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## **Muni Takeaways From the Morningstar Conference.**

Muni managers take sides in the Puerto Rico debate, address the bond landscape in Chicago, Detroit, and California, and discuss the advantages of CEFs in the muni space.

Last week, Morningstar hosted the 26th annual Morningstar Investment Conference. During the conference, attendees heard keynotes from some of the industry's highest-profile fund managers, including Franklin Templeton's Michael Hasenstab, PIMCO's Bill Gross, and AQR's Cliff Asness. While these speakers didn't disappoint, several of the most interesting and engaging conversations happened between keynotes in more intimate panel discussions. On June 20, I moderated a panel with three prominent municipal bond managers to discuss the current market, where they see opportunities, and why closed-end funds can be great vehicles for municipal bonds.

The panelists included John Miller, co-head of fixed income and head of munis at Nuveen Investment, Rob Amodeo, head of municipals at Western Asset Management, and Joe Deane, head of municipal bonds at PIMCO. These three managers run billions of dollars in municipal bond assets and have decades of experience in the asset class. Each runs both open-end and closed-end municipal bond funds.

### **Puerto Rico: The Great Divide**

The hottest topic of the day was Puerto Rico. Deane wasn't shy about his negative view of the territory. He noted that it is the third largest-municipal issuer, behind California and New York, but it's a "small island in the Caribbean" with a tiny population relative to other large issuers. He pointed to a "brain drain" on the island as a major stumbling block to any recovery. Because Puerto Ricans are citizens of the United States, many highly educated residents have left for places like Miami and New York City because of better job opportunities. PIMCO no longer holds any Puerto Rico bonds.

Though Amodeo admitted that Puerto Rico has its problems, he believes COFINA bonds (sales-tax-backed bonds) are worth holding. According to Amodeo, those bonds bring in \$1.3 billion in revenue to cover \$700 million in debt service. In the past, government corruption meant that a good portion of tax revenue went missing, but Amodeo pointed to new measures put in place that he believes will make it more difficult for politicians to divert the revenue.

Miller agreed with Deane that Puerto Rico had high hurdles to overcome and noted that after issuing nearly \$4 billion in bonds just a few months ago, the territory is once again facing liquidity issues. Miller, however, agreed with Amodeo that COFINA bonds were the best to own on the island, and, as of May 30, some of his portfolios held those bonds.

### **Chicago, Detroit, and California**

After a lively debate over Puerto Rico, the panelists were largely in agreement over the situations in Chicago, Detroit, and California. Miller, who lives and works in Chicago, believes that while it has big problems with its pension liabilities, the city can still right its course. In his opinion, the city has

two options to deal with the unfunded (and constitutionally guaranteed) pensions: raise taxes or cut pension benefits. He says Chicago mayor Rahm Emanuel is hesitant to take either path and has, so far, pushed back on the governor of Illinois for reforms at the state level. As for his investments, Miller likes general-obligation bonds backed by Assured Guaranty and bonds issued by the Chicago Transit Authority.

Turning to Detroit, Amodeo noted a “reranking of risk” regarding the city’s general-obligation and revenue bonds. Historically, general-obligation bonds have been considered safer than revenue bonds and have been priced to reflect that relative safety. The Detroit bankruptcy has challenged that assumption. The city’s revenue bonds (specifically, water and sewer bonds) are in better shape than its general-obligation bonds, the holders of which are likely to receive less than full value for those bonds. Amodeo does hold water and sewer revenue bonds from Detroit in his portfolios.

Finally, Deane pointed to California as a success story in the muni market. A few years ago the state was facing massive budget issues, but fiscal belt-tightening stopped the bleeding, leaving the state’s finances in much better shape. He believes those actions provide a blueprint for other cities and states in similar situations.

### Advantages of CEFs

All three panelists agreed that there are many advantages of investing in municipal bond closed-end funds. First and foremost, the funds’ closed structures are a positive. Because closed-end funds aren’t subject to investor flows, for example, Amodeo says that he can invest in illiquid securities that offer higher yields than comparable, more-liquid holdings. In the same vein, Miller said that when open-end funds are selling to meet investor outflows, he snaps up deeply discounted securities.

Deane spoke of the advantages of leverage, but also warned of the added volatility. A positive-sloping yield curve is advantageous to leveraged funds, which can borrow at lower short-term rates and invest in higher-yielding, longer-term securities. This comes with added risk of volatility, especially because the funds may hold long-duration securities. However, Deane believes that over time, leverage will work to an investor’s advantage if he or she is willing to weather the volatility. Finally, Amodeo noted that, from an investor’s perspective, the ability to purchase shares when they trade at a discount is a nice advantage. He also said that he snapped up shares of his own municipal CEFs last year when discounts gapped out.

### Final Thoughts

Amodeo is avoiding tobacco bonds because of concerns over high taxes on cigarettes as well as the competition from e-cigarettes. His firm is also cautious on toll roads because he believes more drivers are weighing the cost of drive time versus paying the toll.

Miller discussed some of the supply issues the industry has been facing and believes those issues will lead to much lower supply this year. Miller says municipalities are loath to take on more debt, slowing new issuance, and continued low interest rates will lead to fewer repricings this year.

Deane prefers revenue bonds to general-obligation bonds, arguing that unfunded pensions will cause big problems for states and cities to deal with over the medium term. He noted specifically that a change in accounting rules for pension liabilities may create major problems for city and state balance sheets. In the past, cities and states could pick a funding ratio used to calculate the unfunded liability (the higher the number, the lower the calculated obligation). But new accounting rules will force cities and states with unfunded pensions to use a predetermined number, which is

likely to be much lower than the ratio they are currently using. This change would cause the reported unfunded liability to go up, creating an even larger hole for cities and states to dig out of.

Finally, all three panelists agreed that tax reform regarding municipal securities is not a near-term concern, as the coming election and partisan climate in Washington make a consensus on tax reform extremely unlikely.

In all, the panelists were constructive on the muni market with reservations about certain sectors and locations.

By Cara Esser | 06-27-14 | 06:00 AM |

About the Author: Cara Esser is a senior fund analyst on the active funds manager research team for Morningstar and heads up the team's coverage of closed-end funds.

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