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Muni Market Not Immune From Illiquidity Fears, Says Bond Star.

The municipal bond market has proven a haven for some investors seeking solace from the more difficult areas of the wider fixed income universe but it is not immune from all its problems.

Citywire A-rated manager David Hammer, who runs several municipal bond funds at Pimco, said liquidity in the municipal bond market has declined in recent years. He said this is exacerbated by the increased use of daily liquidity funds.

'So there's a growing mismatch between the available liquidity and investors that might demand that liquidity. As a result, during outflow cycles in the muni market, what we've experienced are overshoots where valuations' prices really overshoot fundamentals.'

Further pressure has come in the form of outflow cycles, which are largely driven by mass market concerns. 'Back in 2010 and '11 following Meredith Whitney's proclamation on 60 Minutes that there would be billions of municipal defaults caused an outflow cycle.

'In 2013, after the fed-induced taper tantrum, that coincided in the muni market with a down grade of Puerto Rico and also Detroit filing for bankruptcy, so we saw a prolonged outflow cycle,' he said.

His colleague Rachel Betton highlighted how similar pressure was exerted on munis during the 2016 Presidential election in the US. The combined fears of lower taxes and higher interest rates forced many investors to axe muni exposure, she said.

'In these sell-offs, most muni funds have to raise cash to meet redemptions. We don't see outflow cycles going away. In fact, we think they are probably becoming more common and potentially more severe,' she added.

One way municipal bond managers could capitalise on market opportunity, the pair said, is through the use of interval funds. These strategies are less liquid but are aimed primarily at longer-term investors who are aware of how they function during market downturns.

'That puts us as portfolio managers in a better position to take advantage of these outflow cycles, make opportunistic purchases, and create long-term value for investors that expect to be allocated to the muni market for a prolonged period of time,' Hammer added.

On a three-year basis, Hammer has returned 9.8% in US dollar terms across a total of nine funds. The average manager in the Bonds – US Dollar Municipal sector returned 8.5% over the same timeframe.

By Chris Sloley

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