WASMER SCHROEDER

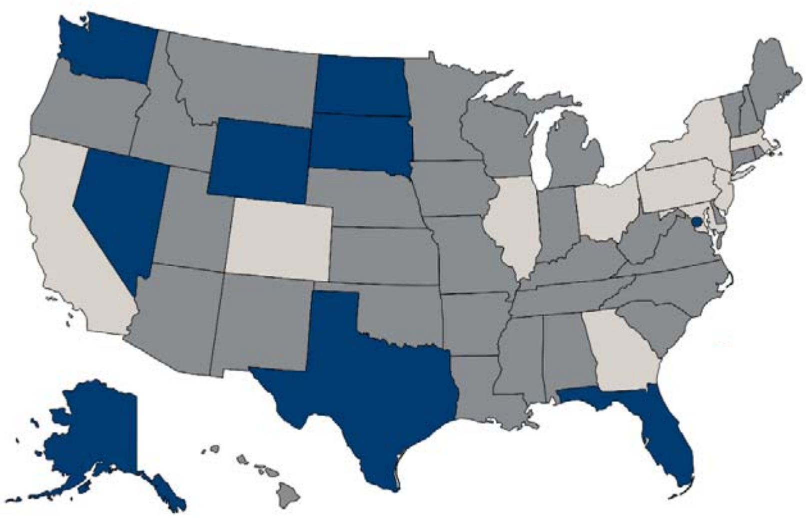
Is Your Municipal Bond Portfolio "Over-Stated"?

Determining Optimal In-State Bond Weightings for Tax Sensitive Investors

January 2020

Overview

The list of characteristics that make municipal bonds attractive for individual investors is a long one. Strong, stable credit quality characteristics, a persistently steeper yield curve relative to US Treasuries, and performance results that tend to inversely correlate to equities are just a handful of the factors that draw attention to the traditionally sleepy muni market. Yet, the most compelling attribute for the typical municipal bond investor is clearly the allure of tax-free interest income.



Over 85% of the almost $4 trillion municipal market is comprised of bonds that pay interest which is exempt from Federal income taxes. However, since the implementation of a cap on the deductibility of state and local taxes (SALT) in the 2017 Tax Cuts and Jobs Act (TCJA), the importance of state tax exemption on municipal bonds has become a far more pressing issue for investors – particularly in higher tax states. In response to the cap on SALT deductions, WS increased our in-state target weightings across the board for clients in our flagship Intermediate Tax Exempt (ITTE) strategy. We also introduced new in-state targets for clients that utilize our Intermediate Strategic Tax Exempt (ISTEFI) and Strategic Tax Exempt (STEFI) strategies.

The development and maintenance of these in-state targets requires continuous analysis of multiple market-based inputs as we seek to determine the optimal combination of in-state vs. out of state bonds, with the ultimate goal being the maximization of take-home income for the client and the preservation of prudent portfolio diversification. In this update, we will discuss these two key factors that WS considers when determining optimal in-state weightings in the portfolio construction process.

The after-tax yield on out-of-state (or "general market") bonds can often eclipse the tax-free yield of an in-state bond. State specific mandates have grown substantially in the municipal bond market since the passage of the TCJA. This has created periods in which there are supply and demand imbalances for high tax state bonds. As an over-the-counter (OTC) market that still exhibits various degrees of pricing inefficiency, it is not unusual to see a California or New York municipal bond trade at yields which suggest investors would be better served looking out of state to maximize their take-home yield. We generally refer to this dynamic in terms of a "hurdle rate", or the amount of additional yield an investor would need on an out of state bond relative to the yield on an in-state bond.

For example, consider an Ohio investor (subject to a 5.00% state income tax) that is deciding between an Ohio bond yielding 2.00% (state & Federal tax exempt) and a similarly structured Texas bond yielding 2.20% (state taxable, Federal tax exempt). In this scenario, the hurdle rate for the Ohio investor to be better off by purchasing the Texas bond would be 11 basis points. Since the Texas bond is yielding 20 basis points more than the Ohio bond, it represents the appropriate choice in order to maximize the investor's income. If this analysis was applied uniformly across a $2.5 million portfolio, the correct economic decision would produce more than $2,200 of additional annual income, net of state taxes.

