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Taper Tantrum Memory Doesn't Fade for MainStay Muni Fund Manager.

MainStay Investments is increasing the percentage of cash held in its municipal bond mutual funds as a hedge against the risk of investor redemptions if the outperforming tax-exempt market turns.

It's $2.7 billion high yield muni fund has raised its cash level to as much as twice its normal range for liquidity, said David Dowden, a managing director who helps oversee about $19 billion of local debt at Princeton, New Jersey-based MacKay Municipal Managers, the fund's sub-adviser. The fund had about 9.6 percent of its portfolio in cash-equivalents as of April 30, the most in two years.

"When everyone suddenly gets all on the same side of the trade, that makes for a very dangerous situation," Dowden said during an interview last week. "That's what we saw in June of '13."

U.S. state and local-governments have taken in cash for 41 straight weeks, according to Lipper U.S. Fund Flows data, as anxiety that the Federal Reserve would raise rates receded and investors sought out the higher tax-adjusted yields and lower volatility than they can find elsewhere. During that period, munis have posted a total return of 5.8 percent, compared with a broader bond market gain of 4.2 percent, according to Bank of America Merrill Lynch index data.

The $45 billion inflow since October has helped replace the cash lost during the "Taper Tantrum" of June 2013. Investors pulled $65 billion from muni funds between June 2013 and January 2014 after then-Fed Chair Ben Bernanke jarred bond investors with plans to scale back asset purchases. The broad sell-off in the bond market highlighted a liquidity squeeze in the muni market, which was hit harder than Treasuries. Between June and the end of August 2013, yields on 30-year AAA rated municipal bonds rose almost 1.5 percentage point.

The level of liquidity risk is lower than in 2013. Banks are more willing to step in and buy and investors are less prone to yank money because munis are producing income, said Dowden. The U.K. vote to leave the European Union has lowered the likelihood that the Fed will raise interest rates before the U.S. elections in November. Muni prices rose following "Brexit" as investors clamored to safety.

As the yield curve flattened, Mainstay has focused its buying on bonds maturing from 12 to 25 years rather than long-term debt maturing in 25 to 30 years, which are more sensitive to changes in yields. Mainstay's High Yield Municipal Bond Fund has returned 7 percent this year, beating 77 percent of its peers, according to data compiled by Bloomberg.

"The reality is that incremental yield can be burned away very quickly in a price move," Dowden said.

The market pulled back last week as investors balked at yields that reached record lows and data on manufacturing and retail sales bolstered optimism in the economy. Yields on top-rated 30-year municipal bonds rose to 2.17 percent from 2.09 percent, the biggest weekly increase since February, according to data compiled by Bloomberg.

Some high yield managers are boosting their cash position for a different reason: they can't find securities that offer value in a market that has run-up more than 12 percent in the last year.

"There's so much cash in and everyone's buying because they have to buy," said Matt Dalton, chief executive officer of Rye Brook, New York-based Belle Haven Investments, which oversees $5 billion of municipal bonds. Belle Haven is the sub-adviser for Transamerica's High Yield Muni Fund, which had had 13 percent of its assets in cash as of April 30.

"We're content with having more cash than we'd like to because of the dearth of opportunities," Dalton said.

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by Martin Z Braun

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