MONTHLY REVIEW

October 2019

MAINLINE WEST

October 2019 - Ways to Invest in Municipal Bonds and What is Right for You.

The municipal market finished the month with minimal pricing volatility and appearing like all is calm. Underneath, the new issuance calendar is growing, led by refunding, new money, declining demand, and highest default activity since 2015. *We are thinking the next 30 to 60 days will bring some opportunities to muniland.*

Last month we cited the increased use of SMA's versus mutual funds by individual investors. We thought we would review the options available to invest in municipal bonds and help our readers understand why we think SMA's are becoming more popular. For full disclosure, MainLine West only offer SMA's and not mutual funds or ETFs. Some could say we are sharing this review to prove we are right and want more business, we say we offer SMA's because they are right. Either way, we recommend the "*Joe & Maggie Smith Tax-Free Fund".*

Muni Market Review

A quiet month in market moves, but issuance and technicals are changing. Looks like the next 30 to 60 days could get a little "choppy" in muniland. Highlights as follows:

- Muni yields on averaged increased slightly, with the curve steepening from -8 to 7 bps.
- Taxable yields moved roughly the same -2 to 7 bps.
- Supply continues to accelerate, as refunding and new money is up over 2018. Details as follows:
    - 2019 year-to-date versus 2018 is up 14% and is now equal to the five-year average level of issuance.
    - 2019 refunding is up 28% from 2018, with 40% of it being issued as taxables. More information on this in the below *"Market & Credit News Update".*
    - Analysts are forecasting this trend to continue until year-end and into 2020.
- Year-to-date muni distress and impairments are up at the highest level since 2015. A report from Municipal Market Analytics (MMA) shows the following:
    - 22% higher notices of financial problems year-to-date versus 2018.
    - 10 of these are in Texas, 6 in Pennsy, and 5 in Colorado and Arizona.

We are prepared to invest customer cash balances and start Fund VI between now and year-end, as we think there could be some opportunities as supply continues to increase, fund inflows continue to slow down, and politics/credit news could cause some alarm.

Market News and Credit Update

- *Much too premature, but an interesting take on Senator Warren's polices and their impact on municipal bonds by Barclays in a recent credit research report.* Highlights are as follows:
  - Revocation of SALT is a priority
  - New taxes: Her preference is for a wealth tax that would significantly hurt the value of munis. The wealth tax would be difficult to implement and has not been successful in other countries, and is very unlikely to be approved. More likely is that it will be replaced by higher tax rates on individuals earning $1 million or more. If this happened, munis would become more valuable.
- **Part of the Tax Reform Act of 201**7, included taking away the ability of municipalities to advance refund bonds. This means reissuance of new bonds at a lower borrowing rate before the old bonds' first call date and, subsequently, setting aside proceeds to retire them. It was felt by the "smart" people of DC that bankers were taking advantage of municipalities by getting them to refinance debt and not realizing the cost savings they thought they were, while paying the Bankers taxpayer money in fees and legal advice. ***Now, with rates so low, municipalities have been advanced refunding old tax-exempts bonds with taxable bonds***. Consequently, we have municipalities refunding and issuing in a market they are not familiar with at a higher borrowing rate then they would have as tax-exempt, ultimately, costing taxpayers more money. Do you think the "smart" minds in DC fixed the problem of municipalities being taken advantage of by Bankers? Alternatively, did they just make it worse?

Ways to invest in Municipal Bonds

There are many different ways for an individual to invest in municipal bonds. It can be as simple as investing in a mutual fund, or as complex as a tax-free municipal hedge fund. We will focus on the three most basic and conservative ways. They are:

- Open-ended Mutual Funds
- Municipal ETF's.
- Individually owned, separately managed account (SMA).

Open-Ended Mutual Funds:

Introduction:

This is probably the simplest and, yet, most tax-inefficient way to invest in munis. There are over 1,000 funds available to investors. Some are focused on investing in issuers from across the USA to avoid federal income tax. These are called ***national*** funds. Some are more focused on providing income exempt from state and federal income taxes. These are called ***specialty-state*** funds. Then you also have variations of different funds such as:

Limited-term (shorter maturing bonds – usually 1-7 years), which have lower price volatility.

High Yield fund, attempts to pay out more income by investing in lower credit quality bonds.

Intermediate Term Funds – bonds intermediate in maturing length (usually 7 to 15 years). These Funds attempt to minimize NAV price movements while paying out a good level of income.

There are lots of "***Family of Funds***". These mutual fund companies offer a variety of different municipal bond funds. As an investor, finding a "good family" can help provide a variety of options.

