



# Taking the Measure of Bond Ladders



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## KEY TAKEAWAYS

- While ladder investment approaches may be suitable for efficient investment markets (e.g.: Treasury bonds), we believe that inefficient markets are less appropriate for passive ladders.
- A municipal bond strategy unencumbered by restrictions that generally characterize ladder strategies may better capitalize on market opportunities and manage risk exposures.
- Breckinridge tax-efficient strategies focus on income generation and stress tax-efficiency throughout the portfolio management process.



Breckinridge offers actively managed, investment grade (IG) 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.

Breckinridge 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 municipal bond ladder strategies as unnecessarily restrictive in their approach.

A traditional municipal bond ladder approach may limit security selection, proactive trading, portfolio structure and, ultimately, opportunities to build, sustain, or enhance investment returns. While ladder approaches may be suitable for efficient investment markets (e.g.: Treasury bonds), we believe that inefficient markets like the municipal bond market are less appropriate for passive ladder management approaches.

Breckinridge believes a less rigid approach to municipal bond management can pursue objectives similar to ladder strategies while providing flexibility to opportunistically take advantage of changing market conditions. We view a municipal bond strategy unencumbered by the restrictions that generally characterize ladder strategies 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 Municipal Bond Ladders Traditionally Work**

Typically, ladder strategies set bond maturities at 6- or 12-month intervals over 5- or 10-year periods.

Investors count on receiving 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 new bonds added to the long end of the ladder's maturity structure. Investors are focused on bonds with the appropriate maturity and other characteristics.

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, especially when deployed for municipal bonds.

### **Municipal Bond Ladders May Limit Security Selection**

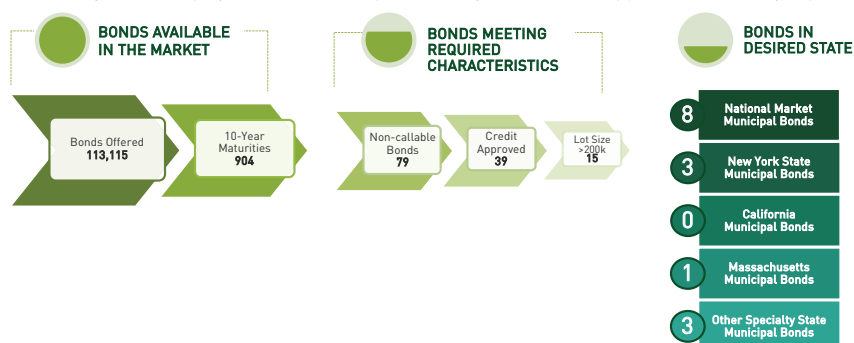
Selecting municipal bonds for ladders assumes that, at every maturity date, bonds with the desired characteristics will be available in the market at an appropriate price. Based on the nature of the municipal market, this assumption may prove impractical at times, such as in cases when there are state-specific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



**FIGURE 1: MUNICIPAL BOND LADDER DRAWBACKS: LIMITED 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.



Source: Breckinridge Capital Advisors, Inc., as of February 14, 2023.

This example is intended to provide an illustration of how security selection can be limited for one type of municipal bond ladder strategy. It is not intended to represent all bond ladder strategies. Data and market conditions are as of February 14, 2023. Data sourced from Breckinridge internal trading systems so it may not be representative of actual market data and what would be available to investors. Market conditions will change and can have a significant impact on the results presented in this example. For this example, we assumed 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 quality. We also assumed that the ladder's strategy requires the returned principal from maturing bonds to be reinvested in another 10-year bond. Any changes to these assumptions could change the results shown. All information is subject to change. There is no guarantee that either passive or active investing will achieve their objectives.

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.

Now consider the increased flexibility of a bond strategy that allows greater optionality in security selection. 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.

## Municipal Bond 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. Changing conditions in the municipal bond market can present opportunities to proactively trade to capture better relative values.

For example, 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, sustain, or enhance after-tax income. Without trading the portfolio excessively, an active strategy may be able to avoid buying bonds during times when prices are higher, or capture values when prices are lower.

A ladder, as a buy-and-hold strategy focused on periodic trading dictated by maturity structure, would tend not to leverage opportunities, or mitigate reinvestment risk through proactive trading as market conditions change over time.



