Breckinridge
CAPITAL ADVISORS

PERSPECTIVES

TAKING THE MEASURE OF BOND LADDERS

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Breckinridge offers actively managed, investment grade fixed income strategies that strive to reach the investment and income goals of our clients. In managing client portfolios, Breckinridge seeks a diversified maturity and duration structure. In addition, its tax-efficient strategies focus on income generation and stress tax-efficiency throughout the portfolio management process. While these goals are similar to those of a municipal bond ladder, we view laddered strategies as unnecessarily restrictive in their approach. The restrictions can limit security selection, proactive trading, portfolio structure and, ultimately, opportunities to build or sustain investment returns.

Breckinridge believes that more flexible bond strategies can pursue similar objectives as ladders. In addition, we believe a strategy unencumbered by the restrictions we believe characterize ladder strategies may be more likely to capitalize on market opportunities and manage risk exposures by offering access to more bonds, trading tactics and portfolio structures. In this article, we will look at some of the key limitations of municipal bond ladder strategies.

HOW LADDERS GENERALLY WORK

Typically, ladder strategies set bond maturities at 6- or 12-month intervals over 5- or 10-year periods. Investors can expect to receive interest payments from bonds across all maturity steps in the ladder. In addition, investors expect bonds to return capital at maturity. Proceeds from maturing bonds are reinvested in a new bond added to the long end of the ladder's maturity structure. It is anticipated that this systematic and repeatable process could help investors mitigate impact of rising rates, create a diversified portfolio, and plan for potential income. However, these benefits can come with severe limitations.

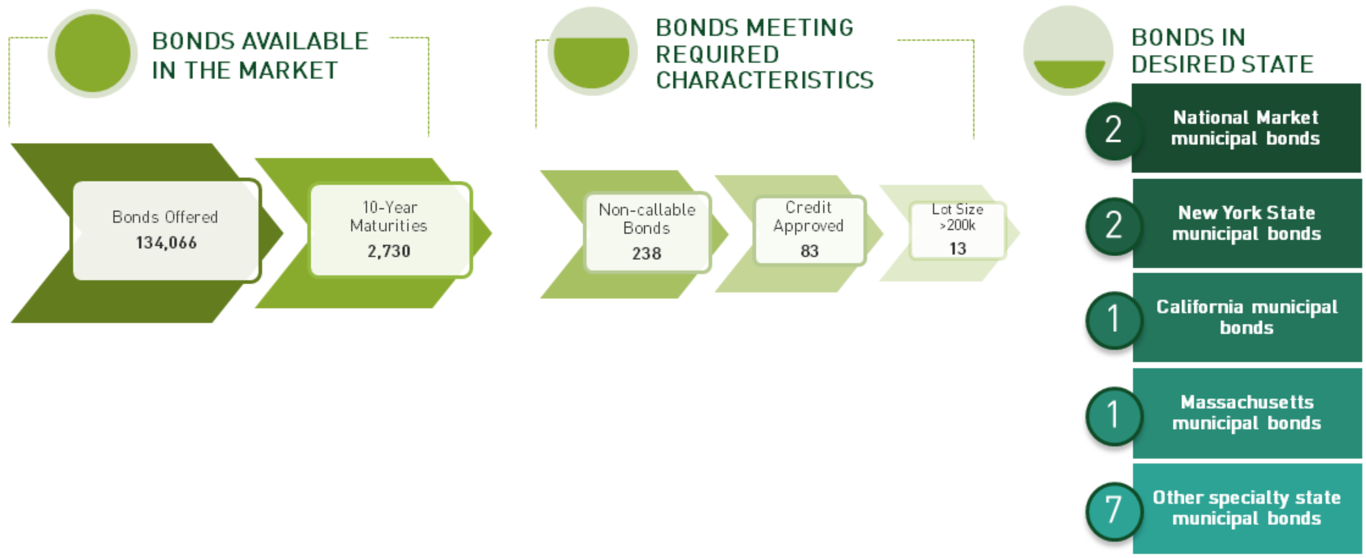
LADDERS MAY LIMIT SECURITY SELECTION

Selecting securities for ladders assumes that, at every maturity date, bonds with the desired characteristics will be available in the market at an appropriate price.
Based on the nature of the municipal market, this assumption can prove impractical at times, such as in cases when there are state-specific or state-biased requirements, for example.

Consider the example illustrated in Figure 1. As illustrated, on any given day, there are only a certain number of bonds with a 10-year maturity on offer in the municipal market. After determining the number of bonds available in the 10-year range, characteristics such as the state of issuance, credit quality, sector and issuer need to be considered in order to meet the criteria set forth by the ladder strategy. The series of limitations, along with the ladder's rigidity, particularly when investing for a state-specific or state-biased portfolio, could reduce suitable investment opportunities substantially.