How They Work:

Mutual funds trade at a "price" that is called "Net Asset Value" (NAV). This is nothing more than the market price plus accrued interest less fees of the bonds divided by the par amount of the bonds. As an Investor, you purchase a share at this NAV. When you sell your shares, you sell at the current NAV. The NAV will change with the direction of interest rates. Since mutual funds hold many different bonds and are a corporation, they have no end date. ***This means you are not guaranteed you will get your entire principal back.*** If the NAV has gone up, you may get more, if the NAV has gone down, you may get less. Mutual funds also charge the investor a fee. This can range quite a bit depending on the specialty of the fund. **There are low cost providers that charge as low as 20 bps a year (.20% of the market value of your investment); others can be up to 75 bps.**

There are open amounts of shares sold, as activity by investors determines how many bonds the fund manager owns, which creates buying and selling activity. Investors can buy or sells shares at will. Most funds do have a sales charge that is presented by different types of shares that have different fees attached. An investor needs to review these different types of shares to see which minimize their sales charge given their investment objective.

Pros of Mutual Funds:

Mutual funds are easy and simple. This can be a pro and a con. Some of the benefits are as follows:

- ***You get expert municipal fund management, and a variety of different types of funds to choose from***, at a reasonable price.
- ***The Fund maintains full discretion of its investment activities by what it tells you it is going to do in its investment policies.*** This keeps an investor from making decisions that may not be in their best interest.
- ***Buy and sell activity can occur in the same day,*** but could also take up to 3 days.
- ***There is research available to help an investor find the right fund.*** Morningstar provides rankings, along with information on funds past performance.
- ***Extensive diversification.*** You own a percent of every bond in the fund. So for example, if it is a $500 million fund, and you invested $50,000, you own .01% of each bond. This limits your principal exposure to any bond position. In the case of bond defaults where there is no repayment, you only lose the percent of the fund you own. This means you would have lost $500 (.01% of $50,000). If you had owned the bond directly, you would have lost the par amount you held.

Cons of Mutual Funds:

Since you are a member of a pool of investors, the inefficiencies are large:

- ***You have no discretion over the investments made*** and have to find a fund that best fits your needs.
- ***You are at risk of the current fund's NAV, and investor buying and selling habits.*** You do not control whether the Fund sells or buys new bonds they can have an adverse effect on numerous items:
    - *Tax Inefficiency* – Nothing is worse than being in a mutual fund that earned a negative total return for the year and, yet, you have to pay taxes on gains. You are stuck paying taxes on bonds sold during the year to fund investor redemptions, regardless of whether the Fund is in the black for the year. Therefore, you have no control over your tax situation.
    - ***You own a portion of each bond's risk and payout.*** This means that, if the fund owns bonds that are not exempt from your state income tax, you will need to pay it. In addition, if you are not able to earn income that is exposed to Alternative Minimal Tax (AMT), you pay it. You are unable to customize a portfolio that is completely tax efficient for you.
    - ***NAV exposes you to losses or gains when you decide to redeem principal.*** Since you own a pool of bonds, you will never receive par back ($1 for $1).

When are Funds best for an investor?

- *You have a minimal amount to invest in municipal bonds.* Diversification is the key, and a mutual fund does a great job of providing this. I feel you need to own bonds in increments of $100,000 in par or more to get decent pricing treatment from the market. Any smaller, and you may not get a good price and have to pay up to buy, and be paid down to sell. This minimal transaction size, plus having proper diversification, says if you want to make an allocation to municipal bonds for less than $1 million, a mutual fund or ETF (next section) may be your best option.

- *I am not an advocate for market timing, but Funds can provide you an opportunity.* Since they are buying and selling bonds continuously, if rates have recently declined, a fund's dividend payout may be higher then what an investor can earn from buying a bond in the current market. Since the fund has book yields at higher levels, any new investor earns this. It also means you will be paying a higher NAV to receive it, but if the NAV stays unchanged, and you redeem your investment in the future, the higher current income payout you received will outperform the bonds you purchase directly. A fund can make sense to an investor with a limited time horizon in a market where rates have recently declined.

ETFS – Exchange Traded Funds:

Introduction:

ETF's are a new investment vehicle for municipal bonds, which eliminate a few disadvantages of the mutual funds, but also carry some different risks. Unlike mutual funds, when you buy an ETF, you have the ability to trade in and out of positions throughout the day. It is like buying a stock in a pool of municipal bonds. In most cases, they are tied to an index and are issued by a various providers resembling a family of funds.

How They Work:

Once you have decided you want exposure to municipal bonds, you decide on an ETF tied to an index that meets your objectives. Unlike a mutual fund, your investment can be made instantly with the current value of the ETF and, therefore, sold instantly. *Whether this ETF price is equal to the underlying value of the bonds or not is not a certainty; an increase of demand can cause the ETF to trade at a premium to its underlying value or a discount.* This can come into play when calculating the total return of the investment. There usually is a minimum to no sales charge, along with a management fee that is nominal.

Pros of ETF's:

- Instant liquidity - you have access to the funds the minute you sell them.
- Minimal sales/management fees.
- Unlike mutual funds, gains and losses are tied to your own investment activity. You realize either the gains or losses when you chose to transact. This is unlike mutual funds, when you share in the fund's activity.
- The ETF maintains full discretion of its investment activities via the investment policy.
- No active management decisions that could cause the investment to underperform.

