"In Volatilitas, Opportunitas": The De-Commoditization of the Municipal Bond Market

The opportunities for investors are potentially enormous as the municipal market experiences a rapid de-commoditization from what had become a generic investment grade/insured market to one that is more stratified in terms of yield and credit. The report below discusses what has occurred, why it occurred, and how patient, long-term investors may profit.

During the early fall of 2008, yields in the high grade municipal bond market backed up to 5.92% from 4.56%, levels not seen in decades and at a rate of increase that was alarming even to long-standing industry professionals. An already steep yield curve for AAA municipal bonds, the gold-standard for the industry, steepened further, creating a nearly 4% difference between the rate on one-year notes and 30-year bonds—another level not experienced in over twenty years. Municipals historically yielded around 80% of Treasuries; now that ratio continually exceeded 130%. As the basis of the Municipal Market Data benchmark index was reset from 5.00% to 5.25% to account for the dramatic changes, many in the market grumbled that it still wasn't enough to reflect the market they were seeing on their screens. These concerns were confirmed when the basis was reset again to 5.50% just a few days later.

The primary market was of no help in finding a bottom. The fourth quarter usually brought a flurry of supply to the market as municipalities and authorities raced to get financings closed before the end of the year. This year was shaping up to be no exception. A forward supply of billions of dollars of public debt financings was building. But with rates rising like a helium balloon in an updraft, few were being brought to market. The forward calendar, usually a reliable barometer of upcoming financings, went from being carefully scripted to an improv act. Billions of dollars of new money financings were pulled or significantly restructured and downsized. Underwriters, unwilling to stock bonds in a market that was declining more every day, would only bring a deal to market that was pre-sold.

The secondary market looked like a view into the abyss. A torrent of bid-wanted lists from mutual funds, forced to puke up bonds into the market because of billions of dollars of redemptions from fleeing shareholders—$3.3 billion in the first two weeks of October alone—caused prices to get set as if traders were playing pin the tail on the donkey. With no reliable benchmark and no definable bottom, in many ways they were. One headline described the ongoing upheaval as "The Muni Meltdown."

But it is anything but a meltdown. <u>It is the de-commoditization of the municipal bond market</u>. It is a market searching to define value, yield, and credit after years of having that conveniently done for it and sometimes conveniently just overlooking it. And when goods cease to become commodities, liquidity dries up as well until a new standard of measurement is set.

To invest successfully in this new environment, how the market got to this point offers some perspective. This is a vastly different market and market environment than just two years ago. At the close of 2006, the municipal bond market was at peak levels. Rates on long AAA bonds were 4.07%. The yield curve had hardly any curve at all, with only a mere .60% difference in yield between a one-year note and a 30 year bond. Spread between credits was almost nonexistent: a single-A hospital revenue bond was priced 40 basis points away from a AAA general obligation bond, absurdly suggesting that a community hospital's creditworthiness was nearly on parity with that of a state bond backed by unlimited taxing power.

This was the net result of a market awash in cash. Nearly $20 billion of new money had come from mutual funds, the largest single year asset increase in those vehicles since 2001. This was on top of the nearly $80 billion that investors had put in since the start of the decade. Additionally, hedge funds poured untold billions into the market. These new market

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entrants, fueled by easy credit and high leverage, bought the bonds on margin for a short-long arbitrage trade. Their trading volume was enormous; some broker dealers just set flat fees for volume trades rather than marking up the bonds.

Suffering from asset bloat as they grew to almost unmanageable size, the mutual funds were unable to sustain the performance of prior years. Compounding the problem, borrowers took advantage of the low rates to refinance the high interest rates loans taken in the late 90s. Ironically, because of the low interest rate environment the mutual funds helped to create, these same funds were now losing the high coupon bonds so necessary to maintain their prior performance and dividends. As those embedded yields disappeared, the funds began to look to replace the income. But in a low-rate environment, there wasn't much higher yielding paper around sufficient to bridge the gap. Between the asset growth and losing higher yielding bonds, competition was furious for new paper at almost any yield.

Correspondingly, the funds were almost compelled to take advantage of the leverage trade, engaging in tender option bond programs that arbitraged the weekly floating rates against a long bond yield. In order for the money market funds to buy that floating rate paper, it needed to be AAA. That paper was easy to find. Nearly 50% of the new issue market in bonds that came to market in 2006 was insured by one of the seven bond insurance companies that were rated AAA/Aaa. This was no surprise; over the prior 10 years, close to 60% of all newly issued debt came with bond insurance. By the close of 2006, the market was overbought, overly liquid, and trading as if credit risk didn't exist and no longer mattered.

Those days are gone. They are not coming back, at least not soon, and almost assuredly not in the same way. As the subprime mortgage crisis amply demonstrated, credit matters. With a recession looming, perhaps it matters even more. Today's municipal bond market is irrevocably changed from the after effects of the subprime mortgage crisis. No participant in the market is untouched: bond insurers, rating agencies, hedge funds, mutual funds, underwriters. Today only two of the original seven bond insurers have AAA/Aaa ratings, and both are under review for possible downgrades. Three others are below investment grade. Given the widely acknowledged failure of the rating agencies to appropriately gauge the creditworthiness of the bond insurers or act in what many felt was a timely manner when the problems became apparent, ratings are viewed with some skepticism. Hedge funds, battered by the swift slide in the market and unable to secure the easy credit they had in the past, have all but stopped buying bonds. Mutual funds are losing shareholders, some of whom witnessed double digit declines in value in their investments. Former market-makers such as Bear Stearns, Lehman Brothers, and UBS are gone, along with their trading desks and liquidity.

