

The Municipal Market: Finding Yield in a Low-Yield Environment

By: SEI Fixed Income Portfolio Management

SEI Fixed Income Portfolio Management manages fixed-income strategies for SEI's Managed Account Program (MAP).

Finding yield in the municipal market has its challenges. Some days, it feels as if there is no yield to be found anywhere. In this environment, our job is to find yield without sacrificing credit quality or deviating from our process. There are two ways to accomplish this in a relatively easy fashion:

1. Lower your credit standards
2. Increase duration

Neither one of these options is acceptable. So what do we do? We adhere to our discipline and process by reaching out to our contact list of brokers across the bond-dealer community. Our objective is to find dislocations and, when they present themselves, take advantage of them. This can be a time-consuming, challenging and frustrating process in a low-yielding, illiquid market.

10-Year Municipals Richen

The yield on the 10-year Municipal Market Data AAA benchmark revisited its recent low of 1.95% during the first week in December as supply ran, pushing prices up and driving yields lower. These conditions made it challenging to add incremental yield in the 10-year space. Through our research, we identified a dislocation that presented an investment opportunity: We noticed that a particular credit issued by Farmington Independent School District was undervalued because of its lower underlying credit rating, which was A1. The credit is secured by the state's pledge of unlimited appropriation, and should have been priced at the state rating of Aa2 (which is a higher credit quality than the "single A"). The enhancement to the offering may have been easily overlooked in the absence of careful credit analysis.

We were able to purchase the credit on December 15, 2011 at a yield of 2.35%, or 40 basis points above the benchmark. We allocated this trade across 52 different client accounts. Our credit brief provides additional insight.

Credit Brief on Farmington Independent School District #192

The State of Minnesota is similar to many other states in the country in that there is a program established that provides credit enhancement for the purposes of supporting school districts' access to the capital markets. Similar programs exist in Pennsylvania and Texas. The programs were initially started to provide a level playing field between wealthy school districts and less affluent districts, as they all have the same capital needs over time.

From a functionality standpoint, under the Minnesota School District Enhancement Program, the bonds are secured by the state's pledge of an unlimited appropriation from its General Fund, should the event arise that a school district is unable to meet its debt-service obligations. If a district believes that it will be unable to make a debt-service payment, it is obligated to notify the State Department of Education which, in conjunction with the Commissioner of Finance, will issue a warrant and authorization for the payment to the paying agent. The District will be responsible for repaying funds in the form of state-aid withholding or a special school district levy, if necessary.

Because these types of programs are essentially pass-through general obligation pledges and appropriation-based, they are typically rated one notch below the State's general obligation rating, which in the case of Minnesota is Aa1. When evaluating credit for these issues, it is important to know the underlying details of the district that is borrowing. But it is even more important to be comfortable with the credit of the state that is supporting the bonds via the program.

Despite the negative trends in the economy and the budget gaps faced by Minnesota in 2010-2011, the State has been able to plug its budget gaps and bolster liquidity. Minnesota ended the fiscal year with a general-fund balance of \$3.2 billion, and has entered into a line of credit with U.S. Bank for \$600 million. This credit line should help in the event of another delayed shutdown of the state government. Minnesota benefits from its broad and diverse economy and income as well as wealth factors that exceed the national average at 109%. These factors, coupled with unemployment which has steadily tracked below the national average and a pension program funded at 88%, provide comfort with the underlying credit-enhancement pledge.

Credit Matters

Credit analysis is done for two primary reasons: (1) to help protect the portfolio from deteriorating credits where loss in principal is possible, and (2) to exploit the dislocations within the marketplace in an effort to create gains. The aforementioned situation highlights that credit analysis provided the portfolio the ability to receive increased yield, which translates into income for the investor. This scenario would likely not have been discovered without the combination of portfolio management and credit analysis.

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