

Using Total Return Effectively in Municipal Bond Management

At Breckinridge, our primary objective in managing municipal bond portfolios is to preserve capital and build a reliable stream of tax-exempt income. While total return is not our priority, we monitor it closely as one of many reliable measures to ensure a portfolio remains aligned with its long-term objectives and risk profile.

There are important limitations to relying solely on total return—primarily that not all returns are created equal.

- The most obvious shortcoming is that total return does not differentiate between taxable and tax-exempt income, a critical and fundamental distinction in municipal bond investing.
- Equally important, though more nuanced, is the insight from prospect theory (Tversky, 1979): losses tend to hurt more than gains help, yet unadjusted total return treats all outcomes symmetrically. Similarly, Antti Ilmanen has noted that returns earned during periods of market stress are more valuable, reflecting the law of marginal utility (just as a little bit of food has more value in a time of famine). Yet total return makes no distinction based on when returns occur or how meaningful they are to investors.
- Finally, municipal bonds, particularly high-quality strategies, are best understood as part of the “risk-free” or “risk-mitigating” allocation described in Tobin’s Separation Theorem (Rzepczynski, 2018). Their purpose is not to maximize return, but to stabilize portfolios and counterbalance risk in other asset classes. An overemphasis on total return undermines that purpose and may lead to excessive credit or duration risk in pursuit of yield, potentially compromising the defensive role of a core municipal bond allocation during periods of economic stress.

Our approach is intentionally balanced. We aim to incrementally enhance tax-exempt income while emphasizing high credit quality, disciplined duration management, and tax-sensitive trading.

Total Return Lens—A Useful but incomplete Diagnostic Tool

Although not our objective, a total return lens offers a standardized, widely understood metric for evaluating performance, especially useful when comparing portfolios built at different points in the market cycle. It enables contemporaneous analysis of yield and price effects, even in markets where matrix-based pricing and limited liquidity can obscure individual security outcomes.



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When interpreted correctly, relative total return can yield valuable insights about portfolio structure:

- Underperformance in stable or declining rate environments may suggest an overly short maturity profile or inadequate call protection, limiting long-term income potential.
- Underperformance in rising rate environments may reflect a duration profile that is too long, reducing flexibility to reposition at higher yields.
- Weak relative returns may also indicate underlying credit issues. While these risks may be diluted in broad composites, persistent underperformance can point to sector- or issuer-level concerns. Conversely, elevated returns may reflect thoughtful yield enhancement—or, alternatively, an aggressive risk posture that may erode the portfolio’s stabilizing role. In all cases, total return lens provides a partial diagnostic view, helping to assess whether portfolio construction and positioning are consistent with intended risk parameters and investment objectives.

Conclusion

In managing municipal bond portfolios, our core objectives are capital preservation and the delivery of a sustainable, tax-exempt income stream. Although total return is not our primary aim, it is a useful tool for evaluating the effectiveness of our decisions and the soundness of our judgment. Exceptionally high returns may signal imprudent risk-taking, while prolonged underperformance may point to excessive conservatism or emerging credit concerns. In either case, total return provides a meaningful lens for evaluating alignment and ensuring the portfolio remains on course through an entire market cycle.



The content is intended for investment professionals and institutional investors.

BCAI-05212025-tixkvbye (5/22/25)

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