# Bigger Isn't Always Better

## And Other Lessons from the Muni Market

Baird Advisors

**Overview**

As investment managers, we spend our time constantly surveying the market to find the best relative value ideas for our funds and portfolios. Money has been pouring into municipal bond funds at a record pace and yields and credit spreads are at-or near-historic lows. The U.S. economy, already setting records for the length of the current expansion, shows no signs of turning negative and U.S. stock market indices, although more volatile this year, performed extremely well in 2019. At the same time, inflation remains below the Fed's 2% target as it has been for most of this cycle. After a modest dip, the Fed's balance sheet is expanding once again. The Fed stands ready to act, evidenced by recent policy statements that called out the escalation in the Iranian conflict and the spreading coronavirus as downside risks to their growth outlook. Finally, the consensus view seems to be: the expansion will continue, credit fundamentals combined with strong technicals should keep spreads near current levels, and interest rates may never go up again (okay, a little exaggerated, but not by much).

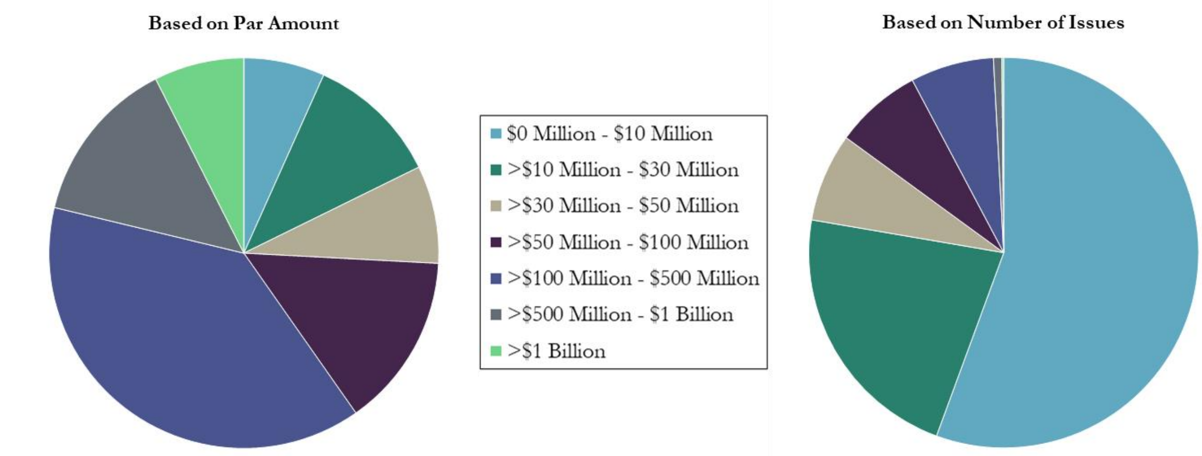
So, while there are still relative value ideas out there, we felt it was time to take a step back and ask ourselves what offers us a competitive edge in today's environment.

1) Size: Too-large of an asset base can be a disadvantage in the municipal market
2) Experience : Remembering that "pigs get slaughtered"
3) Prospective: Acknowledging the full impact of ESG/Sustainable initiatives on municipalities

**Bigger Isn't Always Better**

Over the last 10 years, the total size of the municipal bond market has stayed relatively stable at around $3.8 trillion. However, the amount of outstanding tax-exempt debt has actually declined, replaced by taxable municipal bonds (Finding Value in Taxable Municipals). At the same time, the amount invested in tax-exempt open/closed-end funds plus ETF assets has increased from $539 billion to $944 billion. In 2019, according to Electronic Municipal Market Access (EMMA), the average issue size was about $36 million and there were only 109 issues over $500 million. In today's market, it is not uncommon for an underwriter to receive more than $5 billion in orders for a $500 million deal. A simple pro-rata allocation would mean an investor that put in an order for the entire deal may only receive $50 million in bonds. While this sounds like a lot of bonds, for a $50 billion money manager, this equates to a 10 basis point (0.10%) position. You can quickly see how difficult it becomes for the largest money managers to not only source bonds, but also to buy meaningful positions in issues they find attractive. On the flipside, when mutual fund flows turn negative, raising cash becomes more difficult as the number of municipal dealers has declined and average dealer inventories have fallen as well.

