Bond Case Briefs

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Thornburg 4Q 2015 Municipal Bond Commentary.

It finally happened. After waiting for what seemed like an eternity, the Federal Reserve moved the target on short-term interest rates up 25 basis points (0.25%) with indications of future rate increases to come. The market reaction? Unimpressed. All who predicted doom and gloom from an interest rate increase were quickly reminded that while the Fed has some power, the mechanics of supply and demand inevitably determine the value of interest rates.

While we are all left to ponder the future path of interest rates and Federal Reserve Board actions, it is probably more prudent to discuss where we have been and what that may mean for the future than to try and speculate about where interest rates may be at the end of 2016.

In the fourth quarter of 2015, we held to our philosophy of striving to ensure we are paid appropriately for any risk we add to the portfolios. While that may seem simple, it has become more and more difficult to implement as low interest rates have pushed investors out the risk spectrum in search of better returns and more attractive income.

Municipal investors have a few levers they can pull to try and increase returns. The most effective typically affect credit quality and duration. An investor seeking to generate more yield can always buy a bond with a longer maturity. And bonds of lower credit quality can also be purchased to drive up yield. In both instances the investor is taking on more risk in hope of higher returns.

At Thornburg, we constantly evaluate both of these options, but in the fourth quarter of 2015, as in the previous quarter, we found them less than optimal. Real rates remained low during the entire quarter, and the yield curve was flat. Investors looking for yield by stretching for longer maturities were actually picking up very little relative to the duration risk that comes with longer-dated bonds. Similarly, credit spreads remain at extremely tight levels. Investors who seek to boost returns by purchasing debt from lower-rated issuers were essentially buying the weakest credits at the most expensive levels they have ever seen. Not a great strategy.

The only logical solution for an investor to take when they aren't being paid to take risk is to take less of it. That is exactly what we have been doing in the Thornburg municipal funds for quite some time. All of the portfolios are being managed on the bearish (shorter) end of their respective duration ranges. We have also sought, actively, to increase the average credit quality (at least at the margins) of all of the portfolios. Finally, cash reserve positions are also being managed conservatively.

Following this management style has meant that we have had to sacrifice some performance. However, we are more than happy to give up some short-term gain for the long-term good of the portfolios. More importantly, the actual sacrifice was muted by the fact that, given the current market environment, even taking a lot of risk is not supremely additive to portfolio returns. The Limited Term Municipal, Intermediate Municipal, and Strategic Municipal Income Funds returned a reasonably attractive 1.89%, 2.41%, and 2.61%, respectively, (I shares) for the year ended 12/31/2015.

So, what's next, and what does it mean for investors? Whether you believe that the Federal Reserve is going to move interest rates up by 100 basis points in 2016 (its projection), or whether you believe it will prove a more muted 50 basis points (which is roughly what the market is guessing), we at Thornburg will continue to try to ensure we are paid adequately for any risk we take.

Whatever happens, it seems certain that volatility is on the horizon. Liquidity in the fixed income markets has been, to some extent, sapped by government regulations. We have already seen firms that manage portfolios in the taxable market sacrifice investment prudence in the hopes of higher returns, only to be crushed by their inability to liquidate high-risk securities. It is certainly possible that those same dynamics could bleed into the more conservative fixed income areas, including municipal bonds.

Should we see a dramatic rise in rates and a selloff in the municipal market, the Thornburg municipal portfolios are well positioned to take advantage of the weakness. Higher cash reserve positions allow us the dry powder to enter the market as a liquidity provider instead of as a liquidity taker—during troubled intervals. Rocky times are often the best times to take a little risk, because the market is paying generously to offload said risk. Given that the portfolios have been managed quite conservatively of late, they will each have the ability to not just enter the market, but also to materially extend duration and take advantage of wider credit spreads.

The Thornburg municipal portfolio management team believes that 2016 has the potential to be an interesting year for fixed income, and we look forward to taking advantage of attractive opportunities for the portfolios. No matter what happens, rest assured we will continue to do what we have always done: provide investors with tax-exempt laddered (except in the case of the opportunistically managed Strategic Municipal Income Fund) bond portfolios that aim to generate attractive levels of income, while attempting to preserve principal and minimize volatility. And, of course, we'll only assume the risk for which we believe we are adequately compensated.

Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, see our prices and performance page or call 877-215-1330. The Low Duration and Limited Term funds have a maximum sales charge of 1.50%. The Intermediate Municipal Fund and the Strategic Municipal Income Fund have a maximum sales charge of 2.00%.

Important Information Before investing, carefully consider the Fund's investment goals, risks, charges, and expenses. For a prospectus or summary prospectus containing this and other information, contact your financial advisor or visit our literature center. Read them carefully before investing.

Investments carry risks, including possible loss of principal. Portfolios investing in bonds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The value of bonds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. This effect is more pronounced for longer-term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Investments in lower rated and unrated bonds may be more sensitive to default, downgrades, and market volatility; these investments may also be less liquid than higher rated bonds. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Investments in the Fund are not FDIC insured, nor are they bank deposits or guaranteed by a bank or any other entity.

The views expressed by the portfolio managers reflect their professional opinions and are subject to change. Under no circumstances does the information contained within represent a recommendation to buy or sell any security.

Class I shares may not be available to all investors. Minimum investments for the I share class may be higher than those for other classes.

Income earned from municipal bonds is exempt from regular federal and in some cases, state and local income tax. Income may be subject to the alternative minimum tax (AMT).

There is no guarantee that the Fund will meet its investment objectives.

Please see our glossary for a definition of terms.

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