This type of relative value analysis occurs daily across the municipal market, and changes in market conditions do occur quickly. Yet there remains a persistent tendency for after-tax yields to be mispriced, whether due to the ebb and flow of supply vs. demand variables or simply because of retail investors choosing to avoid state taxes regardless of the math on out-of-state bonds. WS's philosophy is that it is our responsibility to navigate our clients through these scenarios and present them with the most logical and efficient path towards maximizing cash flows, regardless of whether that path runs inside or outside of their state's borders.

Portfolio diversification remains a valuable risk management tool for investors that live in high tax states. Tail risks can present themselves in a number of ways for municipal bond investors, but unlike our *hurdle rate* example above, they remain elusively difficult to quantify in terms of valuation. Budgetary conflicts at the state level can have broad financial impacts at the local level. Natural disaster risk can impact entire regions and result in credit rating downgrades. One state's laws may provide more comprehensive bondholder protections than another state in times of financial stress. In our opinion, "over-stating" your municipal bond portfolio can introduce concentration risks that may not be apparent until the economic damage of under-diversification has already materialized.

For municipal bond investors, diversification can be expressed in a number of ways, such as maturity structure, sector exposures, issuer linkages, and geography. State profiles vary widely when viewed through those diversification characteristics. For example, California has over 1,100 individual obligors in the muni market with over $50 million in outstanding debt. Maryland, on the other hand, has less than 100 obligors that meet that criteria. The significantly broader availability of California credits – by type, sector, structure, geography and credit quality – is one reason that we can build out California portfolios with higher in-state weightings while also achieving prudent diversification.

State of Residence	% of Bloomberg Barclays Muni Index	Tax Out of State bonds?
California	17%	Yes
New York	15%	Yes
Texas	10%	No
Illinois	5%	Yes
Florida	4%	No
Pennsylvania	4%	Yes
Massachusetts	4%	Yes
New Jersey	4%	Yes
Washington	3%	No
Ohio	3%	Yes
All Other States	32%	As of 10/28/19

History can offer plenty of examples where the chase of state tax exemption resulted in questionable decision making within the municipal bond market. Consider the proliferation of Puerto Rico debt, which like all US territory debt is state tax exempt across all states. This state exemption feature fueled the allocation towards Puerto Rico securities across many state-specific mutual funds – in some cases up to 75% of the fund's total assets. The underwriting community recognized the demand for Puerto Rico bonds, which spurred even more debt issuance to the point of insolvency for the Commonwealth. While Puerto Rico is an extreme example, this type of insatiable demand for state tax exemption can result in questionable decision-making unless investors are willing to pivot away from convention when the analysis suggests it is prudent. It is our goal as your advisor to ensure that you are fully educated about your options and that you understand the reasoning behind the recommendations that we make for your municipal bond portfolio.

If you have questions about the in-state composition of your bond portfolio, or you would like more details about the analysis supporting our portfolio targets for your state, please contact your Relationship Manager or Client Services Team and we can provide you with additional perspective on our current views.

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Jason Diefenthaler is the Director of Tax Exempt Portfolio Management and is responsible for the oversight of all tax exempt strategies, as well as the Wasmer Schroeder High Yield Municipal Fund (WSHYX) at Wasmer Schroeder (WS).

Mr. Diefenthaler earned his B.S. in Finance from Florida State University. He is a member of the Firm's Executive, Portfolio Management, Credit, Investment, Risk, and Compliance Committees.

About the Firm: More than 30 years ago, Wasmer Schroeder was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income the right way. From its beginning, the firm has held steadfast in its spirit of collaboration—doing what's right for the advisors, investors, and institutions for whom we manage money. We do right by doing right by them—knowing their businesses, understanding their goals, and consistently finding solutions to meet their needs. As an active fixed income manager with a team of investment professionals across tax exempt and taxable strategies, we are dependable, collaborative, and insightful in our approach. Backed by research and emboldened by technology, our hands-on team is a true partner to the advisors, investors, and institutions who give us their trust.