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How to Safely Beef Up Bond Returns.

It’s easy to see why yield-seeking investors might be demoralized: The rate on 10-year Treasuries, which stood above 3% last autumn, had fallen recently to a mere 1.8%. And things could very well get worse, according to financial advisor Ira Mark.

“It wouldn’t surprise me if we retest the low of the [10-year] U.S. Treasury that was hit in July 2016—1.35%,” says Mark, Barron’s 30th-ranked advisor in New York. But yields of up to 5% are available for those willing to take on a bit more risk, he adds.

A 27-year veteran investor, Mark is unusual among financial advisors in emphasizing fixed income over stocks. He typically recommends that clients use investment-grade bonds or other debt instruments for 75% of their portfolio. For the equity portion, he likes high-quality stocks with a history of increasing their dividends. “It’s a slow and steady way to build a portfolio and offer consistent” returns, he says.

Among Mark’s favorite investments are high-credit-quality municipal kicker bonds. These bonds typically offer strong yield to compensate investors for uncertainty about their call date. They get their name because the yield received by the investor increases, or “kicks,” if the issuer declines to buy them back when their call dates arrive.

Mark recommends essential-service revenue bonds—those issued to pay for tunnels, bridges, airports, water systems, and the like. Consumers can’t really opt out of using such infrastructure, and that’s a pretty good hedge against the possibility of the bonds defaulting. “I have always told clients that you don’t negotiate at the Midtown Tunnel; you pay the toll to go in and out of Manhattan” from New York’s borough of Queens, Mark says. “Those tolls pay the debt services on the bonds, and, if need be, they can raise those tolls.”

Kicker munis have an unusual price structure that frightens off some individual investors: They’re sold for more than their par value, meaning that the issuer pays less than the bonds’ face value when repurchasing them. But Mark finds that their returns still can beat those of regular corporates.

Among his current holding is a Port Authority of New York and New Jersey bond that matures in 2040. Rated AA- (Standard & Poor’s fourth-highest rating), it will yield 1.75% if held to call in May 2025, and 3.77% if held to maturity. Both numbers factor in the premium-pricing issue. The income is free of local, state, and federal taxes for residents of New York or New Jersey. A North Texas Thruway Authority muni bond, meanwhile, yields 2.20% if called at the start of 2027 and 3.89% if held to maturity.

Mark also likes preferred stock, which generally pays a fixed dividend. Preferreds are higher in the credit structure than common shares; in a bankruptcy, their owners would come just behind bondholders in the pecking order for repayment. Recent issues, including one from Bank of America, sport yields in the 5% range.

Such high yields compensate investors for taking on interest-rate risk. If rates rise, the value of fixed-income investments, including preferred shares, falls. But global investors have flocked to Treasuries as an alternative to their own countries' even lower-yielding government bonds, and Mark thinks that dynamic could help suppress U.S. rates for several more years.

Aside from their attractive yields, preferreds offer a tax advantage. Most pay "qualified" dividends, which are taxed at a top federal rate of 23.8%—versus the top rate of 37% on income from corporate bonds.

What's more, current supply-and-demand dynamics bode well for preferreds' potential price appreciation. Financial institutions, the biggest issuers, have scaled back issuance over the past several years.

How much of each investment should investors own? Mark recommends using munis for 60% of a fixed-income portfolio, preferreds for 30%, and short-term Treasuries for 10%.

But if kicker bonds and preferreds are so attractive, why own a slug of Treasuries, too? First, Mark says, 30-, 60-, and 90-day Treasuries out-yield most other cash alternatives. Second, they're exempt from state income tax, adding after-tax return for residents of states with income taxes. And third, the easily liquidated paper is "dry powder to take advantage of future opportunities," he observes. For many investors, that's a winning combination.

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By Steve Garmhausen

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