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Q&A What It Will Take for One Muni Portfolio Manager to Add to Illinois Holdings: Q&A

Duane McAllister, Managing Director, Baird Advisors

- Illinois' enactment of a budget was a good "first step" but the state still needs to enact further reforms, said Duane McAllister, senior portfolio manager at Baird Advisors, who helps oversee $2.5 billion in municipal assets
- The market is becoming more efficient at pricing risk surrounding pensions, said McAllister, whose funds hold Illinois general obligation bonds and credits around the state

Schuette and Robare spoke with Amanda Albright on June 8. Comments have been edited and condensed for clarity

Q: What's your outlook for municipal performance the rest of the year?

A: I would admit to being a little surprised at how well munis did in the first half of this year. Post-election, there was the big reflation trade, interest rates rose and expectations for tax reform pretty significantly increased. We entered the year with that expectation and concern. But we obviously saw, particularly with the difficulty in passing health-care reform, that tax reform was going to be equally difficult. We had strong technical support with lighter supply than a year ago and fairly consistent inflows.

While it's difficult to maintain the same kind of pace of the strength of the muni market in the second half, I also don't think we're going to see significant changes in the outlook. The fiscal policy front is going to remain challenging for the GOP and for President Trump. We're going to have this backdrop of moderate growth, tame and moderate inflation and there's still going to be a core level of demand for tax-free income.

Q: How do you take into account interest rates?

A: I've learned over time that trying to predict the direction of interest rates is really difficult, particularly to do and be consistently right. We start with a view of what is our benchmark and aligning our duration in the portfolio or the funds relative to the benchmark. We all have views, of course, but we don't take duration risk.

What we do spend a lot of time focused on are areas where we think we can hit pretty consistent singles and doubles. That would involve positioning on the yield curve, sector weightings, and most importantly, security selection.

Q: Where are you overweight?

A: The traditional answer I would give you for the last seven or 10 years is we like revenue bonds. It's become kind of a consensus opinion that you want to have an identifiable revenue stream. That's still true — all else equal, we're going to favor the revenue sector over the general obligation sector. What's happened in the last year or two because of all the headlines and concerns about pensions, we've seen more of an equal balancing of valuation between revenue bonds and general obligation bonds. You can't just say anymore that we like revenue bonds over general obligation bonds. I don't think that's a fair way of looking at the market.

Q: How have you seen the valuation of general obligation bonds change?

A: The market has become more efficient at pricing risk in the general obligation sector. You've had this divergence between the haves and the haves not. The haves are those states and municipalities that have fully funded or close to fully funded pensions. Wisconsin — where I live — has a pension plan that is over 100 percent funded. But the state of Wisconsin — while it's a very strong credit and we like the credit a lot — trades at a relatively tight spread to the AAA curve. Whereas our neighbor Illinois has a pension plan funded at less than 40 percent and today the state is trading about 230 basis points off the 10-year part of the curve.

You can look to Connecticut and other states that have pension challenges, and what you've seen is the market has become better at pricing risk. It's no longer appropriate just to say, at least in our opinion, "I'm not going to buy the state of Connecticut general obligation bonds." What you have to say is, "We understand the challenges they face, but what are they doing about it, what can they do about it, and what are we getting paid to assume that risk?"

Q: How do you view Illinois's budget?

A: We were happy to see a budget get passed. I would have loved to have seen some reform measures be a part of that, but I'll take this as a pretty significant first step in solving their long-term fiscal challenges.

Q: Would you buy more of the state's debt?

A: We're not adding right now. I would say that it still trades very wide for a state general obligation bond, but we also realize that there's more that needs to be done here. If we see more progress, whether it's near-term with the current leaders that are in place, or if we have to wait until the next election to see potential changes there, we're going to watch that very closely.

Q: What next steps are you hoping to see out of Illinois?

A: Pension reform is a big, big thing to tackle but I think they have to look to make some progress there. Maybe ultimately it means you have to go to a constitutional amendment process — it's a big hurdle, no doubt about it.

Some of the things that Governor Rauner was pushing for — some of the property tax freeze issues, workers' compensation reform, even term limits — those were things that would have been nice to see to help Illinois in the long-term that didn't happen in this budget.

But watching all the different states, municipalities, and even at the federal level, these things are difficult and they take time. You have to make the progress as you can and you rarely get all that you want in any one measure.