The institutional investor is on the sidelines now. No longer commodities, bonds are readjusting to levels that reflect their value relative to their underlying credit risks. This is creating market dislocations. And in dislocation, there is value.

<u>This is the time for Value Investors</u>. Credit is in the driver's seat. The adroit investor succeeds in this market by being patient, investing for the long-term, and taking time to research the economics, underlying creditworthiness and security of a bond. This information is the key to gauge returns relative to risks—and finding value. Well considered investment decisions will compare a bond's yield against those of similar bonds, as well as yields on bonds with higher or lower creditworthiness.

And where is that value? While large multimillion dollar investment grade bond offerings may have value, smaller sized and lower rated municipal bonds may offer investors even greater opportunities to maximize tax-exempt income. Small bond issues financing essential public purpose entities to build schools, hospitals, senior care, or basic infrastructure are solid credits that simply may not qualify for investment grade ratings based on their size alone. But it is in these smaller financings that astute investors find bonds with above average yields, secured by first liens on assets, revenues, or taxes. This is particularly true in the current market, where investors have choices and the smaller borrower must compete on all levels to attract capital. High yield financings must come to market adequately capitalized, well secured and economically viable.

Individual investors may not have expertise or access to high yield municipal bonds. They may do well to seek out a professional municipal bond money manager with experience in high yield bonds to develop a broadly diversified portfolio.

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Braintree Capital Partners

The Principals of Braintree Capital Partners are Arthur J. Wunder, Managing Partner and Barnet Sherman, Managing Partner. Ms. Gayl Mileszko is a Partner and COO. With a combined experience of over 60 years in municipal bond investment management, sales, and trading, Messrs. Wunder and Sherman have extensive experience in analyzing, investing in, underwriting, trading, and managing tax-exempt assets.

Barnet Sherman. Mr. Barnet Sherman most recently was a Vice President and Portfolio Manager with Morgan Stanley Investment Management. Mr. Sherman concentrated on making investment recommendations and developing market strategy for the then $4.6 billion Van Kampen Tax-Exempt High Yield Fund. Managing the non-rated high yield primary market investment process, Mr. Sherman evaluated over 1,000 financings, personally analyzing, negotiating, and closing over $1 billion public, limited, and private placement offerings. The Fund enjoys a 4-Star rating from Morningstar, who also recognized it as a "Fund of the Decade: 1990-2000". Mr. Sherman is published in his field, contributing to *The Handbook of Municipal Bonds* and the *Morgan Stanley Investment Management Journal*. Smith's Ratings and Research has recognized Mr. Sherman as a First Team All-Star every year since 1998. Mr. Sherman has also been noted in both Who's Who in America and Who's Who in Business and Finance since 1992.

Mr. Sherman holds an undergraduate degree in honors from Syracuse University (BA 1980). He earned his Master's in Public Administration from Columbia University (MPA 1982) where he concentrated in public finance. He holds the Series 7, Series 63, and Series 65 licenses.

Arthur J. Wunder. Mr. Arthur J. Wunder has held senior management positions at Dillon Read, Tucker Anthony, Axa Financial, The Advest Group, and RBC Dain Rauscher. Mr. Wunder's first senior position was at Dillon Read, where he rose to the Head of Institutional Sales and Manager of the Municipal Bond Department during his 19 years with the firm. When Dillon Read was sold to UBS, Mr. Wunder joined Tucker Anthony as Head of the Municipal Bond Department and was instrumental in changing their focus from traditional High-Grade bonds to one of High-Yield. He was subsequently asked to assume the role of Head of Fixed Income where he served until the firm was acquired by RBC, Dain Rauscher. Mr. Wunder remained as Sales Manager at RBC for its High-Yield Muni products, interacting daily with investment bankers and sales personnel in the creation, structuring and distribution of municipal bond products. He was also asked to serve on the firm's underwriting committee. Mr. Wunder was recruited by the Chairman of The Advest Group Inc, a subsidiary of Axa Financial, to head their Fixed Income Division.

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Gayl Mileszko. Ms. Gayl Mileszko serves as the Chief Operating Officer of the General Partner and is responsible for day-to-day systems and management. Ms. Mileszko is the former Director of the Massachusetts Department of Labor and served as a member of the Governor's Cabinet and also as a member of the Massachusetts Economic Assistance Coordinating Council as well as other executive committees. Prior to joining the Department in 2005, Ms. Mileszko served in Massachusetts Governor Mitt Romney's office as Chief of Staff for Legislative and Intergovernmental Relations. She was a member of the staff of the Committee on Appropriations for the U.S. House of Representatives from 1983 to 1988, and previously served on the staff of Congressman Silvio O. Conte (1st District-MA) and in the White House Liaison Office of the Republican National Committee. Ms. Mileszko served as an Executive Committee member of the board of the Massachusetts Health and Educational Facilities Authority from 2005 to June 2008.

In addition to her public service, Ms. Mileszko was a Vice President in public finance and later as a Senior Vice President in the fixed income capital markets division at the investment banking firm Tucker Anthony. She holds a B.A. from Yale College.

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