Having Trouble with the Curve?

Duration Considerations for Municipal Bond Investors

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Overview

The perspective that duration in a bond portfolio is a risk to be avoided is an opinion we often look to discuss with our clients. Rising rate environments have always been a consideration for bond investors, and they will continue to be in the future. However, Wasmer Schroeder believes it is important for investors with long-term time horizons to understand the benefits conveyed by duration, particularly in today's lower interest rate environment, and how avoiding the longer areas of the yield curve can present significant opportunity costs over time.

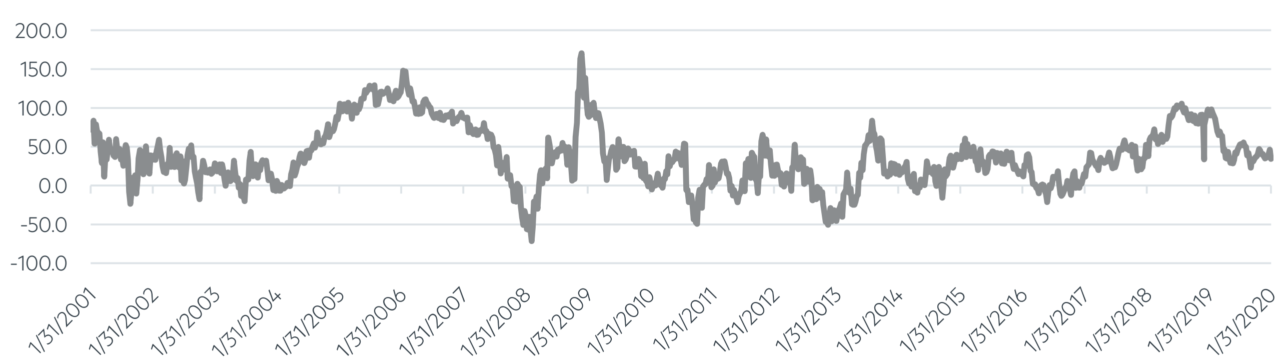
First things first: what is duration and why is it important? Simply put, and for the purposes of this commentary, duration reflects a portfolio's price sensitivity to changes in interest rates. For example, the impact of rising or falling rates will generally have a more significant price impact on longer duration securities than they will on shorter duration instruments. In a normally functioning market, longer duration bonds will also generally yield more than short duration bonds, in effect providing additional compensation to investors for taking on more duration. For a more detailed explanation of duration, please refer to our white paper, "Deconstructing Duration".

In this report, we will examine the nuances of adding duration in a municipal bond portfolio, what that has meant for investors during periods in which long US Treasury yields rose significantly, and discuss why municipal bonds investors might be missing out on an important cash flow and diversification tool when avoiding longer dated bonds.

The tax exempt municipal yield curve has been consistently steeper than the Treasury yield curve, and that consistency presents income opportunities for investors willing to add duration.

Much has been made about the slope of US Treasury curve recently, with the difference between short and long Treasury yields declining to very narrow (or "flat") levels. The municipal market, however, tends to march to the beat of a different drum. Over the last 20 years, covering more than 4,800 trading sessions, the slope of the municipal yield curve as measured by the yield difference between 30-year maturities and 2-year maturities has been steeper than the Treasury curve 85% of the time. Over that period, the average difference in slope between the two curves has been +37 basis points; today that difference is +34 basis points (1/31/20).

2y30y Muni Slope Less 2y30y Treasury Slope



1/31/2001 – 1/31/2020; Source: Bloomberg

Basically, this tells us that investors are typically better compensated for investing further out the municipal yield curve than they are in the Treasury curve. This is primarily a function of the premium coupon structure in the municipal market, and the call features on bonds with maturities beyond 10 years. Nonetheless, there are few areas within the capital markets that present this level of consistency, and in a world where certainty correlates to value, we think investors should view this dynamic as an opportunity.

Retail investors are the largest owners of municipal bonds, and their preferences are often biased towards shorter duration, higher quality securities. This creates value opportunities further out the curve for investors willing to buck the trend and extend duration, and it represents an opportunity cost for overly conservative investors.

Retail investors command the lion share of the municipal bond market, with individual investors owning approximately 70% of the market via direct ownership and indirect ownership through mutual funds, closed-end funds and ETFs. For much of the retail investor base, the idea of duration represents risk in their portfolio. We see these retail preferences materialize in valuations, with short duration, higher credit quality bonds often delivering less value in the form of lower yields and narrow municipal-to-Treasury yield ratios. Investors looking to take advantage of these retail buying patterns can often increase their overall cash flow profile with only a marginal increase in portfolio volatility.

