Bond Case Briefs

Municipal Finance Law Since 1971

WSJ: How Hedge Funds are Trading Muniland.

What's a distressed-debt fund manager to do in this Goldilocks credit market? The answer for many is to play municipal bonds. But the vulture-fund strategies don't translate perfectly in the municipal market and the hedge funds hunting for bargains there are trying out new tactics.

Distressed-debt investors typically make money by shorting a financially strapped corporation's bonds and/or by purchasing the debt at discounts and swapping it for control of the company in bankruptcy court.

Shorting individual municipal bonds is difficult, and bondholders can't credibly threaten to seize assets –think fire trucks and schools – or take over management – think police departments and school boards.

In some cases they are playing municipal restructurings, like Jefferson County, Ala., but more often, hedge funds are snapping up battered bonds and flipping them to other investors when prices rise.

One tactic is to buy top-quality municipal bonds that trade down when traditional municipal bond investors get rattled, a previously rare event that has occurred three times since 2008. The idea is to generate modest returns while taking next-to-no credit risk.

Scoggin Capital, a $1.5 billion distressed-debt hedge fund, is one of the funds looking for the proverbial babies being thrown out with the bathwater. The fund bought some of Stanford University's 30-year bonds in September after Detroit's bankruptcy and sharply rising interest rates rattled markets, a person familiar with the matter said.

Stanford has a triple-A credit rating, better than the U.S. government, and when it issued the bond in May it yielded almost the same rate as Treasury bonds. By September, the bond had fallen 16% in price and its yield, which moves inversely to price, was 114% of the comparable 30-year Treasury's, according to data from the Municipal Securities and Rulemaking Board and Factset.

Scoggin, which swaps out the interest-rate risk on the trade, is betting that Stanford's bond yields will move back in line with Treasurys, pushing the price back up. The yield on Stanford's bond tightened to 107% of Treasurys in October and its price rose by 3%.

Other hedge funds are wagering on the opposite end of the credit spectrum, buying municipal debt with high default risk that they think is oversold.

Many funds hoped Puerto Rico would fall into this category but the Commonwealth's bonds only briefly dipped to prices that made them attractive, fund managers say. So far, the most popular distressed municipal play has been trading in the $100 billion market of so-called "tobacco bonds" backed by payments from cigarette manufacturers to help states care for patients with smoking related illnesses.

Cigarette sales – and consequently manufacturer payments – have declined sharply in recent years and bond prices have plummeted to cents on the dollar on default fears. Hedge funds have waded in, snapping up tobacco bonds on a bet that Americans will smoke more cigarettes than ratings firms and other investors think. Even if some bonds default, residual payments to holders will return more than current prices reflect, traders say.

One of the biggest players in the tobacco trade is Claren Road Asset Management, a $7.8 billion hedge fund owned by private-equity giant Carlyle Group. Claren Road, founded in 2004 by three former Citigroup traders, has been investing in distressed municipal bonds, including some issued by Jefferson County and American Airlines, for several years.

In March, the firm doubled-down its muni bet by poaching Andrew Goodwin, the top Wall Street trader of tobacco bonds from Citi, the largest market maker in distressed municipal bonds.

The 32-year old Mr. Goodwin cut his teeth during the financial crisis, in particular by trading the bonds backed by tobacco-illness settlements, investors who traded with him at the time say. Since his hire, Claren Road has significantly increased the concentration of tobacco bonds in its portfolio, said an investor in the fund.

Claren Road declined to comment on the hire or its investments.