Bond Case Briefs

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Japanese Investors May Add U.S. Munis to Portfolios.

Japanese investors are about to acquire a taste for U.S. municipal bonds, some U.S.-based money managers contend.

Executives with managers such as Neuberger Berman LLC, Eaton Vance (EV) Management (EV) and Invesco (IVZ) Ltd. say the size, safety and diversification benefits of the $4.4 trillion muni market are poised to win that segment of the fixed-income universe a chunk of the Japanese money that's been flowing into U.S. investment-grade corporates in recent years.

Gatekeepers are skeptical.

That prediction says more about the dreams of money managers than the needs of clients such as Japanese pension funds, said Taro Ogai, Tokyo-based managing director of investment consulting giant Towers Watson & Co.'s business in Japan. "I've never heard of a Japanese pension fund who is interested in U.S. muni bonds," he said.

Some pension clients not overly concerned about eventual rate increases could be attracted to munis because of their relative stability in "flight-to-quality" situations, but they should prove to be the exception rather than the rule, said Konosuke Kita, Tokyo-based director, consulting, with Russell Investments.

Meanwhile, a number of executives of corporate defined benefit plans in Japan said they are looking now to invest in multiasset or unconstrained bond strategies, not munis.

But one pension executive conceded that a lack of familiarity may be at issue, saying he's never considered U.S municipal bonds because "I don't have enough knowledge and information" about that market.

Managers with muni bond businesses such as Neuberger, Eaton Vance and Invesco, say they're working now to address that learning curve, confident that for Japanese investors, to know munis will be to love them.

A confluence of circumstances is setting the stage for potential demand from Japanese investors, said Cynthia Clemson, co-director of municipal investments with Boston-based Eaton Vance Management, in an Aug. 4 interview. Rock-bottom yields for domestic bonds in Japan have pushed investors into U.S. credits, which carry risks that U.S. munis can effectively diversify, she said.

With the 10-year Japanese government bond offering an annual yield of roughly 40 basis points, munis can provide an attractive pickup for Japanese investors even without the tax advantages that endear those bonds to U.S. retail and high-net-worth investors, managers said.

An investment consultant from Mercer's Tokyo office, who declined to be named, said over the past year munis have garnered more attention from institutional and retail investors alike in Japan as a fresh and sizable market following years of considerable allocations to other "spread" instruments, including high grade U.S. corporate and high yield bonds.

Japanese investors have focused on U.S. high-grade corporate bonds in their moves out of domestic bonds, which should magnify the diversification benefits offered by munis, said Ryo Ohira, managing director and head of Neuberger Berman's Tokyo business.

About 10 months ago, Neuberger began including munis in its discussions with clients about credit as a source of "good diversification" for high grade corporates, high yield bonds, bank loans and private debt, he said.

The yield for high grade, AA paper with duration of 5 to 6 years is roughly the same for U.S. corporates and munis at about 2.5%, but cash flows for the latter are steadier than the cyclical flows of the former, said Mr. Ohira. Meanwhile, different investor bases make munis more resilient in times of volatility – like the global financial crisis of 2008, where their drawdown was less than half that of investment-grade corporates, he said.

With "extremely low" default rates compared with corporates, munis allow investors with heavy exposure to high-grade U.S. corporates to diversify their credit risk, agreed Craig Brandon, Ms. Clemson's co-director of municipal investments at Eaton Vance.

However, defaults by Puerto Rico this month and by Detroit in 2013 may cloud that selling point.

In an e-mail, a credit officer at a large Japanese institutional investor, who declined to be identified, said default rates historically lower than those of U.S. corporate bonds make U.S. municipal bonds a market segment Japanese institutional investors can consider to diversify their credit risk, but Puerto Rico's recent default could prove a hurdle to doing so for now.

Managers concede the recent headline risk but say those high-profile defaults shouldn't undermine the long-term story of relative safety.

While munis remain unfamiliar ground for many Japanese pension funds, compared to multisector and unconstrained bond strategies, that could be set to change, predicted Mr. Ohira.

For example, Neuberger Berman hosted a seminar in Tokyo on munis last month attended by 160 executives from pension funds and intermediaries, and the arguments the firm's executives made regarding diversification struck a chord, he said.

Some pension fund clients already are dipping their toes in the muni waters, but it's still early days, said Mr. Ohira. He declined to name the firm's clients.

Robert White, Singapore-based president of Eaton Vance Management International (Asia) Pte. Ltd., said he's likewise seeing signs of growing interest in munis now in the number of appointments Tokyo-based gatekeepers for institutional and retail clients are making with his team.

As a high-grade, safe asset class, munis are getting the most attention now from banks with considerable holdings of Japanese government bonds and U.S. treasuries on their balance sheets, although intermediaries are also beginning to show interest, said Mr. Ohira. Pension funds could follow, especially as the prospect of rate hikes in the U.S. focuses attention on the resulting capital losses on sovereign bonds, he said.

In an e-mail, Alex Sato, Tokyo-based CEO of Invesco Japan, said his firm has been pitching munis for more than a year now, with retail investors responding more aggressively than institutional investors thus far.

More institutional clients are looking into it now as well, led by financial institutions, said Mr. Sato.

“It’s the regional banks showing interest right now,” with distributors anticipating retail investors and pension funds will follow, agreed Eaton Vance’s Mr. White. That, meanwhile, was the “growth trajectory” for bank loans, another asset segment embraced by a growing number of pension funds in Japan in recent years, he noted.

PENSIONS & INVESTMENTS

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