**New Issuance by Size: January 2019 – December 2019**




Source: EMMA, Data as of: 12/31/19

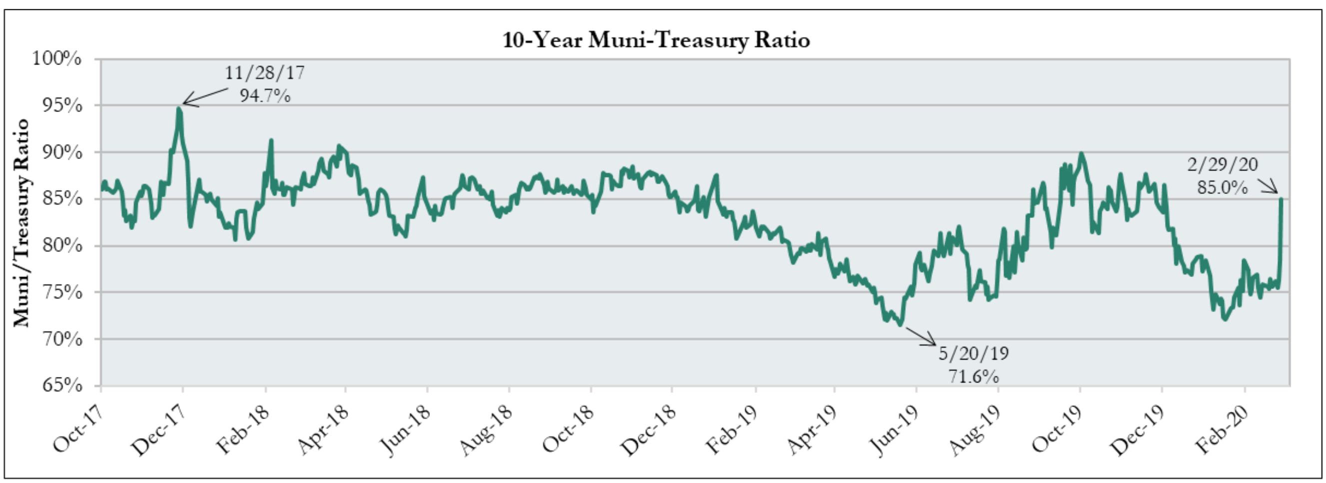
In today's municipal bond market, it's hard to pinpoint exactly what is the ideal size for a municipal bond manager. However, we do know the following characteristics apply to optimal-sized managers:

- **Good ideas** can be sourced in an **appropriate size**
- **Sufficient liquidity** in times of distress
- Can **selectively participate** in the new issue market
- **Ample resources** to analyze portfolios, structures, and credits
- **Strong dealer relationships** – tenure in the market or trading volume

Everyone knows the saying "size doesn't matter," but in the municipal bond market, we also know that being too large may actually make it more difficult to navigate the market.