### **Municipal Bond Ladder Approaches Can Limit Tax Management**

From our perspective, ladders frequently tout their tax-efficiency, as they typically would not sell securities and, thus, incur no capital gain or loss implications for the portfolio.

By contrast, there are three common tax-related tactics active managers can employ to improve the actual return or tax-efficiency on a bond portfolio.

First, actively managing a portfolio's in-state and out-of-state municipal bond holdings is commonly intended to enhance tax benefits and/or after-tax yield, depending on where the investor lives and the relative value of in-state bonds at any given time.

The second tactic is crossover trading strategies—when, for example, a Treasury bond's after-tax-yield exceeds the tax-free yield of a similar maturity municipal bond. With a municipal market that has not grown in over 10 years and a significant increase in demand for tax-exempt bonds over that time, it is natural to see more situations where a taxable bond could provide a better after-tax return.

Finally, active managers can harvest losses to gain potential tax advantages. Tax-loss harvesting entails selling securities at a loss to help reduce taxes on capital gains and/or ordinary income. For example, during a period of rising rates like 2022, a bond may be sold at a loss to provide capital for investment at a higher yield, while capturing a tax benefit. Careful tax-loss harvesting could reduce an investor's overall tax burden while potentially improving an investor's after-tax rate of return. As ladders don't sell bonds until maturity, they eliminate the potential benefits of tax-loss harvesting.

In managing municipal bond portfolios, we seek to be attentive to situations that may optimize returns, including after-tax returns over time.

### **Municipal Bond Ladder Arrangements May Restrain 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.

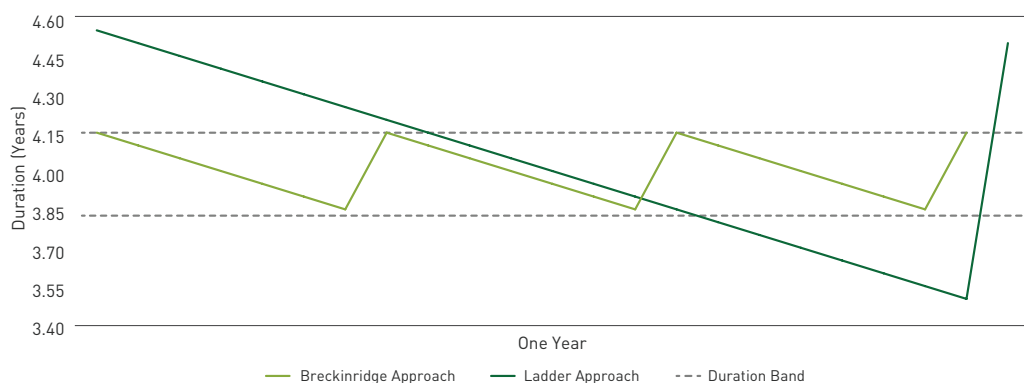
Breckinridge historically has not bet on the direction of rates and has sought diversification. Rather, similar to trading more opportunistically, we believe that active structures can be utilized to effectively help build, sustain, or enhance income by making tactical adjustments to holdings characteristics in light of changing market conditions.

### **Municipal Bond Ladders May Influence Duration**

Municipal bond ladders, by the nature of their traditional portfolio structure and security trading approach, may cause portfolio duration to swing significantly due to the timing of maturities. Lack of duration management can result in significant portfolio dispersion. Exhibit 2 does not present actual portfolios or investment strategies. It is intended to illustrate a potential difference in duration approaches between an actively managed portfolio management approach and a passively managed municipal bond ladder portfolio approach. There are numerous active and ladder approaches available to investors, and those strategies may perform differently than as shown in the illustration.



