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[Muni Watchers View Hedge Fund Presence, Liquidity Favorably.]

Investors in municipal bonds are mostly pleased that hedge funds have increased their bets recently in distressed state and local government debt.

Their presence adds liquidity at a time when traditional providers have pulled back, broadens the base of tax-exempt investors and helps drive inefficiencies out of the marketplace, muni pros say.

“Overall, it’s a good thing,” Chris Ryon, co-portfolio manager of muni funds at Thornburg Investment Management, said of the new hedge fund investors. “You’ve just increased the breadth of the market at a point in time when broker-dealers, for any number of reasons, are leaving the market more and more, because of Dodd-Frank, or internal reasons; having another buyer out there, at a price, is a good thing.”

Triet Nguyen, managing partner at Axios Advisors LLC, a municipal research and investment advisory firm, echoed the sentiment.

“In the long run, it should be a good thing for the market as an asset class to have a wider audience, and to become more of a global fixed income asset class,” he said. “It should provide more stability and less dependence on tax exemption as a main driver of demand.”

In addition, Nguyen added, hedge funds often bring a more activist style; they’re more involved in the bankruptcy process, which is a standard tool for corporate distressed investors. They may be a bit more forceful in steering proceedings or pushing to expand disclosure practices.

Still, some investors may fret that hedge funds tend to bring short-term volatility and questionable dependability as they prospect in distressed muni debt.

John Mousseau, a portfolio manager of private accounts at Cumberland Advisors, noted that investors might wonder, as some market watchers on Twitter did, whether hedge funds would become dependable participants in the market or expand the investor base in a meaningful way.

“When markets turn severely negative again, they’re afraid that the hedge funds, who are buying up stuff, will all try to leave at once,” Mousseau said.

Much of the recent increase in hedge fund activity stems from opportunities they saw in struggling municipalities, such as Puerto Rico, Jefferson County, Ala., Detroit and Harrisburg, Pa. For example, it was common to see Puerto Rico Sales Tax Financing Corp., or COFINA, bond yields trading 20 basis points lower in sessions throughout early and mid-October, which traders attributed to hedge fund buying.

Hedge fund activity has been most notable in Puerto Rico credits, beginning with the initial sell-off in the third quarter, said Jay Alpert, head of sales at Lebenthal & Co.

The high yields that resulted from the commonwealth's ongoing fiscal imbalance "enticed" hedge funds to buy, he said. If the Puerto Rico market remains volatile, Alpert said, hedge fund participation should increase from its current level.

Hedge fund investments in munis are difficult to estimate, industry watchers say, as it can be hard to parse tax-exempt credits from hedge funds' often much wider overall debt focus. Accordingly, estimates are said to number in the hundreds of billions of dollars.

The hedge fund team at Preqin, a London-based firm that provides data and intelligence for alternative assets, tracks 116 hedge funds based in North America that invest in municipal bonds. Collectively, they manage $166 billion in assets.

But even though the number includes funds with strategies that focus predominantly on investing in municipal and government bonds, some of them may involve other fixed-income credits, Preqin noted. And the figures do not include some of the much larger debt-focused hedge funds that invest in municipal bonds, such as Avenue Capital Group or Pine River Capital Management.

Hedge funds typically invest in municipal bonds at times when tax-exempt paper underperforms comparable Treasuries and thus appear attractive on a cost basis, or cheap. They join non-traditional tax-exempt investors such as pension funds and foundations as crossover buyers of high-grade muni credits.

Investors have seen broker-dealers, traditional suppliers of liquidity in the muni market, withdraw a notable amount of their support. The Street has been hamstrung recently by regulations, primarily those from the Dodd-Frank Wall Street Reform and Consumer Protection Act, which has set more stringent capital requirements and risk parameters that have discouraged banks from participating in the market as much as in the past.

The market felt the absence of broker-dealers during the sell-off from May through early September.

"It was clear there was not enough capital in the market by the absolute paucity of bids that were around in June and July, when the municipal bond funds were having their comeuppance and their redemptions," Mousseau said.

And the traditional retail buyer, wary of distressed credits such as Detroit, JeffCo and Puerto Rico, hasn't fill the current void broker-dealers have left, Nguyen said. Demand, particularly for the more challenging credits, isn't there.

Most hedge funds are new to the muni space, Nguyen said. They choose different approaches to the market from those traditional investors employ and diverse ways of structuring trades, buying and selling at different points in the market.

"It doesn't have to be the same entry points as with traditional buyers," Nguyen said. "They have the potential for introducing more volatility into the market. But on the other hand, particularly at this point in the cycle, they do bring new liquidity at a time when the broker-dealers have been pulling back. I do hope it becomes a permanent allocation for them."

In addition, hedge funds buy paper and combine it with different credit default swaps and other derivatives, Mousseau added. Subsequently, they construct investment vehicles that carry considerably less risk than they appear initially to hold.

MatlinPatterson, a credit-oriented fund group whose strategies include hedge funds that invest in municipal bonds, likes what it sees in the tax-exempt marketplace. It expanded its holdings in June when it launched a dedicated municipal strategy because it recognized the growing opportunity in the marketplace, said Craig Ruch, co-portfolio manager of MatlinPatterson's credit trading group.

"We have up to 20% of our fund at any one time invested in municipal opportunities," he said. "We buy what we feel are undervalued opportunities in the municipal bond market."

Ruch views the hedge fund muni participants as positive for valuations. Falling prices and cheapening valuations brought munis to the attention of hedge funds, which, he added, cannot short tax-exempt bonds.

He is skeptical of notions that hedge funds make muni bond prices appear more volatile to investors.

"Anytime you have new investors come in, it can increase volatility, especially if they turn around and dump the asset class," Ruch said.

"But I'd argue that in this case, it's probably a dampener of volatility," he added, "because in these distressed instances such as American Airlines, Puerto Rico, Detroit, where you have negative headlines, prices fall, and then selling leads to further price depreciation, a lot of that selling is retail, either redeeming from mutual funds or selling individual bonds. So, hedge funds coming in as a value buyer, if anything, they're dampening that volatility; they're arresting the fall in the price of those bonds by coming in and becoming buyers."

Hedge fund involvement often isn't as straightforward as quickly entering and exiting a position for profit, Ruch added. Speaking anecdotally about JeffCo, he said the hedge funds who owned the credits were involved for a significant amount of time, working to restructure the county's finances.

"It depends on the opportunity," Ruch said. "If it is a quick trade, it probably says good things about the market, because it probably says the market is recovering quicker than anyone would've guessed."

Some investors of Puerto Rico paper tell Mousseau that they don't like where the bonds are trading. But they add quickly that, because hedge funds entered the scene, their commonwealth credits are probably more liquid than anything else they own, Mousseau said, "in terms of being able to get a tight market out of something."

BY JAMES RAMAGE