Winning a Loser's Game

Three Decades of Active Municipal Risk Management

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Will Rogers once said, "Good judgment comes from experience, and a lot of that comes from bad judgment." I can appreciate both the humor and wisdom in this quote when I consider the investment lessons learned over my career. Any honest portfolio manager will admit that investing is a humbling business. At the same time, our investment experiences, both good and bad, should lead us to a greater understanding of and appreciation for – risk. Even market sectors perceived as low-risk, such as the municipal bond market, can offer valuable lessons and insights for those who study the market. Fixed income investors have always known, for example, that interest rate risk was a very real part of bond investing, as we have experienced most recently during the Fed's policy normalization. But interest rate movements are just one of the many risks in the fixed income markets. I was fortunate to have gained an appreciation for the complexity and risks of the municipal bond market early in my career.

Municipal Complexity

I recall attending a large investment conference nearly three decades ago where the Director of Municipal Research from a major Wall Street firm stood before the audience – which included equity and fixed income analysts and portfolio managers – and proclaimed that the municipal market was, in fact, the most complex of all financial markets. He proceeded to outline the many risks inherent in the market. Not only was there interest rate risk, as in the Treasury market, and credit risk, similar to corporates, but municipal bonds also had optionality and cash flow uncertainty, much like the mortgage-backed sector. He warned of the liquidity risks municipal managers face given the potential for (perhaps irrational) shifts in sentiment among its dominant retail investor base and the difficulty dealers have in trying to effectively hedge municipal inventory. He also cited examples of the regulatory, legal and political risks that municipal investors must consider and highlighted the then-relatively recent $2.25B default of the Washington Public Power System (WPPSS, or "Whoops" to many) in 1983 and how it took five years to reach a final settlement. He ended his list of risks by reminding us that tax policy risk was also ever-present and how tax law changes could significantly alter the supply/demand balance of the entire municipal market (which the most recent round of tax reform proved to be true once again).

Municipal Management – A "Loser's Game"

Around this same time, I happened upon a fascinating article that had an equally significant impact on my understanding of risk and how to manage it. The author, Charles Ellis, described the difference between a "winner's game" and a "loser's game" as it relates to investing and used tennis as the basis for the analysis. Professional tennis, for example, was a winner's game, because the professional who hits the best shots generally wins. Amateur tennis was different, since the winner is often the player that makes the fewest mistakes. I realized that, like amateur tennis, municipal management, even for the professional manager, was primarily a loser's game. Except for those rare occasions of significant market disruption – which happen maybe once or twice in a decade – when a more aggressive approach may be justified, the best way to win as a municipal manager is to minimize errors. Keeping the ball in play in the municipal market, therefore, meant controlling risk.

What History Can Teach Us

Keeping the ball in play has certainly been the primary focus of my municipal bond career. I am reminded of the importance of this focus as the two newest Baird tax-free bond funds, overseen by our municipal team, approach their three-year anniversaries – particularly in the current environment, where the additional yield received for taking credit risk has declined over the last several years. Risk management has never been more important than it is today. And you don't have to look too far back in history to find examples of when taking one's eye off the proverbial ball led to undesirable outcomes for municipal fund managers and their investors:

Puerto Rico: Tax Efficiency Over Credit Risk

An understandable motivation for investing in the municipal market is the federal tax exemption of the income earned from the bonds. In many states the income received from in-state bonds is exempt from both federal and state income taxes, making them doubly appealing. The income from Puerto Rico bonds is exempt from all local, state and federal income taxes, regardless of your state of residence.

Seeking tax efficiency in a municipal bond portfolio is certainly important, but the desire to minimize taxes must be balanced with the prudent management of credit risk. Puerto Rico bondholders ultimately paid a very high price for the tax efficiency they sought as the vast majority of municipal issuers on the island defaulted on their debt. Severe price declines and fractional recovery values are the outcome for those left holding Puerto Rico debt today.

The Great Recession: An Advanced Study in Credit Risk

Credit spreads in the municipal market narrowed to the tightest levels on record prior to the start of the financial crisis in 2007–2008. What was apparent then to a prudent investor – that the risk of investing in lower-quality credits was not worth the reward – became abundantly clear to all when credit spreads widened dramatically in 2008–2009. When there is so little additional yield to be gained from investing in lower quality credits, risk management warrants a move toward higher-than-average quality in a municipal portfolio. Investors look to the municipal market for stability and tax-free income, not excessive risk and volatility.

Orange County: Concentration Risk

Orange County, California, is one of the wealthiest counties in the U.S. today – just as it was in December 1994, when it filed for Chapter 9 bankruptcy protection. An overleveraged county investment pool declined sharply in value as interest rates rose, leaving Orange County taxpayers on the hook. The key takeaway from this unexpected event was an appreciation for diversification in a portfolio. Because of the county's highly rated status at the time and the strong in-state demand for California bonds, many investors held concentrated positions either in California municipal debt or specifically Orange County credits. Unfortunately, several California municipalities that had invested in the pooled vehicle were also pulled into the uncertainty and price volatility of the bankruptcy. A broadly diversified investor slept well through the bankruptcy, while those with a concentrated municipal portfolio likely did not.

Lessons Learned, and Still Learning

There have been many lessons learned over these last decades, and there is little doubt that there will be many more. Egos should be left at the door and every good manager knows that money management is a team sport, where a broad diversity of thought, experience, background and perspectives is not just welcome, but essential for success. That is why we remain students of the markets and of history, and why everyone on the Baird team looks forward to getting just a little bit better at serving our clients' investment needs every day.