Rather than focusing solely on a “reach for yield,” we believe investors should heavily weigh price stability/appreciation in their investment decision. In the current low interest rate, tight credit spread and flat yield curve environment, excess yield is often not commensurate with price risk.

The municipal bond market has staged an impressive and protracted rally. The strength has been driven by a macro-economic environment characterized by muddling economic growth and benign inflation. In a yield starved world, municipal bonds have been further buttressed by robust investor demand in the face of anemic new issuance. Municipal bonds have been considered a safe haven for tax-exempt income and preservation of principal. Investors have recognized the relatively attractive yields provided by municipal securities, as well as the high credit quality and diversification benefits when compared to riskier and more volatile fixed income assets and equities.

The by-products of this rally have included the lowest interest rates since at least 1960, a tax-exempt yield curve that is the flattest since the financial crisis and the richest credit spreads since 2007.

Muni-Bond Yield Curve flattest Since 2008

Heavy demand for higher-yielding securities has pushed longer term bond prices higher and yields lower

Source: Standish, Thompson Reuters as of June 30, 2016

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As interest rates declined, many investors have sought bonds with additional yield to bolster their portfolio's income production, with too little consideration of price risk. This reach for yield at record low rates and credit risk premia may cause investors to import unanticipated risk into their muni bond portfolios. The benefit of additional yield from longer maturities and/or lower quality can be quickly overwhelmed by negative price movement if muni valuations normalize.

For example, an investor who sells 5% of their $10 million portfolio maturing in 2 years and buys 10 year bonds, picks up $5,000 (0.0005% or 5 basis points) in income. Portfolio interest rate risk would increase, as duration would extend ¼ year. The entire $5,000 extra yield would be obliterated by a mere 0.002% or 20 basis points increase in rates.

Equally, credit risk provides limited cushion in today's market environment to mitigate the additional risk. Excess yield of BBB rated bonds only needs to rise by 0.001% or 10 basis points for the negative price movement to overwhelm the excess yield.

**Conclusion**

Standish believes that investors must be compensated for adding additional risk in the municipal market, and that risk/reward is challenged in the current environment. In order to preserve portfolio value, it is critical to focus on total return: income plus price movement. In Standish's view, a relatively high quality credit bias and moderate maturity risk is favorable.