

Taking the Measure of Municipal Bond Ladders

SUMMARY

- While ladder investment approaches may be suitable for efficient investment markets (e.g.: Treasury bonds), we believe that inefficient markets (e.g. municipal bond markets) are less appropriate for passive ladders.
- A municipal bond strategy unencumbered by restrictions that generally characterize ladder strategies may better capitalize on market opportunities and manage risk exposures.
- Breckinridge tax-efficient strategies focus on income generation and stress tax-efficiency throughout the portfolio management process.





Breckinridge offers actively managed, investment grade (IG) fixed income strategies that strive to reach the investment and income goals of our clients. In managing client portfolios, Breckinridge seeks a diversified maturity and duration structure.

Breckinridge tax-efficient strategies focus on income generation and stress tax-efficiency throughout the portfolio management process. While these goals are similar to those of a municipal bond ladder, we view municipal bond laddered strategies as unnecessarily restrictive in their approach.

A traditional municipal bond ladder approach may limit security selection, proactive trading, portfolio structure and, ultimately, opportunities to build, sustain, or enhance investment returns. While ladder approaches may be suitable for efficient investment markets (e.g.: Treasury bonds), we believe that inefficient markets like the municipal bond market are less appropriate for passive laddered management approaches.

Breckinridge believes a less rigid approach to municipal bond management can pursue objectives similar to ladder strategies while providing flexibility to opportunistically take advantage of changing market conditions. We view a municipal bond strategy unencumbered by the restrictions that generally characterize ladder strategies capitalize on market opportunities and manage risk exposures by offering access to more bonds, trading tactics, and portfolio structures.

In this article, we will look at some of the key limitations of municipal bond ladder strategies.

How Municipal Bond Ladders Traditionally Work

Typically, ladder strategies set bond maturities at 6- or 12-month intervals over 5- or 10-year periods.

Investors count on receiving interest payments from bonds across all maturity steps in the ladder. In addition, investors expect bonds to return capital at maturity.

Proceeds from maturing bonds are reinvested in new bonds added to the long end of the ladder's maturity structure. Investors are focused on bonds with the appropriate maturity and other characteristics.

It is anticipated that this systematic and repeatable process could help investors mitigate impact of rising rates, create a diversified portfolio, and plan for potential income. However, these benefits can come with severe limitations, especially when deployed for municipal bonds.

Municipal Bond Ladders May Limit Security Selection

Selecting municipal bonds for ladders assumes that, at every maturity date, bonds with the desired characteristics will be available in the market at an appropriate price. Based on the nature of the municipal market, this assumption may prove impractical at times, such as in cases when there are state-specific or state-biased requirements, for example.

On any given day, there are only a certain number of available bonds with characteristics such as maturity, state of issuance, credit quality, sector, and issuer that may meet the criteria set forth by the ladder strategy.

The series of limitations, along with the ladder's rigidity, particularly when investing for a state-specific or state-biased portfolio, could reduce suitable investment opportunities substantially.

Now consider the increased flexibility of a bond strategy that allows greater optionality in security selection. Rather than being restricted to adding a bond maturing in 10-years at the end of a ladder, for example, an active approach might choose to purchase a 12-year bond with a 10-year call option or two bonds with maturities bracketing the target 10-year maturity, as long as they also meet the investor's tax-exemption, income, credit quality, sector, and other requirements.



One can logically expect that as the options available to the strategy increase, so too will the security selection choices. As more choices are available to the portfolio manager, the potential that the investor's objective can be reached more efficiently and with great flexibility may also increase. A broader security opportunity set also holds the potential of allowing adjustments along the way to accommodate evolving investor objectives in response to changing circumstances.

Municipal Bond Ladders May Limit Proactive Trading

Ladders typically limit reinvestment timing to redemption dates. From time to time, selling a bond before maturity or call and reinvesting the proceeds can capture value. Changing conditions in the municipal bond market can present opportunities to proactively trade to capture better relative values.

For example, over the course of a year, the municipal market may experience a lack of supply and/or an increase in demand, potentially decreasing opportunity. The converse is true as well, as the municipal market can trend toward oversold, with more bonds for sale and fewer buyers for them, potentially increasing opportunity.

As such, the flexibility to sell a bond before maturity and purchase another bond can help to build, sustain, or enhance after-tax income. Without trading the portfolio excessively, an active strategy may be able to avoid buying bonds during times when prices are higher, or capture values when prices are lower.

A ladder, as a buy-and-hold strategy focused on periodic trading dictated by maturity structure, would tend not to leverage opportunities, or mitigate reinvestment risk through proactive trading as market conditions change over time.

Municipal Bond Ladder Approaches Can Limit Tax Management

From our perspective, ladders frequently tout their tax-efficiency, as they typically would not sell securities and, thus, incur no capital gain or loss implications for the portfolio.

By contrast, there are three common tax-related tactics active managers can employ to improve the actual return or tax-efficiency on a bond portfolio.

First, actively managing a portfolio's in-state and out-of-state municipal bond holdings is commonly intended to enhance tax benefits and/or after-tax yield, depending on where the investor lives and the relative value of in-state bonds at any given time.

