



Reducing interest-rate risk in a muni bond portfolio

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Traditional muni indices are concentrated in higher quality bonds and may have more interest-rate risk.

Passive products that track traditional municipal bond benchmarks may give investors excessive exposure to duration (interest-rate) risk, because of the way traditional indices are constructed.

Problem: Traditional Indices have a quality bias

Municipal bonds have long been viewed as high-quality assets, partly because the majority of them historically carried a AAA rating. Until 2008, monoline insurance was prevalent, enhanced the credit rating of a bond and provided additional protection to investors in the case of default. However, the 2008 financial crisis caused insurers to lose their coveted AAA ratings and resulted in municipal bonds trading based not on the insurance, but on their underlying creditworthiness. Nearly 70% of the municipal market was rated AAA prior to the financial crisis. Just above 15% is today.¹

Even with this change, the majority of the muni market is still rated investment grade, and many municipal indices have been designed to focus exclusively on these higher quality bonds.

Opportunity: Lower quality sectors may enhance yield with lower interest rate sensitivity

The ratings recalibration ultimately created a tremendous opportunity for municipal investors. The market now differentiates among issuers based on fundamentals and applies a risk premium reflective of their sector, creditworthiness and idiosyncratic factors. This results in investors earning more yield than when the bonds were insured and rated AAA. This yield advantage also helps buffer interest-rate volatility.

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We use a metric called empirical duration to more accurately measure a bond's sensitivity to changes in interest rates. Investors often focus on effective duration — a theoretical measure of interest-rate sensitivity based primarily on the maturity of the bond. But empirical duration uses real historical price changes to show the true sensitivity of a bond to changes in interest rates. As a general rule, true interest rate sensitivity tends to fall — and the gap between effective and empirical duration increases — as you move down the credit quality spectrum. As lower rated investment-grade and high-yield municipal bonds generally have lower empirical durations relative to their higher quality counterparts, investors are taking on less interest-rate risk when allocating to these sectors. Credit risk may matter more. Because interest-rate risk and credit risk are relatively uncorrelated, introducing the latter into an otherwise high-quality portfolio can provide important diversification benefits.

Bottom line

Tracking a traditional municipal bond benchmark may leave investors overexposed to higher quality bonds and, consequently, subject to excess interest-rate risk. A strategic municipal bond approach, with a focus on diversification and the flexibility to navigate interest-rate risk and credit risk, may help address this challenge.

¹ Source: Bloomberg, as of 06/30/20.

Diversification does not assure a profit or protect against loss.

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