Bond Case Briefs

Municipal Finance Law Since 1971

Goldman Sachs Joins BlackRock in New Flexible Funds: Muni Credit.

An investor may argue that if a fund beats 96 percent of peers in a five-year run, it doesn't need fixing.

That's not the philosophy of the municipal-bond chiefs at Goldman Sachs Asset Management and BlackRock Inc. (BLK)

The Goldman Sachs arm, which oversees $37 billion in munis, changed its core tax-free mutual fund this month to give it flexibility to extend or shorten maturities and buy junk debt. The fund, ranked in the top 5 percent of its class in the past five years, follows BlackRock's Strategic Municipal Opportunities Fund (MAMTX), which altered its mandate a year ago and saw assets more than triple.

"This is a market that provides a lot more opportunity if you can be more flexible than just having a specific duration band that you have to stay in, or only investment grade," said Ben Barber, head of munis in New York at the Goldman Sachs unit. "There's more volatility — that leads to more opportunity."

The moves jettison labels in the $3.6 trillion municipal market that restrict purchases to certain maturities or credit ratings, and take a page from unconstrained bond funds in the taxable universe. While those were the best-selling part of fixed-income in 2014, they underperformed intermediate-term funds, traditionally the most popular bond investment, according to Morningstar Inc.

Swing State

The Goldman Sachs fund aims to buy bonds that others sell amid swings in fund flows resulting from shifts by individual investors, who own the majority of the market either directly or through mutual funds.

Local debt rallied 9.8 percent last year, the most since 2011, as individuals added $21 billion to muni funds, Lipper US Fund Flows data show. In 2013, they pulled a record $63 billion amid a 2.9 percent loss, the worst since 2008.

Barber said he envisions Goldman Sachs's Dynamic Municipal Income Fund as an investment for all market circumstances. He and co-manager Scott Diamond plan to adjust average maturity and credit quality based on market moves.

Under its former name, the Goldman Sachs Municipal Income Fund (GSMTX), it had a duration of within one year of its benchmark, according to July documents filed with the U.S. Securities and Exchange Commission. It invested in securities rated at least BBB, two levels above junk.

Duration Stretch

Now, average duration can range from two to eight years, and speculative-grade debt may represent 30 percent of the fund.

That's still a stricter mandate than some peers. The Eaton Vance Municipal Opportunities Fund (EMOAX), which began in 2011, isn't constrained by duration and can invest 50 percent in junk. It delivered better returns than 99 percent of peers in the past three years.

Under the new mandate, the Goldman Sachs fund could have added high-yield and long-maturity debt when those areas cheapened in 2013, Barber said. Individuals that year yanked $9.9 billion and $27.5 billion, respectively, from funds focused on those segments.

"Each year over the last five or six years is different in terms of where flows go into or come out of," Barber said. "It creates pressure on one portion or another of the curve."

BlackRock's $2.7 billion strategic muni fund could serve as a guide. The world's largest money manager altered it in January 2014 to allow for an average duration of zero to 10 years, said Peter Hayes, who oversees about $114 billion as head of munis.

Duration reflects bonds' price sensitivity to movements in interest rates. The longer the duration, the more the security's price will rise as interest rates fall.

Junk View

The fund, formerly known as the BlackRock Intermediate Municipal Fund, previously had at least 80 percent in investment grade, according to documents from November 2013 detailing the strategy change. The average maturity was from three to 10 years.

The fund can now invest as much as 50 percent in junk-rated bonds and 20 percent in securities other than tax-free munis, and may use derivatives, according to the prospectus.

The BlackRock strategic fund attracted about $1.9 billion of cash in 2014, after starting the year with $680 million, Bloomberg data show. That was the second-highest growth rate among muni mutual funds.

The fund outperformed 88 percent of peers in the past year, and 96 percent for the last five. The new mandate is tailored to outperform as interest rates rise, said Hayes, who began managing it last year. It's betting on declines in Treasury futures, according to data from the company as of Nov. 30.

Unconstrained Risk

"People don't expect a negative return in their muni portfolio, so the way we're managing this is to try to give them some positive return when rates rise," Hayes said in a telephone interview.

"The risks are clearly asymmetric: Rates are more likely to go up than go down, so this is the type of vehicle that should succeed in that environment," he said.

It's fitting that BlackRock and Goldman Sachs are among the first adopters of more flexible muni funds, since they were among early entrants into unconstrained taxable funds, said Jason Kephart, an alternative-strategy analyst at Morningstar in Chicago.

Those taxable funds also highlight the risks in betting on movements in interest rates, he said. The $25.4 billion Goldman Sachs Strategic Income Fund (GSZIX), which began in 2010, trailed 98 percent of peers for the past 12 months as it fell 2.6 percent while the broad bond market gained almost 7 percent, Bloomberg data show.

The BlackRock Strategic Income Opportunities Portfolio (BSIIX) trailed about 60 percent of peers, according to Bloomberg data that categorizes it among aggregate bond funds. That's the same group against which the Goldman Sachs Strategic Income fund is measured, according to Bloomberg classifications.

'Manager Risk'

"Beyond interest-rate risk and credit risk, you're taking on 100 percent manager risk because they have so much freedom," Kephart said in an interview. "You have to be right about interest rates for these funds to really work."

Analysts failed to predict the muni rally in 2014 as the consensus forecast was that interest rates would rise. Projections are mixed for this year: Forecasts range from gains of 5 percent to losses.

The Goldman Sachs fund's biggest stakes as of Sept. 30, before its transition, were bonds due in 2034 for Houston's airport system and convertible capital-appreciation debt backed by Puerto Rico sales taxes, Bloomberg data show. Tax-exempt general obligations from California and Illinois were also in the top 10.

The entry of Goldman Sachs shows the segment will keep growing, said Lyle Fitterer, who helps run the $1.6 billion Wells Fargo Advantage Strategic Municipal Bond Fund. (VMPAX)

"People are really worried about what's going to happen to their bond portfolios once interest rates start to rise," said Morningstar's Kephart. Increased flexibility "has been popular in taxable income, so I don't see why it wouldn't become as popular in tax frees."

Bloomberg Muni Credit

By Brian Chappatta Jan 20, 2015 9:36 AM PT

To contact the reporter on this story: Brian Chappatta in New York at bchappatta1@bloomberg.net

To contact the editors responsible for this story: Stephen Merelman at smerelman@bloomberg.net Mark Tannenbaum, William Selway