Cons of ETF's

- You have no discretion over the investments made and have to find a fund that best fits your needs.
- Investment usually based on an index and not on an individual's objectives and risk/tax parameters.
- No active management that could add additional return to your investment.
- ETF's can trade at a premium or discount to its underlying assets of the fund. This means you could pay more for an investment in municipal bonds then what the underlying bonds are worth.
- Just like a mutual fund, the NAV exposes you to losses or gains when you decide to redeem principal. Since you own a pool of bonds, you will never receive par back ($1 for $1).

When ETF are is best for an investor?

- *Looking for instant exposure to municipal bonds and the price is right for the ETF.* This means the fund is trading at a discount and municipal bonds are under appreciated. Sort of like a stock which is underpriced.
- *The investor has no specific liquidity needs, or tax issues that need to be planned for.* The investment is quite generic and geared to the current value of municipal bonds.
- *The investor has a minimal amount to invest in municipal bonds.* Diversification is important, and an ETF does a great job of providing this. You need to own bonds increments of $100,000 in par or more to get decent pricing treatment from the market. Any smaller, and you may not get a good price and have to pay up to buy and be paid down to sell. This minimal transaction size, plus having proper diversification, suggests, if you want to make an allocation to municipal bonds for less than $1 million, a mutual fund or ETF may be your best option.

Owning Individual bonds – Separately Managed Account (SMA):

Introduction:

For high net worth investors with municipal assets of $1 million or greater SMAs makes more sense. You hire your own portfolio manager to buy and manage a portfolio customized to your needs. This allows your investment objectives to control what bonds are owned to maximize taxes, liquidity needs, and risk preferences. If you do not shop around, you could end up paying handsomely for this customization. Yet, there are managers out there that will provide you (the high net worth investor) with mutual fund pricing.

How they Work:

It is imperative for you, as the investor, to work with your investment manager on customizing your "Portfolio" needs given your investment objectives. This means understanding the following:

- Ability to realize investments that are exposed to alternative minimum taxes.
- Needs for liquidity at points in the future.
- Your comfort for credit/principal risk.
- Your need for income exempt from federal and state income tax.

You are paying the manager to diversify your risks and get you good value bonds that meet with your objective. You are not part of a pool of investments, and need the specialize attention. This can be important when picking the proper manager. I will not spend the time to tell you how to pick a manager, but unlike mutual funds, sometimes bigger is not better. *You do not want to be part of a "generic process" and, therefore, Just another client to a manager who manages several SMA's for multiple customers.* In that undesirably scenario, the manager buys the same bonds, and uses the same investment philosophy for each portfolio. Essentially, this is nothing more than a smaller mutual fund. You need bonds to be bought just for you and your investment objectives.

Pros of SMA's:

Most efficient. Buying bonds in greater than $100,000 increments, should get you better pricing power and allow you into deals off the underwriting desk. The most efficient way to buy a bond.

You maintain the ability to have some, none, or full discretion of what you invest in.

Diversified and constructed to your needs, tax wise, liquidity wise, and risk tolerance.

If you need to sell a bond, you can do so and receive proceeds within three days.

Tax efficient, state, AMT, and gain/loss realization centers around your needs and constraints.

Cons of SMA's:

Hard to pick the right firm and manager. It is nearly impossible to compare performance and know that the

Cons of SMA's:

- ***Hard to pick the right firm and manager.*** It is nearly impossible to compare performance and know that the person you are hiring is going to take care of you. Reputation, record of accomplishment, and where they have worked is very important.
- ***Time can be a factor.*** If you have a large allocation to municipal bonds, you should take the time to understand them a bit and provide input to your manager. This is the only way you can maximize the manager's abilities and your portfolio's income.
- ***There are some industry wide studies showing the underperformance of SMA's versus Mutual Funds.*** These studies are hard to reconcile and, in my mind, are not making a fair comparisons. What is the duration risk, credit quality risk, tax equivalent return calculation (using AMT, state income exempt & gains/losses impact), and liquidity requirements of the SMA investor versus that of the mutual funds? These are all critical, making it impossible to make apples to apples comparisons.

Conclusions:

The investment advice above is based on an investor looking to invest in tax-efficient fixed income securities and coming from us at MainLine West who provides only SMA's. ***We feel the safety and investment nature of municipal bonds provide for a buy and hold strategy that can be easily followed and understood by individual investors.*** What becomes important is the efficient execution of this strategy regarding taxes, liquidity needs, paying the best price possible for the bonds, principal protection and effective reinvestment of proceeds. An experienced, low cost investment manager who can construct a "Fund" for you. Mainline feels a "***Joe & Maggie Smith Tax-Free Fund"*** best achieves this objective.