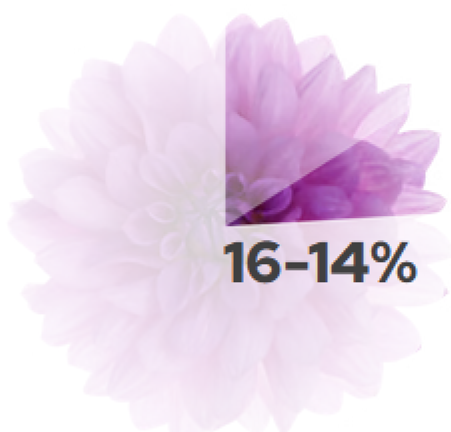
CHAPTER 3

When cultivating multi-asset portfolios, advisors, wealth managers and investment consultants are planting different portions of assets in the municipal bond market, as we found out from five of them.

Jennifer Hill



Crescent Grove Advisors

For clients of Crescent Grove Advisors in the top tax bracket, municipal bonds typically account for 40-60% of fixed income exposure. A balanced 60/40 equity/bond portfolio would therefore have an allocation to munis of 16-24%.

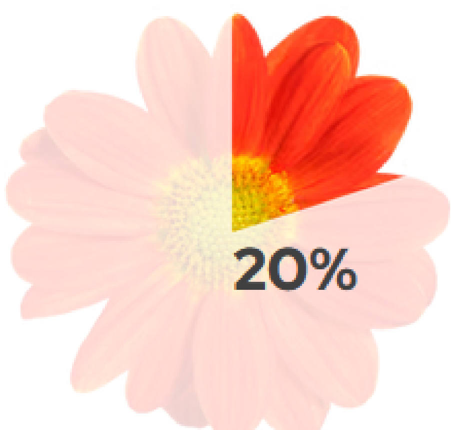
‘Since rates began moving higher in 2022, our municipal allocations have generally increased for clients in the top tax bracket,’ says Andrew Krei, co-chief investment officer of the firm which has offices in Milwaukee, Wisconsin, Lake Forest, Illinois and Atlanta, Georgia.

‘For more conservative clients with existing municipal bond allocations that may have meant a 10-20% incremental increase in fixed income. For clients who had been more aggressive with their fixed income portfolios during the low interest rate environment that may have meant a brand new allocation to municipal bonds given the more attractive yields on offer.’

The firm caters to ultra-high-net-worth families and individuals who have great appreciation for the tax advantages of the asset class. Their municipal exposure is largely focused on high quality, investment grade mandates that provide steady income and can help to offset the volatility of equity allocations.

‘We get our exposure through separate accounts and mutual funds, choosing the appropriate vehicle based on the client’s needs and circumstances,’ says Krei. ‘We focus on finding full-cycle managers who can add value through security selection and curve positioning.’

The rest of clients’ fixed income exposure is comprised of relative value opportunities in areas that provide differentiated income and total return potential across both public and private markets.



Manulife Investment Management

In taxable accounts with a standard 60/40 equity/bond split, Manulife Investment Management recommends that tax-free municipals populate half of the fixed income bucket, giving an overall allocation of 20%.

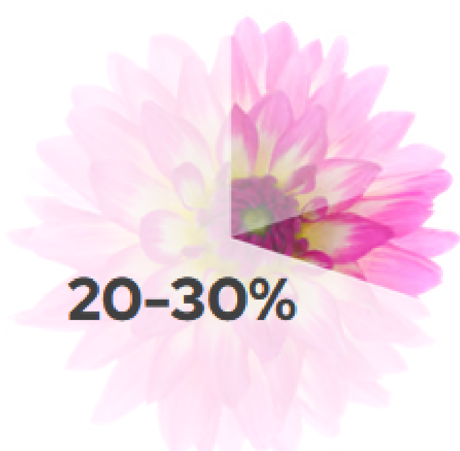
'This is sufficient to diversify clients' fixed income holdings while achieving the maximum after-tax income but can be adjusted up or down for clients in a high or low tax bracket,' says Adam Weigold, a senior managing director and head of municipal strategies, based in Boston, Massachusetts.

He points to municipals being a good source of diversification given their relatively low correlation to equities relative to other parts of the fixed income universe. Other benefits that cement their integral place in portfolios include tax-free income, generally high credit quality and defensiveness in the face of recession.

'When looking at previous recessions the variation in credit quality for municipals is far lower than that of corporate credit,' says Weigold. 'In recessionary environments, municipal credit tends to hold up a lot better and certain muni sectors, such as water and sewer, and public power, typically outperform amid a flight to quality.'

At the same time, however, the muni market is more fragmented and less liquid than other bond markets – giving the opportunity for alpha generation.

'Despite being less than half the size of the corporate bond market, the muni market has more than double the number of individual CUSIPS outstanding,' says Weigold. 'These characteristics provide for an inefficient market, which can be exploited for gains by an active manager.'



Innovest Portfolio Solutions

With yields rising alongside interest rates and total returns growing in attractiveness, Innovest Portfolio Solutions is starting to position municipal fixed income more heavily in portfolios. In a balanced taxable portfolio, it is now allocating 20-30% to municipals up from 10-15% a few years ago.

