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Hedge Funds Fill Gap in the U.S. Municipal Bond Market.

Besides shouldering risks on municipal paper that mutual funds won't take, hedge fund firms are pushing for better disclosure from issuers.

At the end of July, Wells Fargo & Co. analysts Natalie Cohen and Roy Eappen published a research note suggesting that hedge fund buyers are becoming bigger players in the $3.6 trillion U.S. municipal bond market. But as the New York–based researchers pointed out, there's no clear way to see what those firms are buying and why.

Tracking players in the market is tough because of a quirk in how the U.S. Federal Reserve Board counts what it calls household investors. "The Federal Reserve (sadly) includes both non-profit organizations and hedge funds in the Household category" of bondholders, Cohen and Eappen wrote.

Still, a scan of the headlines suggests that hedge funds are going all in on obvious U.S. distressed plays like Puerto Rico, any issuance coming out of Illinois and, more recently, the city of Hillview, Kentucky. (Hillview has filed for bankruptcy, but there's some question about whether it will be able to proceed.)

Hector Negroni, co-founder, co-CEO and CIO at New York–based Fundamental Credit Opportunities, an $800 million municipal finance fund, says the opportunity set for hedge funds is much larger than distressed debt. Although people think municipal bonds are just for mom-and-pop investors, he explains, before the financial crisis proprietary trading desks at the U.S. bulge-bracket banks and even foreign banks were big players.

"Hedge funds have stepped into that gap," says Negroni, who ran Goldman Sachs Group's municipal desk until he founded Fundamental Credit Opportunities within New York–headquartered, $2.2 billion alternative-asset manager Fundamental Advisors in 2012. "It's a liquidity option to be in municipal bonds."

For hedge funds, the municipal bond market is still a bit small for the block trades and other big moves they often make. However, munis have emerged as a viable opportunity for a modest bond sleeve within multistrategy funds or as part of a diversified credit exposure. In Negroni's experience, the types of bonds available within the municipal market vary widely, and they're responsive to ebbs and flows in the market.

Hedge funds create demand for municipal bonds that mutual funds and other retail investors won't touch, notes Vikram Rai, a New York–based analyst and head of municipal strategy at Citigroup. "Hedge funds have longer holding periods as well and are thus willing to take their chance on the steps of the bankruptcy court, whereas mutual funds do not want to see a disruption in their coupon income," Rai says, adding that hedge funds also see liquidity opportunities in municipal bonds owing to the market's overall strength.

That relative strength appears to be bringing foreign banks back too, as regulations permit.

According to Wells Fargo's Cohen and Eappen, international buyers have boosted their holdings by 144 percent since 2006: "These investors find municipal securities attractive when they are cheap relative to Treasuries, and the spread effectively overcomes the U.S. tax code." This move to munis is most common during so-called flight-to-quality events like the one that has roiled international markets in recent weeks. Munis even saw increased interest from international buyers on the heels of the U.S. credit rating downgrade in 2011.

The price is right when the current yield on an index of triple-A-rated municipal bonds beats that on equivalent Treasuries. For example, the yield on municipal bonds is hovering around 3.82 percent, according to the Bond Buyer Go 20–Bond Municipal Bond index. As of September 10 the highest yield on U.S. government bonds was 2.98 percent on 30-year paper, the Department of the Treasury reports.

The growth of nonretail interest in municipal bonds has come with pushback from critics who say that hedge funds are just in the market to speculate, but Negroni disagrees. "Hedge funds are professionalizing the municipal bond market," he says. "Hedge funds are the ones putting bond issuers' feet to the fire and asking for better disclosures. That's not a bad thing."

Alternative-investment firms may get some help from the Securities and Exchange Commission on this score. Municipal bond underwriters are on the agency's radar as part of its Municipalities Continuing Disclosure Cooperation Initiative. Under this effort the SEC is bringing administrative actions against brokerages selling bonds to investors at inflated prices. On August 13 Edward D. Jones & Co. settled with the regulator on exactly this issue. The St. Louis–based brokerage had to pay a fine of more than $20 million but did not admit or deny wrongdoing.

More surprising is that after the settlement, SEC commissioners issued a separate statement calling for new and clear rules for municipal bond dealers that would require them to disclose markups and markdowns on trades. Taken together, the two actions signal that the agency is keeping a close eye on the municipal bond market and potential pricing violations.

So, why weren't mutual funds and asset managers already pushing for all of this? The short answer is, mandates. Mutual funds and other retail investment vehicles in the municipal bond market are tasked with generating the most tax-exempt coupons. By contrast, hedge funds must provide the best risk-adjusted returns.

"Hedge funds have deep pockets and a higher appetite for risk," Citi's Rai says. "They typically step in at certain price points and provide demand for paper that mutual funds and other real money investors don't want to hold. This has happened in the case of Puerto Rico and other credits as well, like Detroit."

Alternative-investment firms with the right expertise are also providing specialty finance and municipal financing. Those packages can include bridge loans and municipal bond offerings around the same projects to create comprehensive solutions.

Rai believes the municipal bond market is strong enough to withstand "a handful" of defaults and subsequent distressed-debt interest without creating havoc. "I am quite optimistic about the overall credit landscape for munis," he says.

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