SEGALL BRYANT & HAMILL
ASSET MANAGEMENT

Decoding the Municipal Bond Market: Why Smaller Managers May Have an Edge

The municipal market is in uncharted yield and volatility territory relative to the last 20 years. **Nick Foley, Senior Portfolio Manager, Director of Municipal Bonds**, discusses what's driving the market and why smaller investment managers may have an edge.

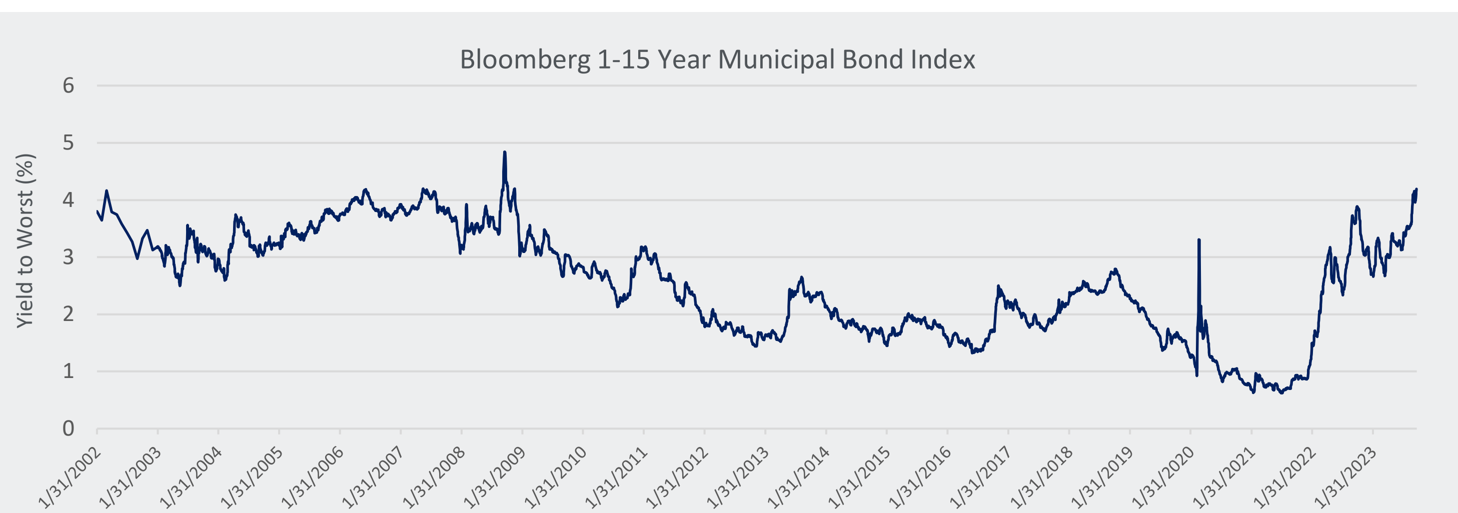
Robin Fujimoto: What a year it's been in munis. We are in uncharted territory relative to the last 20 or even 30 years from a yield perspective. And we've been seeing unusual volatility in the market. Several factors seem to be impacting the market from yield hikes, to Federal Reserve (Fed) policy rhetoric, to an uncertain macro background. Could you help us understand what is really driving this market?

Nick Foley: I would say all those things. There is uncertainty and much more persistent inflation than we initially thought we would see at the beginning of the Fed rate hikes. As municipal rates have risen substantially, the risk-return payoff has improved for investors.

Fujimoto: Nick, short-term municipals have compelling yields. Could you talk about how they stack up against Treasuries and money markets?

Foley: One of the more interesting events we have seen in the second half of this year has been the rise of front-end yields in the municipal market (**Exhibit 1)**. One thing that was occurring last year through the start of this year was the rising of long-term yields while short-end yields remained very compressed as investors were just very excited to be buying 2%, 3% yields; it kept those yields very compressed. So, the big story for the second half of this year has been that the front-end of the yield curve has risen to 4%+ (for 1 year muni bonds), which after tax is 4.15%. The highest federal tax rate is 7%. We believe that looks attractive. Taxable money markets are yielding somewhere between high 4%s to low 5%s.

Exhibit 1: The Front-End of the Yield Curve Has Risen in the Second Half of 2023



Source: Bloomberg as of 10/20/23.

The ability to be in high investment grade municipal bonds in a taxable account is an attractive opportunity for an investor that does not want to buy more duration in an intermediate portfolio. SBH's intermediate portfolios are heavily focused on a heavy barbell approach since the municipal curve is significantly inverted. What I mean by that is yields are falling and then they are sloping back up again in that belly of the curve (such as 7, 8, 9, and 10 years). The heavy barbell approach has allowed SBH to capture higher yields further out, such as 12, 13, and 14 years; on the front-end, with those yields coming up, this other allocation is making the total yield of the portfolio higher. It has made the heavy barbell approach much more attractive in our mind.

Fujimoto: Nick, I am loving the muni bond yields in California right now.

Foley: Absolutely! The specialty states—in particular, California, New York, Minnesota, and Oregon—these are states that have high tax rates which makes the tax-adjusted yields significantly higher. It's shocking to us to see yields between 8% to 9% in California and New York for intermediate portfolios, as well as other high tax states. We believe it looks attractive when compared to longer-term return expectations for a majority of the asset class, which we consider to be much riskier. We are optimistic about returns going forward given the rate level we are currently at in municipal bonds.

Fujimoto: It is impressive to get those yields with investment grade instruments. So, the important question is, why use SBH?

Foley: We set out from the beginning to differentiate ourselves from the masses. What I mean by that is there are a ton of options to invest in municipal bonds, from essentially free ETFs to low-cost ladders. When we look across the municipal landscape, we see that the majority of the market is focused on a small number of municipals. At SBH, we see that 92% of all outstanding municipal bonds in the market have a CUSIP size or a maturity size of 10 million or less; they are small. Larger managers have to focus on that larger 8% of the market to allocate bonds across a large number of portfolios.

We believe SBH's highest competitive advantage is our smaller size, which is just something that competitors really cannot do anything about. We think it is important to be correctly sized for the market you are investing in and the underlying structure of that market. SBH's data indicates that the underlying structure of the municipal market is poorly understood. Our analysis demonstrates why investors would want to work with a smaller size shop that is institutional-quality and sophisticated in how it invests. A couple million bonds can be a meaningful position size for us versus a rounding error for a larger manager.

Key Takeaways

- There has been significant market uncertainty and persistent inflation which has exceeded our initial expectations. As municipal rates have risen substantially, the risk-return payoff has improved.
- The inverted yield curve has led our investment team to employ a barbell strategy. This balances long-end higher yields with rising short-term yields, maximizing income.
- SBH's highest competitive advantage in the municipal bond space is focusing on smaller, niche opportunities overlooked by larger managers.

To learn more about SBH Fixed Income Strategies, please reach us at (800) 836-4265 or contactus@sbhic.com.