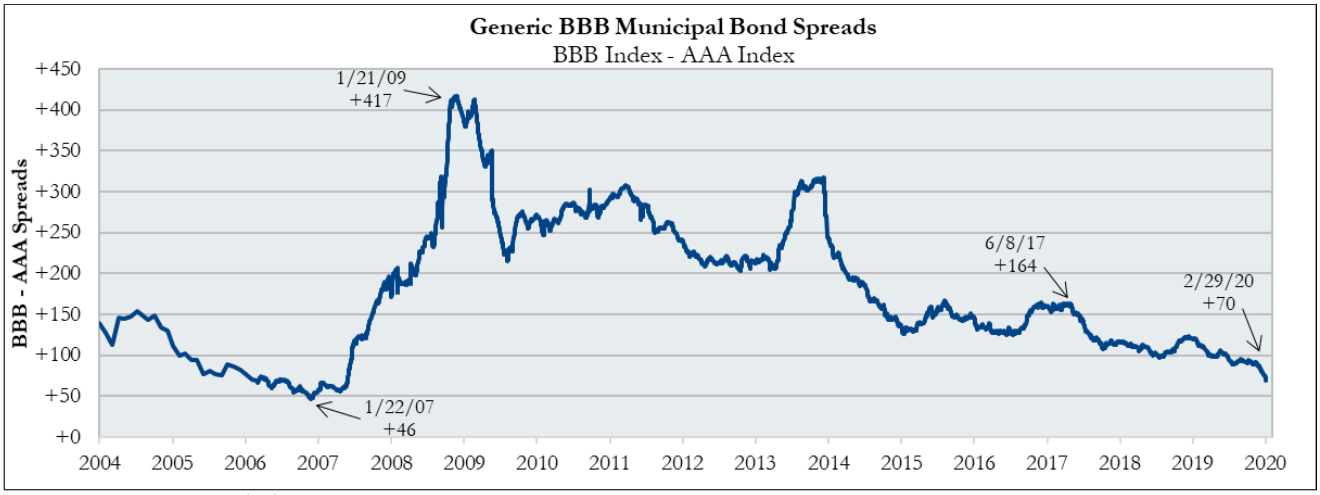
**Dotards Revisited** (Pigs Get Slaughtered)
Back in 2017, we published a white paper titled Dotards Unite!. It was our attempt at the time to defend the intelligence of municipal bond managers. In that paper, we discussed the merits of investing in the municipal bond market despite the much talked about pension issues facing many municipalities. We talked about why it may make sense to invest in certain municipal credits even in Illinois or New Jersey; states that had some of the worst pension funding ratios. We still believe municipal bonds remain attractive, especially on a tax-adjusted basis; however, with spreads at historically narrow levels, we also believe it makes sense to be a little more cautious when taking credit risk in the municipal market.

Credit fundamentals within the municipal market generally look solid. Tax receipts have been rising as the U.S. economy continues to grow at a modest pace, overall municipal debt outstanding has remained steady over the last 10 years, average rainy day funds are back above pre-recession highs, and demand has never been stronger (as measured by mutual fund flows). However, valuations look quite a bit different today relative to where they were in November 2017. 10-year AAA rated municipals yielded over 90% of U.S. Treasuries and had fallen below 80% in February.




Source: Bloomberg, Data as of: 2/29/20

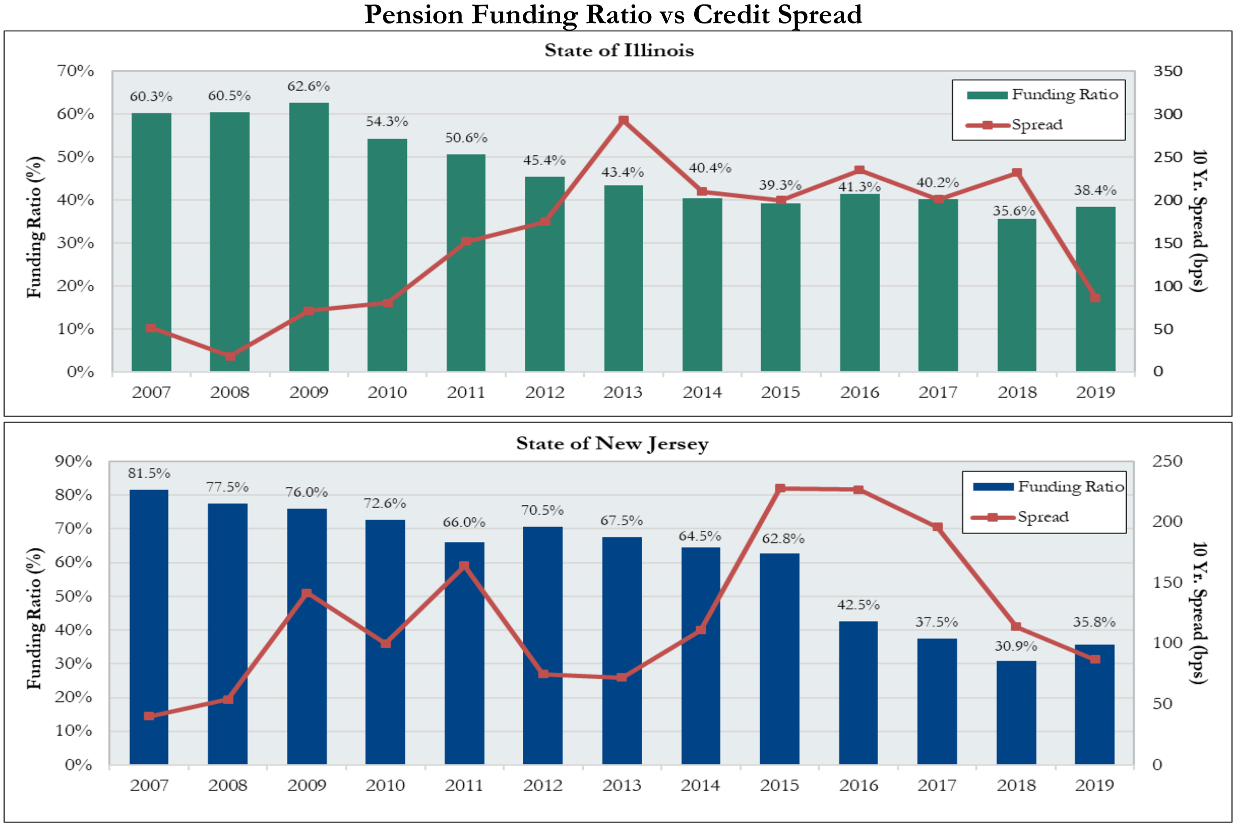
BBB rated municipal bond spreads have declined from about 164 bps to 75 bps over the last 3 years and are nearing pre-recession lows.




