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Dreyfus Bet on Tobacco Bonds Pays Off With Top Muni Fund Returns.

- **Fund avoided Puerto Rico, FirstEnergy Solutions bonds**
- **Nuveen, Goldman Sachs high yield funds rounded out top three**

Dreyfus Corp.'s $170 million high-yield municipal-bond fund is beating bigger and better-known competitors by riding a rebound in tobacco bonds while avoiding pitfalls such as Puerto Rico debt.

The fund returned 10.2 percent through the first three quarters of the year. High-yield tax-exempt funds managed by Nuveen Asset Management and Goldman Sachs Asset Management ranked second and third, respectively.

Dreyfus's fund held almost 11 percent of its portfolio in tobacco bonds at the end of July and benefited from a 18.5 percent run-up in the debt in the year's first half. Tobacco bonds rebounded after money managers dumped the securities — among the most liquid high-yield municipal bonds — to meet redemptions during the bond-market rout that erupted after President Donald Trump's victory.

Refinancings by New York City and California and moderate smoking declines have also boosted performance.

"After it became clear Trump wasn't going to his enact his agenda, there was a strong tobacco rally and we were well positioned for that," said Dan Barton who co-manages the Dreyfus fund with Jeffrey Burger in Boston. "A lot of funds are looking for yield-ier alternatives to Puerto Rico."

High-yield munis returned 7.7 percent through the third quarter, three percentage points more than investment grade municipal bonds, according to Bloomberg Barclays Indexes.
The sector has benefited from an imbalance in supply and demand.

Two-thirds of the $10.5 billion investors added to the municipal market this year flowed into high-yield funds, according to Lipper U.S. Fund Flows data. Meanwhile, just $2.5 billion unrated or speculative grade municipal bonds has been issued through the third quarter, a 50 percent decline from the same period last year, according to data compiled by Bloomberg.

"You just buy anything under the sun because you have to utilize your cash," said Mikhail Foux, head of municipal strategy in New York at Barclays Plc.

In a year full of retail bankruptcies, the deal was postponed so the underwriter, Goldman Sachs Group Inc., could drum up more buyers. Since American Dream's $1.1 billion bonds were sold in June, prices on the longest-maturity securities have risen to 116 cents on the dollar from 103 cents.

It's "one of the last really exciting and last really cheap deals priced in the high yield area with size and liquidity in the last couple of months," said John Miller, Nuveen's co-head of fixed income.

Nuveen's $15.6 billion high yield fund owned $370 million American Dream bonds as of August 31. The fund returned 9.3 percent through the third quarter. Miller invested about 7.5 percent of the fund's assets in tobacco debt.

Nuveen also reaped a windfall from its bet on its hometown school district. Chicago school bonds rallied after Illinois Governor Bruce Rauner signed a measure that boosts funding to the district by an additional $1.1 billion over the next five years. Chicago Board of Education bonds with a 7 percent coupon maturing in 2044 have returned 27 percent this year, Miller said. Nuveen owns $263 million of the securities.

The performance of the American Dream bonds took Dreyfus, which doesn't own any, by surprise. Not so, tobacco debt, whose cash flows can be modeled assuming varying degrees of cigarette consumption declines, Barton said.

Under a 1998 national settlement, the major tobacco companies agreed to make annual payments to the states in perpetuity to resolve their liability for health-care costs attributed to smoking. Some states and cities borrowed against the payments, which are based on cigarette shipments.

Altria Group Inc., estimated that domestic cigarette industry shipment volume decreased by about 3.5 percent in the first half of 2017. Moody's Investors Service projects 80 percent of the securities won't make scheduled payments based on historical declines of 3 percent to 4 percent in U.S. smoking.

A U.S. Food and Drug Administration proposal in July to cut the amount of nicotine in cigarettes to non-addictive levels cut tobacco bond returns 0.4 percentage point in the third-quarter, a potential buying opportunity, Barton said. Tobacco companies are expected to vigorously oppose the proposal.

"Near-term, we don't see a ban of nicotine in cigarettes," Barton said.

There's also value in certain zero-coupon tobacco bonds trading at discounts of more than 50 percent to accreted value that may be refinanced, said Ben Barber, who manages Goldman Sachs Asset Management's $5.2 billion high-yield muni fund. The fund returned 8.2 percent through the third quarter and had 8.8 percent of assets in tobacco debt at the end of August.

Nuveen stumbled on its investment in FirstEnergy Solutions, the power-generation unit of FirstEnergy Corp. The Akron-based owner of coal-fired and nuclear plants aims to exit the generation business and restructure FES's debt. Nuveen owns about $300 million of secured and unsecured FirstEnergy Solutions bonds with a market value of $193 million.

Dreyfus doesn't hold FirstEnergy debt or bonds issued by Puerto Rico or the U.S. Virgin Islands.

Performance is about "as much what you don't own as what you do," said Barton.

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