Municipal Bond Q&A

Longfellow Investment Management Co.

Why does LIM use municipal bonds?

Longfellow uses municipal bonds in two ways. One approach follows typical implementation, while the other is less conventional. Most municipal bonds are federal tax-exempt; some may be state tax-exempt as well. Consequently, the typical investor in municipal bonds is a taxpayer looking to earn higher after-tax yields. We buy municipal bonds for our taxpaying clients: family trusts, banks, insurance companies, and corporations.

We also try to take advantage of favorable relative value opportunities that enable non-taxpaying clients – foundations, defined benefit plans, and non-for profit organizations – to benefit from municipal bonds. The relationship between municipal bond yields and taxable bond yields has been volatile, especially in the aftermath of the 2008 financial crisis. At times, municipal yields are high enough relative to taxable bond yields to make municipals a good buy even for tax-exempt clients.

What are the major points of evaluation for municipals?

While the basic process for assessing the relative value of a municipal is similar to that of a corporate bond or many other fixed income securities, the analysis is considerably more nuanced given the characteristics of the market and the attributes of the bonds themselves. Most municipals are fixed rate bonds with a stated maturity date and are not amortizing. Many municipals are callable, so evaluating option adjusted spreads are important. Additionally, municipals are subject to a special tax rule, known as the "market discount rule," which can have a fairly dramatic impact on price performance in a rising interest rate environment. State tax-exemption can also affect a bond's value. The most important point of evaluation, however, is credit quality.

What do you focus on when analyzing credit?

First and foremost, we look at the credit fundamentals. For most municipal bonds, that means analyzing the strength of the local economy and the issuer's financial performance. Other factors come into play as well, due to the wide variety of credit structures used in the municipal market. These structures – pledges of certain revenue streams and various indenture provisions such as additional bonds tests and debt service reserve funds – can enhance or detract from credit quality. It's important to look "behind the name," and understand precisely what security stands behind the bonds.

What are the major risks for municipals?

As with any fixed-interest investment, the primary risk to investors at this time is the potential for rising interest rates. With respect to credit quality, the vast majority of municipal bond issuers have come through the financial crisis and recession in reasonable condition. Nevertheless, a number of credit challenges remain. For instance, many governmental entities have found themselves with severely underfunded pension and OPEB plans. Some universities are under increasing pressure as costs continue to rise, competition grows, and the existing higher education operating model faces change. Non-profit hospitals must manage through a difficult competitive environment and continued changes to reimbursement regimes.

Disclosure:

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