Bond Case Briefs

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Fund Manager Seeks City Projects With High-Yielding Bonds.

When Steve Czepiel talks about traffic on the Pennsylvania Turnpike or retirement communities in Florida, odds are he isn't referring to his daily commute or plans for his golden years. As co-manager of the $944 million Delaware National High-Yield Municipal Bond fund (ticker: CXHYX), Czepiel spends his days thinking about the economics of toll roads, charter schools, hospitals, and other projects financed by municipal bonds.

Over the past decade, his fund has averaged 5.6% returns annually, putting it in the top 2% of Morningstar's high-yield muni category, with most of its total return coming from income. Those results, however, aren't the product of interest-rate bets—the fund keeps its duration in line with its Lipper peer group—or wagers on places like Puerto Rico or Detroit. It is the product of careful securities selection. "Our focus is on building the portfolio bond by bond," Czepiel says.

Those bonds are typically rated just above or below investment grade or, in the case of 22% of its holdings, not rated at all. The managers' goal: Find a mismatch between the viability of a project and the rating of its bond to deliver high yield to investors without an inordinate amount of risk. "At times, it's like finding a needle in a haystack," says Czepiel of choosing the right securities; high-yield muni bonds represent just a sliver of the muni-bond market. "It's a regionalized and fragmented market that can be very quirky." Investors who understand the twists and turns are earning 5% to 7% in tax-exempt income.

Czepiel, 57, for his part, has made a career of navigating the nuances of the muni market. After graduating from high school, the Pittsburgh native worked road construction for three years to save up enough to study finance and economics at Duquesne University. When he graduated in 1982, he was the first person in his family to have gone to college. "I always tell people I'm most proud that I put myself through school," says Czepiel, who landed a job at Kidder Peabody after graduation and went on to trade muni bonds for more than two decades. In 2004, Patrick Coyne, president of Delaware Investments, and Joe Baxter, head of municipal bonds, recruited Czepiel to join the Philadelphia firm.

In a typical week, Czepiel, his two co-managers, and seven credit analysts look at a dozen deals, ultimately passing on most. They add about 30 new holdings to the portfolio a year, with most of these bonds coming in as new issues. "Once these bonds are issued, you may never see them again," Czepiel says, noting that most are owned by individuals and held to maturity. Because of this, the team spends two to three weeks peeling back the many layers of each project and deal structure. "In some cases, we'll suggest changes to the underwriter," he adds.

The fund's universe is composed of revenue-based bonds that get dinged by credit-rating agencies for any number of reasons. "An example would be a hospital in a lower-income area," says Baxter, who is a co-manager on the fund. "It might get a lower rating because of its location, but that doesn't mean it's going to default."

Delaware Nat. High-Yield Muni Bond

	Total Returns* 1-Year	5-Year	10-Year
CXHYX	9.7%	7.0%	5.6%
Barclays Muni Bd Idx	5.0	4.8	4.7

Top 10 Holdings	**Coupon**	**% of Portfolio****
Buckeye Tobacco Settlement Financing Authority	5.88%	2.6%
County of Jefferson, Ala., Sewer Revenue	6.50	2.1
Golden State Tobacco Securitization	5.75	1.8
Salt Verde Financial	5.00	1.6
Tobacco Settlement Financing Corp/N.J.	5.00	1.5
New York Liberty Development	5.25	1.3
Pennsylvania Turnpike Commission	5.25	1.1
New York Liberty Development	7.25	1.0
Foothill-Eastern Transportation Corridor Agency	6.00	1.0
California Statewide Communities Development Authority	5.50	1.0
Total		**15.0%**

*Returns are as of 4/29; three- and five-year returns are annualized.
**as of 3/31 Sources: Morningstar; company reports

Unlike general-obligation bonds, which are backed by the taxing authority of local and state governments, these high-yield bonds are typically earmarked for specific projects and depend on relatively narrow sources of revenue to repay that debt. Investors need to go into these deals with their eyes wide open, says Czepiel, but the default rate among below-investment-grade municipal bonds is significantly lower than that of junk-rated corporate bonds. Between 1970 and 2013, for example, the cumulative default rate for U.S. speculative-grade muni bonds was 6.5%, versus 33.1% for speculative global corporate bonds, according to Moody's Investors Service.

One of the more interesting sectors is health care—more than 22% of the fund. This group includes hospitals, nursing homes, assisted-living facilities, and continuing-care retirement communities. The fund recently owned debt tied to six such developments in Florida, including one in Boca Raton with a 6.75% coupon. "This facility was a start-up," says Czepiel, "but we were reassured by a number of factors, including a high level of investment from the developers."

Corporate issuers make up 19% of the fund. "You see corporate debt in the muni world if the bonds are being issued for the public good," Czepiel says. These bonds provide financing for everything from tobacco settlements and pollution control to opening new gates at airports.

Education is another area rich in tax-exempt income. The fund recently owned debt from dozens of charter schools in 16 states and the District of Columbia. One such holding is View Park Preparatory Accelerated Charter School in Los Angeles, which raised $15 million in BB-rated bonds last fall to build a new facility. "This is an established school that had gone through several charter renewals," says Czepiel. "They have good test scores, a strong school board, and a 94% student-retention rate."

The revenue, based on per-pupil payments from the state, is enough to cover its debt and expenses, says Czepiel, but the slim margins of charter schools tend to lead to lower credit ratings. In this case, the bonds yield nearly 6%.

Though turnover is low, “the ongoing surveillance of these projects is critical,” says Czepiel, who keeps tabs on everything from construction timelines and budgets to revenue and operation costs. “If we see that something isn’t tracking properly, we’ll sell.”

One trend that Czepiel is keeping a close eye on is the intersection of private investors and public issuers in what’s known as a public-private partnership, or P3. The fund has invested in a number of these deals, including one that is building and repairing bridges in Pennsylvania, putting a light rail line from downtown Denver to its airport, and helping water-starved California desalinate seawater. If everything goes according to schedule, the Carlsbad Desalination Project will begin producing 50 million gallons of fresh water daily by 2016. “It will provide 7% of San Diego County’s daily water usage,” says Czepiel. In the meantime, the municipal bonds that financed the lion’s share of the $1 billion project are pumping out 4.5% tax-free income.

BARRON’S

By SARAH MAX

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