The second tactic is crossover trading strategies—when, for example, a Treasury bond's after-tax-yield exceeds the tax-free yield of a similar maturity municipal bond. With a municipal market that has not grown in over 10 years and a significant increase in demand for tax-exempt bonds over that time, it is natural to see more situations where a taxable bond could provide a better after-tax return.

Finally, active managers can harvest losses to gain potential tax advantages. Tax-loss harvesting entails selling securities at a loss to help reduce taxes on capital gains and/or ordinary income. For example, during a period of rising rates like 2022, a bond may be sold at a loss to provide capital for investment at a higher yield, while capturing a tax benefit. Careful tax-loss harvesting could reduce an investor's overall tax burden while potentially improving an investor's after-tax rate of return. As ladders don't sell bonds until maturity, they eliminate the potential benefits of tax-loss harvesting.

In managing municipal bond portfolios, we seek to be attentive to situations that may optimize returns, including after-tax returns over time.



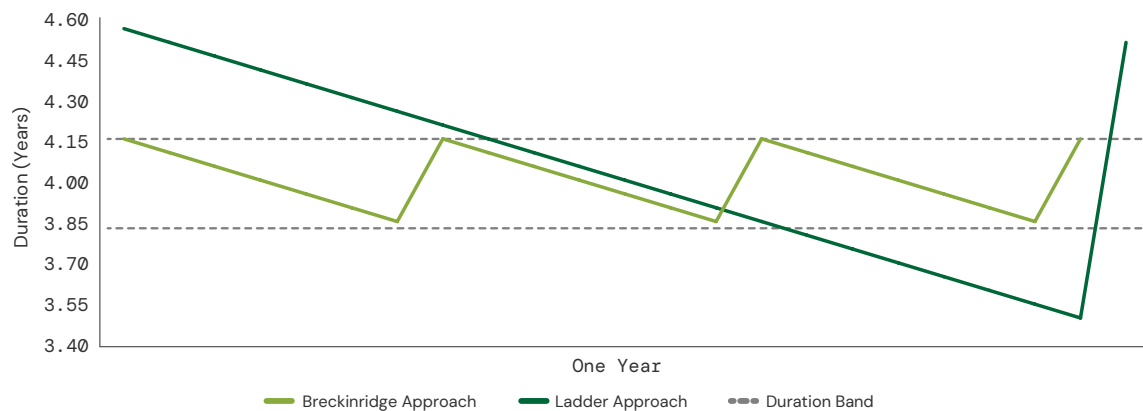
Municipal Bond Ladder Arrangements May Restrain Portfolio Structure

In addition to limiting the number of securities available for purchase, a ladder also constrains the portfolio structure.

Because a ladder is, by definition, an equally weighted portfolio, its profile along the yield curve does not change. Ladders invariably reinvest at the long end of their maturity limit, even when that maturity may not represent the best relative value or risk-adjusted return. In contrast, active strategies can modestly adjust yield curve exposure, targeting a more bulleted or barbelled position, based on market conditions.

Breckinridge historically has not bet on the direction of rates and has sought diversification. Rather, similar to trading more opportunistically, we believe that active structures can be utilized to effectively help build, sustain, or enhance income by making tactical adjustments to holdings characteristics in light of changing market conditions.

FIGURE 1: COMMON DURATION TOLERANCE FOR A 1-YEAR PERIOD



Source: Breckinridge Capital Advisors, Inc.
The graph is intended to illustrate a potential difference in duration approaches between an active approach (Breckinridge Approach) and a passive approach (Ladder Approach). They do not represent actual portfolios or investment strategies. This illustration does not represent all active or laddered strategies. In fact, there are numerous active and laddered approaches available to investors, and those strategies may perform significantly different than what is shown.

Municipal Bond Ladders May Influence Duration

Municipal bond ladders, by the nature of their traditional portfolio structure and security trading approach, may cause portfolio duration to swing significantly due to the timing of maturities. Lack of duration management can result in significant portfolio dispersion. Figure 1 does not present actual portfolios or investment strategies. It is intended to illustrate a potential difference in duration approaches between an actively managed portfolio management approach and a passively managed municipal bond ladder portfolio approach. There are numerous active and laddered approaches available to investors, and those strategies may perform differently than as shown in the illustration.

A more active approach to municipal bond portfolio management can potentially limit duration volatility, when compared with more passively managed municipal bond ladders. Actively managed municipal bond portfolios offer the opportunity to establish a tighter duration band around a maturity target intended to meet a client's income needs.



Conclusion

A laddered approach to fixed-income portfolio construction and management may make sense in certain bond markets. In the U.S. Treasury and corporate bond markets, characteristics such as new issue supply, credit quality, maturity, and other features are relatively more orderly than is typically the case in the municipal bond market. For example, tax season can influence issuance and trading in the municipal bond market in ways not seen to the same extent in Treasury and corporate bond markets.

We believe that the municipal bond market calls for an active investment management approach. Active management offers the opportunity to apply a disciplined approach to interest rate exposure and maturity planning, while avoiding constraints common to a ladder approach. The municipal market's inefficiency and erratic supply can offer opportunities for income and investment enhancements that might be unavailable within the structural and trading constraints of a traditional ladder approach.

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