

Muni Bonds—Monitoring the Trials and Tribulations

By: SEI Fixed Income Portfolio Management



SEI Fixed Income Portfolio Management (SFIPM) manages fixed-income strategies for SEI's Managed Account Program (MAP).

Historically, buying municipal bonds was a relatively safe and easy way to make money. Investors took comfort in the unlimited taxing powers of General Obligation issuers (local governments) or the ability of Revenue issuers (toll roads, water infrastructure, power plants, etc.) to raise their customers' prices. Today, a number of issuers are under tremendous financial pressure due to funding gaps driven by softer-than-expected tax revenues and increasing long-term liabilities such as pensions. Clearly, this is not your grandfather's municipal market.

The Old Way and Our Way

It is common for investors in the municipal bond market to make purchasing decisions based solely on external features such as credit rating, duration and yield to maturity. With more than 60,000 issuers across the full range of credit ratings, from investment-grade to speculative and even unrated, SFIPM believes that investors relying on such shallow measures do so at their own peril.

SFIPM goes beyond the basics when we conduct our analysis. We have a dedicated team of seasoned credit analysts and portfolio managers whose primary responsibilities are to monitor the entire municipal market and track the issuers and credits that we hold. Unlike equity markets, which are extremely fluid and can change direction or temperament in an instant, the municipal market generally moves more slowly. As a result, trends relating to deterioration in an issuer's viability can be easier to identify than in equity markets—but only if careful and detailed analysis is employed. If there are signs that a credit is deteriorating, the necessary steps for correction or loss mitigation can usually be put into place well ahead of the development of any significant issues.

While the core of SFIPM's credit process focuses on quantitative analysis, we also emphasize qualitative factors. Each credit in our portfolio has undergone an initial and thorough review, which

consists of in-depth financial analysis, rating-agency-report research and peer comparisons in the marketplace. The financial analysis includes not just the current financials of the issuer, but also revenue, expenditure and debt trends. By using the audit of the issuer as well as the Official Statement (which details the exact credit support for the bond and any other covenants), we gain a clearer picture of the issuers' financial health and obligations. Only when a credit is deemed to be strong enough is it approved for the portfolio. The team continuously monitors news flows, and keeps abreast of ratings changes and any other developments—positive or negative—that could impact an issuer, including local, regional, national and even global events. The team conducts annual in-depth credit reviews, and our industry-wide relationships give us broad insight into municipal market trends as well as sentiment on various credits in the marketplace.

Due to the economic recession of 2007-2009, there have been rising fiscal pressures in most states, and headline risk has started to plague the municipal market as a result. In this type of environment, our qualitative analysis plays an even more important role, and a credit that might otherwise be approved from a fundamental and quantitative standpoint may be rejected on qualitative grounds. For example, State of Illinois General Obligation bonds, although backed by the full unlimited taxing power of the state, entail considerable uncertainty regarding Illinois' upcoming 2012 budget, and market reaction to their latest proposed bond issue has been tepid at best.

A Market in Flux

Of course, Illinois is not the only issuer under duress. Events in many other states, including California, New Jersey, Ohio and Wisconsin, are adding to the air of uncertainty around state and local debt. It takes a team of dedicated professional analysts to vigilantly monitor events and make appropriate portfolio adjustments.

The municipal market is also beginning to adapt and adhere to the demand for more timely information, a fact reflected in recently proposed legislation that would improve reporting and transparency for state and local pension obligations. Moves like this will only enhance SFIPM's already rigorous credit process.

Market concerns and related headline risk are not going away any time soon. However, it is important to keep the headlines in perspective and separate reality from the more remote possibility of any doomsday scenario they portend. There is also no reason to panic if proper due diligence is pursued. Our expectation is that the vast majority of municipal obligors will make timely debt-service payments that are consistent with the sector's last sixty years of performance. However, the unprecedented stress

within the sector is also likely to produce defaults at a higher rate than we have seen in the past. We believe defaults are most likely to occur among smaller issuers, non-essential debt and high-yield and unrated securities. We plan to manage these risks by remaining highly diversified and by purchasing high-grade credit within sectors that we feel offer the most optimal balance of risk and reward.

Our Funds

In managing our portfolios, we seek consistent long-term results while attempting to mitigate short-term volatility, headline risk and unforeseen deterioration within credits. We monitor the risk-reward relationship very closely, and will sometimes turn down individual credits in which we believe headline or credit risk offsets any marginal expected pick up in yield. Due to the nature of the portfolio's strategy, we would prefer to give up a couple of basis points in yield in order to own a stronger credit. As the asset class enters an era that is fraught with uncertainty in the year ahead, we believe investors stand to benefit from hiring talented, professional muni managers.

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