Source: Bloomberg, Data as of: 2/29/20

Credit spreads for some of the most challenged states-like Illinois and New Jersey-have declined dramatically even though their unfunded pension status has not improved. (In fairness to Illinois, they are seeking approval of a progressive income tax later this year, which, if implemented, would substantially increase revenues; however, they have shown no signs of addressing the 800 pound pension gorilla.)

**Pension Funding Ratio vs Credit Spread**




Source: Pew Trust, Data as of: 12/31/19

We are also seeing some signs of late-stage credit cycles: debt covenants becoming weaker, an increase in project finance transactions that have unproven revenue projections and no government guarantee (which tend to have higher default rates), a modest increase in the number of defaults and also a decline in the time between when a deal is issued and when it defaults.

As long-time municipal fund managers, it is hard to balance the income expectations of investors, with a risk control and relative value discipline, as money continues to pour into funds. At Baird, we have been slowly moving up in credit quality, while trying to maintain income levels by substituting structure risk for credit risk. Specifically, we have been buying AA or AAA rated municipal housing PAC (planned amortization class) bonds that have some cash flow variability, but offer yield spreads that are similar to BBB rated bonds. While we believe the *Forbes* article was wrong in 2017 when it labeled municipal bond fund managers Dotards, as we get further into this credit cycle we will see if managers lose "the ability to make rational sense." Remember the old Wall Street saying -- "Bulls Make Money, Bears Make Money, Pigs Get Slaughtered."

**Fifty Shades of Green**

A thought piece in today's world would not be complete without at least some mention of ESG or sustainable investing. One of our portfolio managers recently had a conversation with his brother who works for a large, coal-fired power plant. The employees received news a few weeks ago that the plant's owner was looking at either selling or, if they couldn't sell, shutting down the plant. Shutting the plant would displace about 1,000 workers. We are not looking to debate whether closing all coal plants is good or bad, but it made us realize that we, as investors, need to think about the ripple effects of what may be considered sustainable investing as we seek to better define/refine our investment processes. Will these 1,000 workers be retrained? How will this impact the local economy or funding for the local school districts? Will replacement power sources have any negative impact on the environment?

In some ways, we are fortunate to be municipal bond investors. An argument could be made that the majority of what gets financed in the municipal bond market checks many of the boxes for ESG/sustainable investing. The municipal market finances public transportation, public housing, various forms of education, improved water systems, not-for-profit healthcare systems, and various other issues that benefit the public as a whole. What shade of green you want to assign to each of these investments may vary by investor. While ESG/sustainability has always been a part of our investment process, as we go about refining our process to better measure the impact on each and every credit, we have to remember to not only think about the immediate impact, but what will be the secondary and tertiary impacts on other credits as well.

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