still looms large. Downgrades alone may destroy years of performance.

1 We assume the investor is in the 37% federal tax bracket—the highest state income tax rate—which is subject to the 3.8% Medicare tax. The state tax is deductible from the federal income tax.

2 Income is grossed up at one minus the effective tax rate, and all interest income is exempt from federal tax. If state portfolios are selected, all interest income is exempt from state and federal tax.

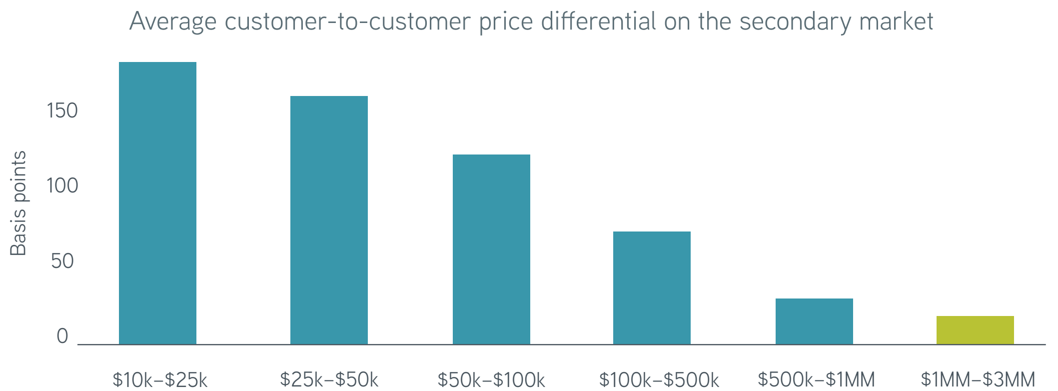
Risk exposures should align with an investor's unique set of circumstances, so careful analysis is needed to avoid land mines. Professional credit research is designed not only to uncover potential value but also to provide ongoing monitoring of issuers' credit profiles. Rigorous credit review and monitoring is a key benefit of professionally managed laddered portfolios—potentially eliminating or reducing a major source of unnecessary risk for both investors and financial advisors.

The power of institutional pricing and execution

A laddered municipal portfolio managed by professionals provides market access, which can offset the difficulty individuals typically have with obtaining the best execution price. The number of dealers in the municipal bond market has shrunk because of industry consolidation—and the remaining dealers carry comparatively smaller inventories of municipal bonds.

Individual investors who are able to find a counterparty may pay a hefty price to execute trades. A study released by the Municipal Securities Rulemaking Board in 2014 found that, relative to institutional investors, individual investors typically pay higher prices when buying municipal bonds and receive lower prices when selling the same securities. A root cause is that spreads depend upon the size of trades, and as figure 3 shows, individual investors and financial advisors typically trade smaller blocks of municipal bonds and end up paying more for the same securities.

Figure 3: Pricing based on large trading blocks[3]



Source: Erik R. Sirri, "Report on Secondary Market Trading in the Municipal Securities Market," Municipal Securities Rulemaking Board, July 2014, http://www.msrb.org/msrb1/pdfs/MSRB-Report-on-Secondary-Market-Trading-in-the-Municipal-Securities-Market.pdf.

Individual investors may realize more favorable spreads on their municipal securities transactions by enlisting the help of an investment manager. This manager may have access to better pricing and execution through trade aggregation, in addition to the ability to leverage relationships with a variety of local and national broker-dealers.

Conclusion

Determining a tax-exempt investment strategy in a changing municipal landscape requires careful planning for investors to reduce risk. Individuals who manage and advise their own investments not only run the risk of not using the benefits provided by professionally managed accounts, they could also end up paying more for less.

[3] Source: Jennifer A. Galloway, "MSRB Publishes Report on Secondary Market Trading in the Municipal Securities Market," Municipal Securities Rulemaking Board, July 2014, http://www.msrb.org/News-and-Events/Press-Releases/2014/MSRB-Publishes-Report-on-Secondary-Market-Trading.aspx.

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15336 | 4.26.2021