FIGURE 2: COMMON DURATION TOLERANCE FOR A 1-YEAR PERIOD

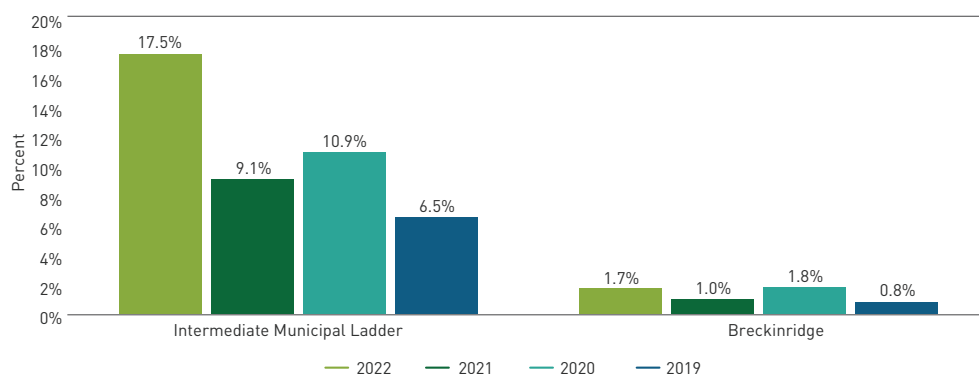


Source: Breckinridge Capital Advisors, Inc.  
The graph is intended to illustrate a potential difference in duration approaches between an active approach (Breckinridge Approach) and a passive approach (Ladder Approach). They do not represent actual portfolios or investment strategies. This illustration does not represent all active or laddered strategies. In fact, there are numerous active and laddered approaches available to investors, and those strategies may perform significantly different than what is shown.

A more active approach to municipal bond portfolio management can potentially limit duration volatility, when compared with more passively managed municipal bond ladders. Actively managed municipal bond portfolios offer the opportunity to establish a tighter duration band around a maturity target intended to meet a client's income needs.

Based on an examination of data sourced from eVestment and Breckinridge internal systems as of 12/31/2022, Exhibit 3 is intended to illustrate the dispersion between an intermediate municipal bond ladder composite and Breckinridge's actively managed intermediate tax efficient composite. As illustrated, the dispersion of returns for the actively managed composite is lower in each of the years from 2019 through 2022.

FIGURE 3: COMMON DURATION TOLERANCE FOR A 1-YEAR PERIOD



Source: Data sourced from eVestment and Breckinridge internal systems as of 12/31/2022. The graph is intended to illustrate the dispersion between an Intermediate Municipal Ladder Composite, specifically Parametric's Intermediate Ladder Composite, and Breckinridge's Intermediate Tax Efficient Composite. Parametric's Intermediate Ladder Composite was chosen for comparative reasons as this composite had durations and average credit quality most like those of Breckinridge's Intermediate Tax Efficient Composite. However, there will be differences in each composite's investments, limits and restrictions, objectives, risks, number of accounts and other factors that could contribute to other dispersion differences. Dispersions were calculated by limiting the composites to just portfolios that remained in the composites for a full calendar year and calculating the difference between the minimum and maximum portfolio returns. All information is subject to change and shown gross of fees. Past performance is not indicative of future results. There is no guarantee that Breckinridge's approach will achieve its investment objectives. All investments involve risk, including the loss of principal. Diversification cannot assure a profit or protect against loss. No investment or risk management strategy can guarantee positive results or risk elimination in any market.

## Questions To Ask a Municipal Bond Ladder Portfolio Manager

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

- Is the manager selecting and marking up municipal 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 municipal bond dealers operating nationwide with whom the manager maintains relationships?
- What are the municipal bond credit research capabilities of the manager?



- 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 investment 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, passively managed municipal bond ladder strategies seek a diversified structure, income generation, and tax-efficiency. Unlike Breckinridge's active approach to portfolio management, their structure can be considered more rigid, which can limit their ability to adjust 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 municipal bond ladder strategies may suit some investor objectives, we believe they are not well suited to the municipal market's inefficiency and erratic supply.



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Equity investments are volatile and can decline significantly in response to investor reception of the issuer, market, economic, industry, political, regulatory or other conditions. In addition, when interest rates rise, equity investments, including dividend-paying securities, may become less attractive to investors as bonds and other fixed-income investments may offer higher yields. There is no guarantee that a company will continue to pay, increase or declare a dividend.

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Breckinridge's ESG analysis is based on third party data and Breckinridge analysts' internal analysis. Analysts will review a variety of sources such as corporate sustainability reports, data subscriptions, and research reports to obtain available metrics for internally developed ESG frameworks. Qualitative ESG information is obtained from corporate sustainability reports, engagement discussion with corporate management teams, among others. A high sustainability rating does not mean it will be included in a portfolio, nor does it mean that a bond will provide profits or avoid losses.

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