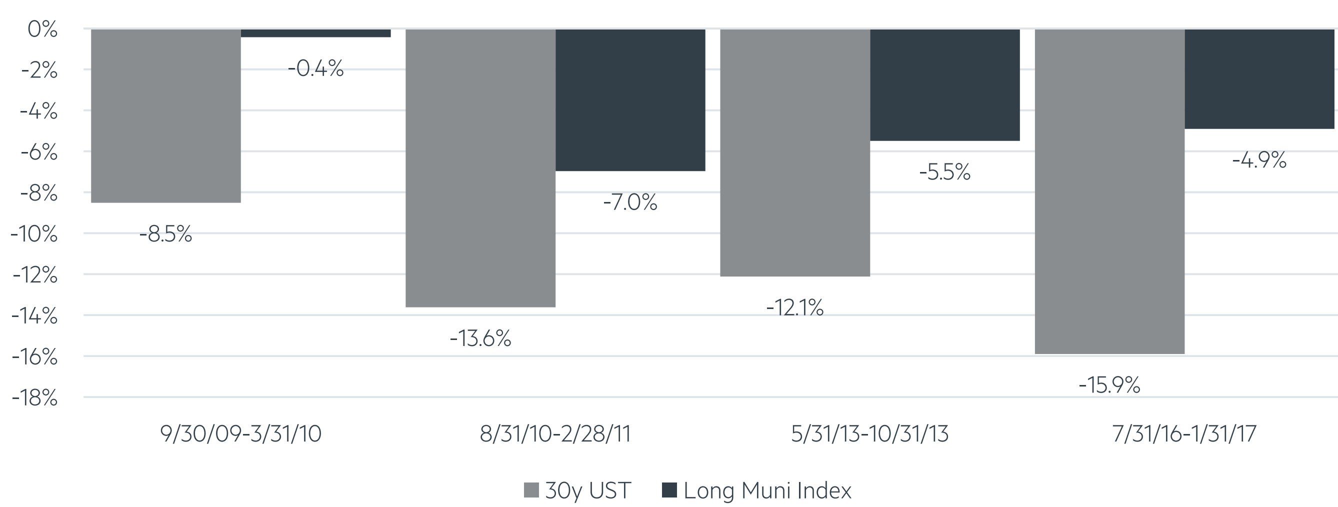
Those investors that pursue shorter durations are exposing their portfolios to higher levels of reinvestment risk and potentially lower cash flows if interest rates decline. Extending out the curve can lock in cash flows over longer periods of time and reduce cash flow volatility for investors that rely on their portfolio's income.

When investors think of risk in their fixed income portfolio, they typically are thinking about the risk of higher interest rates and the associated performance and volatility effects. However, we often remind our clients of the opposite risk: that interest rates fall, thereby introducing the potential for lower income as maturities get reinvested at lower rates. Locking in a diversified maturity structure with short, intermediate and longer-term bond structures can add much needed consistency to an investor's cash flow profile and help to mitigate reinvestment risk in environments of low absolute interest rates.

Historically, long tax exempt municipal bonds have delivered more absolute yield than 30-year US Treasuries with far less volatility and better down-side protection in rising rate environments.

Investors have been conditioned to fear interest rate risk, which in our view often creates psychological hurdles when developing long term asset allocation roadmaps. This conditioning can also introduce opportunity cost, as yields on long municipal bonds have been, on average, 50 basis points higher than 30-year US Treasury yields over the last 10 years. Considering that the modified-adjusted duration on long 5% coupon municipal bonds is around 8.2 years compared to 22.5 years for 30-year US Treasuries, the risk-adjusted return profile of long municipal bonds looks even better.

Total Return Comparisons: Long Treasuries vs. Long Municipals



Source: Bloomberg Barclays Indices

That said, there have of course been periods in which longer duration fixed income securities have delivered poor (and in some cases, terrible) performance results. However, owing to the duration differences noted above, municipal bonds have typically captured far less negative performance during those draw down periods, as expressed in the chart.

When one considers the consistently higher yields and consistently lower volatility delivered by municipal bonds relative to Treasuries, the added benefits of downside protection make the argument even more compelling for longer term investment horizons.

Wasmer Schroeder has developed municipal bond strategies with long-term track records that seek to take advantage of these duration dynamics within a separately managed account (SMA).

Wasmer Schroeder delivers a wide range of portfolio solutions to our clients spanning short, intermediate and long duration mandates. Within our long duration models, clients have the option of choosing between high quality ('AA' average credit quality), strategic ('A') and credit focused ('BBB') portfolio mandates. Our Strategic Tax Exempt model, which has an inception date of 2003, is designed with two key themes in mind: seizing on the municipal bond market's primary value tenets of duration and credit.

For investors searching for higher income with a longer investment horizon, we would recommend you reach out to your Relationship Manager or Client Service Manager to determine whether a longer duration mandate might be appropriate in your overall asset allocation.

JASON D. DIEFENTHALER
Director of Tax Exempt Portfolio Management

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.

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