‘We’ve increased the allocation over the last year not only due to the more attractive return profile of municipal fixed income but also because of its ability to mitigate overall portfolio risk due to its lower volatility characteristics,’ says Sloan Smith, a principal and director of the Denver, Colorado-based investment consulting firm.

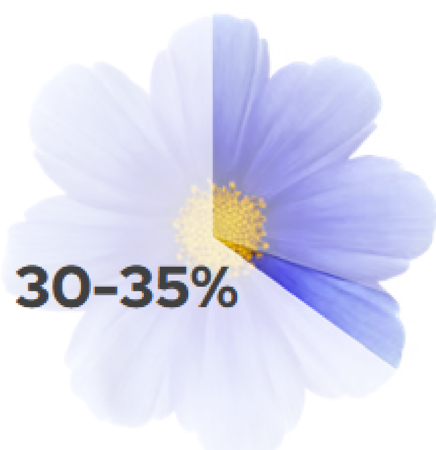
He recognises the relative unattractiveness of muni bonds for more than a decade due to the low interest rate environment.

‘This dynamic changed dramatically though in 2022 when the Federal Reserve decided to raise interest rates to hinder inflation,’ he says. ‘At the end of 2023 intermediate-term municipal fixed income was providing a roughly 3% yield, which equates to 5% from a tax-equivalent standpoint, compared to around 2% or 3% respectively two years earlier.’

Innovest allocates to municipals through mutual funds, exchange-traded funds and separate accounts.

‘Separate accounts are advantageous because we can customize the mandate and potentially overweight the portfolio to municipal bonds in states where the client resides, which could provide a state income tax exemption,’ says Smith.

The firm typically pairs an allocation to munis with taxable and opportunistic fixed income, providing clients with exposure to corporate bonds, high yield bonds and floating rate corporate loans.



Franklin Templeton Investment Solutions

In its tax-aware 60/40 portfolios, Franklin Templeton Investment Solutions typically prefers municipal bonds over Treasuries and corporate bonds, while keeping an eye on overall credit risk and duration. Typically, it allocates the bulk of fixed income exposure to munis at 30-35%.

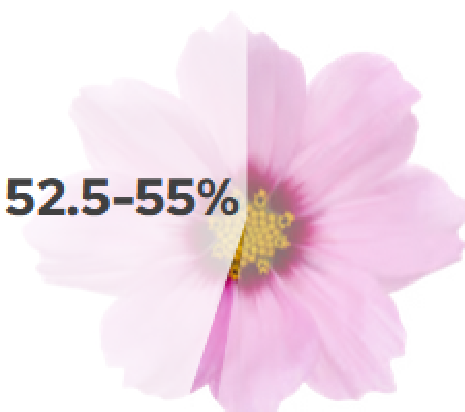
'We've kept this relatively consistent over the past year in line with our longer-term strategic asset allocation views,' says chief investment officer Wylie Tollette from San Mateo, California.

In populating the muni bond allocation, the Franklin Federal Tax-Free Income fund is typically the largest holding on the strength of its duration profile and broad diversification across municipalities and credit sectors. In some of its higher risk, higher return portfolios where risk is viewed most favorably, the multi-asset manager makes a smaller allocation to the Franklin High Yield Tax-Free Income fund.

For more conservatively oriented tax-aware portfolios, the remainder of the fixed income sleeve is typically allocated to Treasuries and Treasury inflation-protection securities for their defensive and inflation-hedging characteristics and corporate bonds for their additional yield.

After widening dramatically during Covid-19 lockdowns in 2020, municipal bond yields as a percentage of Treasuries have tightened considerably and are hovering near multi-year tights.

'They are slightly expensive compared to taxable bonds on a post-tax basis,' adds Tolette. 'As interest rates rise, funds often flow out of munis, causing them to cheapen relative to taxable bonds. We are monitoring for this scenario as an opportunity to add to munis, however it is not our base case outlook currently.'



Fiduciary Trust International

Fiduciary Trust International has a strategic 50/50 equity/bond split for balanced investors and is currently overweight fixed income to the tune of 2.5-5%. For top tax bracket investors it almost exclusively allocates fixed income holdings to the tax-exempt sector, giving them an overall allocation to munis of 52.5-55% at present.

‘Given the move higher in yields over the past year-and-a-half we have moved to an overweight in client portfolios,’ says Jeff MacDonald, its head of fixed income strategies, based in New York City.

At times, opportunities can arise in taxable parts of fixed income markets – something that MacDonald and his team are alive to.

‘We prefer to allow ourselves, within client established guidelines, the flexibility to take advantage of these conditions,’ he says. ‘Given current levels of spreads and yields in the market we’re not seeing compelling after-tax relative value in crossing over to taxable sectors of the market but are always on the lookout across the broader bond market when the playing field is levelled across risk and after-tax outcomes.’

For core holdings, the firm thinks it can add considerable value through security selection and therefore prefers to select individual bond holdings as opposed to funds.

‘The technical dynamics of the tax-exempt municipal market often offer value across specific structures that we believe can provide our clients a better customized, risk-adjusted, after-tax outcome than broad exposure to a mutual fund or ETF where we surrender security selection control to another manager or index,’ says MacDonald.

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