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[Muni Managers Get Busy After Fed Stands Pat.](#)

Asset managers are keeping active in the municipal market as they prepare their portfolios for a prolonged period of uncertainty over interest rates. Some are adding risk to boost their fourth-quarter yields following the Federal Reserve Board's decision on Sept. 17 to keep rates unchanged, while other are playing a more defensive game.

Sean Carney, head of municipal strategy at BlackRock Inc. said year-end posturing includes looking more favorably at duration in the near-term and focusing on the trajectory and destination of future rate hikes, as well as the potential impact on the municipal market.

"Where appropriate, we will look to add marginal duration and/or credit so to be able to harvest greater returns as seasonals turn more positive," he said.

For some managers, that means exploring the high-yield sector. Carney, however, favors the A-rated space at a time when many managers are clinging to higher quality.

"When you look at returns in the market over time, it becomes evident that one must add some credit to their portfolio" to boost returns, he said.

The A-rated portion of the market "has grown from less than 10% to 30% of the overall outstanding universe, and since 2009, has outperformed the broad market by 10% when measuring total return," Carney said.

Others, however, believe the risks outweigh the benefits in lower-rated sectors, and as a result are being highly defensive and choosing securities from tax and revenue-backed governments and entities that are less susceptible to credit issues.

"We are concerned about risks, such as underfunded pensions, Chapter 9 bankruptcy, and shake-outs in certain non-essential service enterprise sectors," said David Litvack, managing director and head of tax-exempt research at U.S. Trust, Bank of America Private Wealth Management.

Some of those concerns dominated the headlines in 2015 and speculative issuers gave investors and money managers reason for great concern – especially cash-strapped municipalities like Puerto Rico, Detroit, Illinois, and New Jersey.

As a result of the highly visible, yet isolated, credit situations, Litvack said he prefers tax-backed bonds of governments with stable economies, solid finances, and manageable debt and pension liabilities, as well as revenue bonds of utilities and transportation authorities.

"We are selective in higher risk sectors, such as higher education and health care," he said. U.S. Trust manages more than $380 billion in total client assets.

Others who are concerned about the future of interest rates are still seeking high-quality investments as the year comes to a close.

Mark Tenenhaus said his low expectations for Fed movement in 2015 means no major changes in the municipal strategy through year end at RSW Investments, where he is the director of municipal research.

“We have positioned our holdings well in advance as we did not and do not foresee the Fed taking any action during the course of the year,” he said. The Summit, N.J.-based asset management firm oversees $2 billion of separately-managed municipal bond client accounts.

“The Fed’s lack of action, to us, highlights the inherent weakness in both the domestic and global economies, supporting our emphasis on highest credit quality investments,” Tenenhaus said.

Janney Montgomery Scott Inc. is also maintaining its strategic approach when it comes to municipal investments, according to Alan Schankel, municipal bond strategist at the Philadelphia-based firm.

“We do not expect [the rate hike] to translate into significantly higher long term interest rates,” Schankel said. That’s led the firm to advise municipal investors to focus on the six- to 14-year range of the tax-free yield curve, with 5% range coupons, as well as higher quality paper in the double-A and higher spectrum.

Schankel said he recommends larger, non-profit healthcare issuers as the growth in the insured population increases demand, as well as the toll road and airport sectors because they benefit from the lower energy prices and improving economic conditions.

Stephen Winterstein, managing director of research and chief strategist at Wilmington Trust Investment Advisors, Inc., said that rather than making interest rate bets, his firm is focused on maintaining adequate exposure in the municipal portfolios to mid-grade and high-grade securities that are extremely liquid, frequent-to-market, and actively traded.

All the volatility and uncertainty over the Fed tightening put the market in a tailspin – with the latest expectations for a potential rate hike in March 2016.

“The market’s antics over the past several months only provide support for our agnostic view of interest rates,” Winterstein said.

Wilmington manages $4 billion in tax-exempt municipal assets consisting of separate accounts for ultra-high net worth individuals.

“The sensible way to manage the unknown is to prepare for adverse volatility in the event that we do experience a material increase in tax-exempt yields,” he said.

The firm continues to give clients full exposure to the term structure of their respective benchmark indices notwithstanding an interest rate forecast.

“We do not express a view in our portfolios of the future shift in, or shape of the curve,” Winterstein said.

Like his peers, he is steering clear of riskier sectors for now, but won’t rule them out entirely, as he said relative value is a key component to his overall strategy.

He is currently avoiding “precarious” sectors, such as resource recovery, tobacco settlement, life care, and nursing homes until spreads widen out. “We may be interested in certain names in the BBB category at some point, but with 10-year spreads at about 114 basis points, lower investment-grade yields still have quite a distance to cover to even get to the 152 basis point spread where they were in the beginning of 2014."

"While we do not wilt from risk, we travel into the BBB arena, not in search of a higher yield, but for opportunities where credits may be improving," Winterstein added. "As a total return manager, we are focused as much on price performance as yield, and so any potential upgrade or other progress in a credit may be the catalyst to spark our curiosity."

Overall, the managers said they are well prepared for the remainder of 2015 — and optimistic about the arrival of 2016, even with interest rate volatility.

"We do not fear the Fed in the sense that we believe the muni market holds up rather well in most scenarios," Carney of BlackRock said.

"Our conviction around a September lift-off was low, and in many cases below market expectations," he added. Following what he referred to as the Fed's "dovish" comments in September — and subsequent data indicating lower-than-projected growth outlooks – Carney expects a "lower for longer" interest rate environment to continue going forward.

"Even if the Fed does go, their accommodative stance coupled with low inflation expectations should keep the long-end of the curve well bid," Carney said.

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