
How an $8 Billion Municipal Bond Fund Finds Opportunity in a 'Quirky' Market.

Fresh out of college in 1991, Ben Barber joined the management training program at Franklin Templeton in San Mateo, Calif., and rotated through different departments. In the end, it wasn't emerging markets or the up-and-coming technology sector that captured his interest, but municipal bonds.

"I love the aspect of you're financing infrastructure, generally for the common good, whether it's airports, roads, schools, or hospitals," says Barber, 50, who is co-head of municipal investments for Goldman Sachs Asset Management, or GSAM.

The $3.8 trillion muni market is the mechanism by which states, counties, municipalities, and other government entities fund operations and public-works projects. The nuances of every issuer, sector, project, and tax treatment make for a "quirky" market where every deal is different.

That's all the better for Barber, his co-managers Scott Diamond and Joe Wenzel, and their 34-person team to look for upside. Over the past decade, their $7.7 billion Goldman Sachs Dynamic Municipal Income fund has returned an average of 4.6% annually, better than 91% of its peers, and 1.5 percentage points, per year, better than its benchmark.

The fund (ticker: GSMIX) focuses on national tax-exempt bonds but has a broad mandate. "We want to be up and down the entire yield curve, the entire credit spectrum, and across different structures, and we want to be national," says Barber.

Relative to the rest of the bond market, munis look like a good deal. Default rates tend to be lower than their corporate counterparts, but after-tax equivalent yields are higher. The net supply of new issues is down slightly this year, while demand remains strong. Individual investors own two-thirds of all muni assets—that adds stability to the market but also leaves room for Barber's team to capitalize on inefficiencies.

After joining the muni team at Franklin Templeton, Barber followed his boss and mentor to GSAM and was named head of the muni team in 2002. Barber—who grew up feeding chickens and milking cows on a hobby farm in the Central Valley of California—is based in San Francisco. The rest of the team works in Salt Lake City and New York, making it easier to cover a market that comprises tens of thousands of issuers around the country.

State government general obligation bonds represent the largest slice of the fund at nearly 12% of assets, and not surprisingly. These perennial issuers account for more than a quarter of the fund's benchmark. While state bonds are a portfolio staple, their prices can fluctuate on news of state budgets, economic outlooks, and natural disasters. "Our job is to figure out if it's just noise," Barber says.

Meanwhile, investors often paint muni bonds with a broad brush—and Barber has been able to take advantage of that. Take Illinois, where a state pension crisis has led to persistent downgrades of state-issued muni bonds, which now sit just above junk status. Investors have turned a skeptical eye to other issuers throughout the state as a result, Barber says. Bonds issued for Chicago O'Hare International Airport, for example, trade at a discount to comparable bonds in other states, says Barber. The fund recently had about 12% of its assets in "all things Illinois," though only 5% of that exposure is tied directly to the state.

Historically, taxable muni bonds have been the minority, accounting for less than 10% of the market. A provision in the 2017 tax-cut law—which prohibits states from advanced refinancing of tax-exempt bonds—coupled with low interest rates have prompted many states to refinance with taxable bonds. In response, the fund has bought tax-exempt bonds with short calls—a short period before the issuer can cancel the bond—which are more likely to be refinanced.

State munis offer no shortage of opportunity, "but a much more interesting part of the market are the smaller issuers that may come to the bond market once or a handful of times at most," says Barber. Airports, sports stadiums, and water-treatment facilities fall into this category. So do hospitals, which recently accounted for nearly 8% of the fund's assets.

Tobacco-settlement bonds, meanwhile, make up 3% of the fund. These high-yield, long-term bonds were issued by states and are backed by annual payments from tobacco companies as part of the landmark 1998 legal settlement that resolved 46 states' lawsuit against the industry's major manufacturers. More than two decades later, these bonds are influenced by everything from cigarette sales (settlement payments are based on U.S. cigarette consumption) to broader interest and inflation rates. Recently, the fund has focused on zero-coupon tobacco bonds, which don't pay out interest but have more potential for price appreciation. The sector "requires very specific analysis to succeed," Barber says.

The fund can own up to 30% of its assets in junk-rated munis, though Barber and his team have trimmed their high-yield exposure to 16% of assets, down from a high of 23% in 2017. The reason: valuations. As more investors have ventured into high-yield debt, the difference, or spread, between yields on these lower-rated bonds and comparable investment-grade bonds has narrowed.

Fortunately, the team has the leeway to find deals in many places, including Puerto Rico. It has for years owned Cofina bonds issued by the sales-tax financing authority. Bonds maturing in 2058, for example, yield 4.3%. Recent restructuring of the bonds prompted the team to add to the position, which is the fund's third largest. Yes, Puerto Rico has had its issues, "but bonds tied to sales tax tend to be more stable than any other type of bonds," says Barber. •

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