FIGURE 1: AN EXAMPLE ILLUSTRATING HOW A LADDER APPROACH COULD LIMIT SECURITY SELECTION

A state-preference, 10-year municipal bond ladder strategy needs to replace a maturing 10-year bond at the end of the ladder. The illustration below shows the potential challenges when attempting to find a new bond to replace a maturing bond that would comply with the ladder strategy requirements.



This example is intended to provide an illustration of how security selection can be limited for one type of bond ladder strategy. It is not intended to represent all bond ladder strategies. The market conditions used were based on conditions on June 15, 2020. Market conditions will change and can have a significant impact on the results presented in this example. For this example, we are assuming a portfolio market value of $4 million and the investor is: (i) seeking to optimize after-tax income through "triple tax-free bonds" which are exempt from local, state and federal taxes and (ii) seeking bonds of investment grade (IG) quality. We also are assuming that the ladder's strategy requires the returned principal from maturing bonds must be reinvested in another 10-year bond (maturity between 05/15/2030 - 08/15/2030 to complement a theoretical maturity in early 2030).

Now consider the increased flexibility a bond strategy would enjoy if it is allowed greater optionality in selecting bonds. Rather than being restricted to adding a bond maturing in 10-years at the end of a ladder, for example, an active approach might choose to purchase a 12-year bond with a 10-year call option or two bonds with maturities bracketing the target 10-year maturity, as long as they also meet the investor's tax-exemption, income, credit quality, sector and other requirements.

One can logically expect that as the options available to the strategy increase, so too will the security selection choices. As more choices are available to the portfolio manager, the potential that the investor's objective can be reached more efficiently and with great flexibility may also increase. A broader security opportunity set also holds the potential of allowing adjustments along the way to accommodate evolving investor objectives in response to changing circumstances.

LADDERS MAY LIMIT PROACTIVE TRADING

Ladders typically limit reinvestment timing to redemption dates. From time to time, selling a bond before maturity or call and reinvesting the proceeds can capture value. Over the course of a year, the municipal market may experience a lack of supply and/or an increase in demand, potentially decreasing opportunity. The converse is true as well, as the municipal market can trend toward oversold, with more bonds for sale and fewer buyers for them, potentially increasing opportunity.

As such, the flexibility to sell a bond before maturity and purchase another bond can help to build or sustain income. Without trading the portfolio excessively, an active strategy can attempt to avoid expensive periods or take advantage of cheaper periods by being more attentive to the changing market conditions. A ladder, as a buy-and-hold strategy, would tend not to leverage opportunities or mitigate reinvestment risk through proactive trading.

LADDERS MAY CONSTRAIN PORTFOLIO STRUCTURE

In addition to limiting the number of securities available for purchase, a ladder also constrains the portfolio structure. Because a ladder is, by definition, an equally weighted portfolio, its profile along the yield curve does not change. Ladders invariably reinvest at the long end of their maturity limit, even when that maturity may not represent the best relative value or risk-adjusted return.

In contrast, active strategies can modestly adjust yield curve exposure, targeting a more bulleted or barbelled position, based on market conditions. Importantly, active structures at Breckinridge are not meant to represent a bet on the direction of rates and will always strive to be diversified. Rather, similar to trading more opportunistically, we believe that active structures can be utilized to help build or sustain income more effectively than a traditional ladder by making tactical adjustments in light of changing market conditions.

Questions to ask your ladder manager

Here are four additional questions to ask when considering a bond ladder strategy.

- Is the manager selecting and marking up bonds chosen for the ladder from its own existing inventory of bonds or purchasing bonds from the broader universe available in the municipal market each day?

- How is trading conducted by the manager? How broad is the network of dealers operating nationwide with whom the manager maintains relationships?

- What are the credit research capabilities of the manager of the bond ladder? Does the manager maintain its own credit research teams or relay solely or primarily on third-party research?

- How does the manager allocate bonds among its investors' accounts? If a bond available in limited supply is considered to be an appropriate investments for multiple accounts managed by the firm, how is the decision to allocate that bond across various accounts such as ladders, actively managed accounts, mutual funds, separate accounts or other investment accounts?

CONCLUSION

Similar to Breckinridge's tax-efficient strategies, ladders seek a diversified structure, income generation and tax-efficiency. Unlike Breckinridge's approach, they have a rigid structure that can limit their ability to adjust the portfolio according to market opportunities or risk factors. We believe an active investment manager can apply a disciplined approach to interest rate exposure that seeks diversity and consistency without the constraints of a ladder. While the restrictions that we believe are inherent in bond ladder strategies may suit some investor objectives, we believe they are not well suited to the municipal market's inefficiency and erratic supply.