Flexibility Is Invaluable During Difficult Periods

Riskier, less liquid securities can bring substantial benefits.

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When seeking to generate steady bond income during turbulent times, a little flexibility can go a long way. The freedom to invest in a wide variety of bonds, including some riskier, less liquid products, can be invaluable when conventional instruments, such as sovereigns and corporate bonds, offer either narrow spreads or too much credit risk.

Earlier this year, we exercised this freedom to begin purchasing taxable municipal bonds, which we'd never previously owned in our portfolio. Most municipal debt is tax-exempt, but there has been a surge of taxable bond issuance since a 2017 law change stopped issuers from refinancing bonds on a tax-exempt basis beyond 90 days from their call date. Taxable debt represented 16% of long-term municipal bond issuance in 2019, up from 9% the prior year.

We started investing in taxable munis in January because we were looking for securities offering attractive returns that would also enable us to reduce the amount of corporate credit risk in our portfolios. Then the coronavirus hit and corporate credit became very cheap, so we added significant corporate risk in the spring. But after corporate spreads tightened in early summer, we went back to munis because the spreads available were still comparatively wide.

Not every muni bond is a good fit for our portfolio. A lot of taxable munis are long-dated, with 20- or 30-year maturities. We tend to avoid these because they come with a lot of spread duration so are not a very efficient investment. In other words, they have too much price volatility for the spread (we tend to avoid long-dated corporates for similar reasons). We prefer high-quality securities, with A or AA ratings and maturities of 4–7 years. Recently, some of these bonds have been offering spreads of 100–175 basis points. When we include roll down—the gain in price as a bond gets closer to maturity and "rolls" down the yield curve—it adds up to an attractive return potential for bonds with very little credit risk.

> "...there has been a surge of taxable bond issuance since 2017...

We also invest in the so-called crossover space—the low BBB, high BB area

One of our biggest investments in taxable munis this year was in state of Illinois bonds...

spanning investment-grade and high yield bonds. There's less of these issuers in the muni sector, and they do carry some credit risk, but we have a strong municipal debt research team and are confident in our ability to analyze and underwrite these products.

One of our biggest investments in taxable munis this year was in state of Illinois bonds, which are rated BBB- by the agencies and have a negative ratings outlook. Illinois' finances are in a poor state, and there are concerns that the state's debt burden will deteriorate further. That said, we're more positive about Illinois' prospects than the market is, which is pricing Illinois like a low BB credit. Some governments with debt problems have few tools at their disposal to tackle them, while others have the ability to do something about them—for them, it's just a matter of finding the *will* to do something. We believe Illinois belongs to the latter category—it has the ability to return to financial stability provided the political will is there.

And there are signs that it does have the will. In November's elections, ballot forms in Illinois will ask people to vote on whether to abandon the state's flat rate of income tax in favor of a graduated tax that would require those with higher incomes to pay more. If it passes (which it is expected to), the measure is likely to significantly increase the state's tax revenues. Then there's the prospect of further fiscal stimulus from the federal government. Although Congress has so far failed to agree on a new coronavirus stimulus package, it is likely that one will eventually pass—either before or after the election. Depending on the outcome of the election, Illinois could be set to receive up to USD 5 billion in aid, which would go a long way to plugging the hole in the state's budget. Illinois will probably still get downgraded, but in our view not as much as the market is pricing, making their bonds attractive in a low-yield environment.

Less liquid securities such as taxable munis do, of course, come with additional risk—investors in these securities are effectively trading some credit and liquidity risk in exchange for yield. But we believe that spreads available should more than compensate for this risk and provide useful diversification for our portfolios.

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