
Peering Under the Coupon.

Pimco veteran Joe Deane focuses on the reality of what's backing up muni bonds. On the Municipal Bond fund, he teams up with David Hammer.

Early in Joe Deane's career—back in the mid-1970s, when New York City was on the verge of bankruptcy—he learned a valuable lesson about municipal finance.

"What you have on a piece of paper is not going to matter nearly as much as what's going on in the real world," says Deane, now the head of municipal-bond management at Pimco. In other words, the realities of keeping a city afloat can trump paying municipal-bond holders.

New York City averted bankruptcy in 1975, but Deane's fascination with municipal bonds was established. Forty years later, that era still resonates with Deane, who oversees $14 billion of municipal-bond assets at Pimco in separate accounts and 19 mutual funds.

Since the mid-1970s, numerous fiscal disasters have played out, most recently in Detroit and Puerto Rico. Deane, however, steered Pimco away from those troubled securities. "In 2012, when I was considering coming to Pimco, I saw they had a tiny exposure to Puerto Rico in their portfolios that shortly thereafter went to zero," says David Hammer, 37, Dean's right-hand man, whose duties include co-managing the $555 million Pimco Municipal Bond fund (ticker: PMLAX). "I looked at Joe's position versus many in the industry, and thought it was a really smart position."

Hammer, who began his career at Morgan Stanley, worked at Pimco in 2012 and 2013. He returned to Morgan Stanley briefly and then came back to Pimco in May, recruited by Deane and the allure of co-managing many of the firm's municipal funds.

Neither Hammer nor Deane has an office, instead sitting next to each other on a trading desk in a midtown Manhattan skyscraper, an arrangement that allows them to communicate directly throughout the day. "I'm a little more big picture, and Dave is a little bit more about getting every trade done," says Deane.

Deane, 68, adds that he will keep managing money for "as long as it is fascinating for me." Outside the office, he is especially keen on downhill skiing and golf. "You never conquer golf," he says. "You may conquer it for a day, a week, or a year, but it's always changing. The same thing is true of the markets."

Deane worked at the same firm from 1972 until 2011, although it went through multiple iterations. He began at E.F. Hutton, which became part of Smith Barney. That company was acquired by Citigroup, which swapped its asset-management business for Legg Mason's brokerage business in 2005. Legg Mason owns Western Asset Management, a bond shop that is one of Pimco's biggest competitors. Deane ran what is now the Western Asset Managed Municipals fund (SHMMX) from 1988 to 2011, during which the portfolio had an annual return of 6.5%, tops in its category, according to Morningstar.

Western is based just north of Los Angeles and Pimco, just south, but Deane, who grew up in Staten Island, has been steadfast about not relocating to Southern California.

Deane joined Pimco in July 2011, well into his 60s, in large part because he wanted to work with Bill Gross, Pimco's co-founder, whose investing prowess Deane admires. Gross abruptly left Pimco three years later and last week sued his former firm, claiming that "a cabal of Pimco managing directors plotted to drive" him out of the company. Deane says he's not concerned about the recent turmoil. "I viewed Pimco as the No. 1 bond firm in the world with Bill, and it's still the No. 1 bond firm today," he asserts.

Upon arriving four years ago, Deane immediately sold the fund's stake in Detroit general-obligation bonds, and, by early 2013, had sold all of its Puerto Rico holdings, too. "There were so many deals that were done where all of the revenue just went to pay the debt service of other bonds that had been previously issued," he recalls.

The fund now has a solid three-year annual return of 2.9%, besting 61% of its peers.

Clearly, for Deane, sound fixed-income investing comes down to zeroing in on "what's backing this bond up." That has been particularly true since the financial crisis, as the municipal-bond market has changed considerably. Many of the insurers that backed municipal bonds lost their AAA ratings or, in certain cases, went out of business. The upshot is that most municipal bonds coming to market today aren't backed by insurance. "It reminds me very much of the market I grew up in—in the '70s and '80s—where credit quality was every bit as important as duration," says Deane.

Many managers favor general-obligation bonds, since they're backed by taxes that can be raised, if necessary, to pay back bondholders. But they can be subject to political pressure, Deane says, and a big worry has been increasing unfunded pension obligations, with the states of New Jersey and Illinois having especially bad problems. After Deane scaled back on GO bonds earlier in the year, he and Hammer changed course over the summer and snapped up some Chicago GOs. The city's mayor, Rahm Emanuel, "has flat out stated that he is going to get a significant property-tax increase through," says Deane.

DEANE TYPICALLY PREFERS revenue bonds, which are backed by the money generated by a specific entity—a water authority, for example. In Detroit, "revenue-bond holders were generally protected and unimpaired through the bankruptcy," says Hammer.

Owing to a recent change in the flagship fund's prospectus, the managers can hold as much as 20% of the portfolio in high-yield munis, up from 10%. They like tobacco master settlement agreement bonds, which grew out of a 1998 settlement between the major tobacco companies and most state attorneys general. As cigarette consumption has declined, the revenue backing these bonds has dropped, as well, increasing the likelihood that they might default at some point. However, even in default they will continue to pay out the funds they have, until all interest and principal is paid—an attribute that's undervalued by investors.

It has been a tough year for municipal bonds, with increased issuance and concerns about when the Federal Reserve finally will raise interest rates. The fund is up a mere 1.1%, year to date. Still, Deane says he's not worried. The portfolio is a bit more defensive today, with the coupons of many holdings at about 5%, with a tilt to shorter-term securities to offset duration risk.

"There are a lot of guys out there buying" bonds with lower coupons, he observes, "but that's not where we want to go." The 5% coupons tend to be less affected by rate hikes and offer more income to reinvest at the higher rates, says Deane.

BARRON’S

By LAWRENCE C. STRAUSS

Updated Oct. 17, 2015 12:21 a.m. ET