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Going Wide With Muni Ladders: The Long And Short Of It.

People invest in municipal bond ladders for several reasons, the obvious being they can benefit investors seeking tax-efficient income. Also, by buying bonds with varied maturity dates, investors can increase liquidity and avoid getting locked into a single interest rate, which can ease the impact of rising rates. And, because bond ladders hold several issues, they offer investors some diversification through type of issuer and credit quality.

But what happens when the market shifts, like what's happening right now? Fragmentation makes it harder to find what you're looking for. Almost 70% of the municipal bond market (as represented by the Bloomberg Barclays Municipal Bond Index) used to be rated AAA, whereas at the end of last year, it was less than 16%, based on our team's analysis of the index from 2004 through 2020 using Bloomberg data. On top of that, the bull market for bonds is subsiding and the world is working toward putting a global pandemic in the rearview mirror. It's clear the market doesn't look the same as it did when many existing bond ladders were initiated. By virtue of their design, ladders don't automatically shift to stay current with rapidly changing market trends — they are manually adjusted. So in 2021, I believe it may be time to consider ways to enhance traditional ladder strategies, perhaps by complementing them with passive multi-sector strategies that are built to exploit the broader credit opportunities. Cost efficiency becomes even more important in low-rate environments.

What's In A Bond Ladder, Anyway?

The typical municipal bond ladder is comprised of 10 to 15 bonds, usually general obligation (GO) bonds, with one-, three-, five-, 10- and 20-year maturities. A GO bond is a municipal bond that is secured by a state or local government's pledge to repay bondholders using available revenue. Investors might choose state GO bonds for the tax benefits and security of repayments, and they may ask their advisors to layer in certain bonds that are near and dear to their heart — those that support their home state or causes they care about, such as education or preserving parks and green space.

But how diversified are they really? How many sectors does the typical bond ladder provide access to? The reality is, the municipal bond market is picked over, particularly in smaller states. Investors' and advisors' options are limited. There are many non-GO sectors investors can consider, which are tied to specific projects or revenue streams, each with its own yield profile. Also, not all investors benefit equally from state municipals; depending on their tax bracket and domicile, after-tax returns may differ. So some investors in bond ladders aren't necessarily getting the broad yield opportunity they might think they're getting, much less sector diversification.

Ladders Don't Move With The Market

If an investor is in a 10-year bond ladder, they chose bonds in that ladder within the context of a market that no longer exists. Not only has the U.S. Treasury bond bull market likely ended its run, but the global pandemic has dramatically changed the world and has had a profound impact on many industries.

As Covid-19 vaccinations continue to roll out and individual states' economies open up, certain sectors are poised to reap the benefits. For example, as people begin traveling again, airports and toll roads are likely to generate more revenue. President Biden's proposed $2 trillion package of investments for infrastructure and domestic needs, including a large proportion going toward the construction of roads, bridges and rail lines, would further open opportunities in the municipal bond market. And by virtue of their limited exposure, investors in traditional bond ladders may be missing out on sectors that are on the verge of strong performance.

Using A National Municipal Bond Strategy As An Alternative Approach

While bond ladders put the onus on the advisor or individual to diversify holdings, a nationally diversified municipal bond strategy typically provides exposure to 200 to 400 bonds, automatically delivering both geographical and sector diversification. As the market shifts, such a diversified strategy is in a stronger position to capitalize on outperforming sectors in the marketplace.

Professionally designed municipal bond strategies, including those accessed through strategic beta exchange-traded funds (ETFs), choose sectors and investments they believe will boost yield, regardless of where they're located.

As for the disadvantages of a nationally diversified municipal bond strategy, income is exempt from federal but not state taxes. As such, this product might not appeal to or fit the needs of residents living in high-tax states such as New York.

Bottom Line

In a higher-rate environment, bond ladders can be a cost-effective strategy to balance the need for recurring income and reinvestment risk. In a low-rate environment, however, strict laddering can be limiting. An investor's need for real income is usually constant and does not adjust as rates rise and fall — making it difficult for those who use ladders, which consequently limits their investment universe. By adding a national municipal strategy to the laddered portfolio, investors and advisors may be able to increase income while maintaining cost efficiency and transparency. Sometimes, the decision to widen the opportunity set is as important as deciding where on the curve to land.

Forbes

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May 13, 2021