Breckinridge CAPITAL ADVISORS

When to Bench the Municipal Bond Benchmark

Authors

CHRIS DAY
HEAD, INTERMEDIARY DISTRIBUTION

Key Takeaways

- *Investors in municipal bond strategies should exercise caution when using indices to set portfolio structure or performance targets.*
- *Benchmarks offer a birds-eye view of asset classes to compare relative value, and they provide historical context for performance. However, they have their limitations.*
- *In Breckinridge strategies, we aim to preserve capital and to create a reliable income stream with customized tax efficiencies for our clients.*

To find the most appropriate benchmark for a strategy, investors and managers typically aim to use an index closely aligned to the strategy's characteristics while representing the return trends of an asset class.

Most major indices for heavily traded, liquid assets such as equities or corporate bonds tend to rely on characteristics such as market capitalization, market sector or market prominence and trading volume to determine constituents.

It is worth noting that it is not possible to invest directly in an index. That is why passive investment strategies seek to replicate a bond benchmark index like the BBG Aggregate Bond Index or the BBG Municipal Bond Index.

A challenge for individual investors is the impracticality of trying to hold all of the securities in the index in proportions that match the index's changing weightings. In addition, unlike equities, fixed income indices over time increase weightings to issuers with higher debt burdens—the opposite of what fundamental analysis usually dictates. Finally, changes in a key index characteristic such as duration can further complicate the comparability of a benchmark and a portfolio, as we will review with regard to a common municipal bond index.

For these reasons, bond investors must exercise caution when selecting and using indices to set portfolio structure target or performance expectations.

In this piece, we compare the composite for the Breckinridge Intermediate Tax-Efficient Strategy (the Strategy) and its primary benchmark, the Bloomberg Barclays 1-10 Year Blend (1-12) Municipal Bond Index (the Index). Note that individual portfolios within the Strategy may differ from the composite and the Index. Thus, the results presented in the comparison may be very different from a comparison of an individual portfolio with the index.

Breckinridge vs. the Index

For our tax-efficient strategies, performance may differ from their benchmarks. First, the relevant indices are not investable, so holding all of the securities in the same proportions of the index is a challenge. Second, we intentionally structure our strategies differently from the benchmark in some respects.

For example, we typically invest in investment grade issuers with credit ratings of at least A- or better at time of purchase. We seek to own bonds with less call risk and to maintain exposure to states and sectors in more customized allocations than many indices. The index, in contrast, includes lower-rated bonds and a broader representation of bonds across sectors and security features, some of which we may not find attractive given our philosophy and mandate.

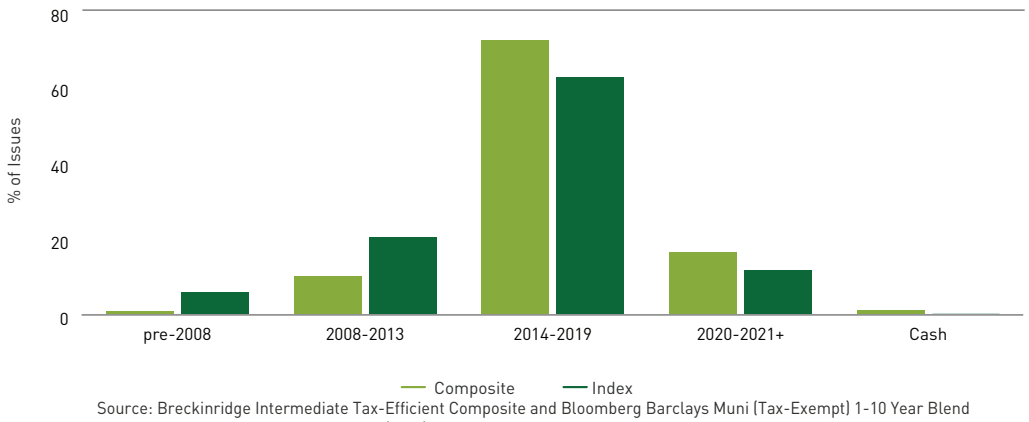
To provide a deeper understanding of these differences, we detail characteristics of the Index and the Strategy below.

Security Availability

Index: The Index is not investable and contains many bonds too infrequently traded for reliable pricing. Illustrating this point, roughly 11 percent of the Index par value has traded year to date as of March 31, 2021, a statistic that is relatively consistent across other municipal indexes.[1] The Index consists of over 30,000 bonds, and almost half of the bonds were issued more than five years ago (Figure 1), reducing the likelihood of frequent trading for those securities.

Breckinridge: The Strategy seeks to invest in securities with more-recent issue dates than the Index and adequate liquidity based on their likelihood to trade.

FIGURE 1: PRE-2013 ISSUES ARE MORE PROMINENT IN THE INDEX THAN THE STRATEGY



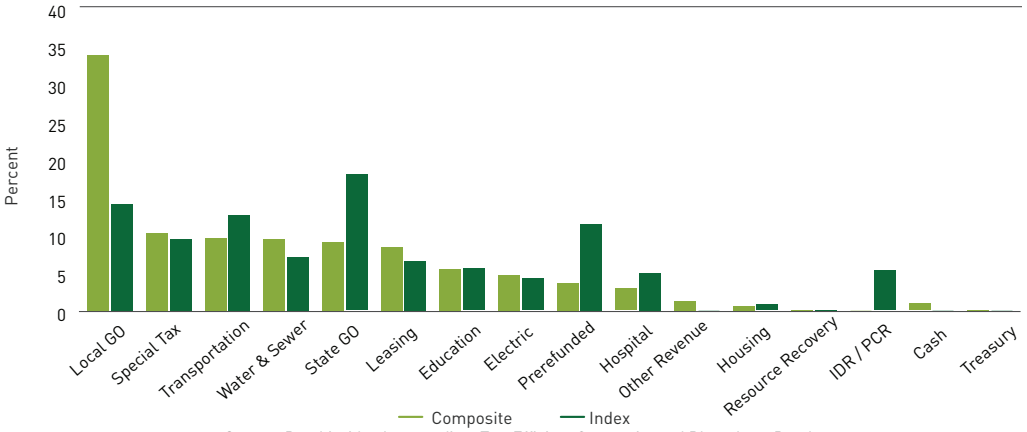
Source: Breckinridge Intermediate Tax-Efficient Composite and Bloomberg Barclays Muni (Tax-Exempt) 1-10 Year Blend (1-12) Index, Prices as of March 31, 2021.

Sector Exposure

Index: It has meaningfully larger exposure to what are traditionally considered riskier sectors, such as industrial development and tobacco bonds. Additionally, given the market weighting of the Index, it tends to have more exposure to sectors such as state general obligation (GO) bonds, which comprise large issuers.

Breckinridge: We emphasize investment grade assets and completely avoid some riskier sectors that the Index holds (such as those mentioned above). We are also generally overweight essential-service bonds due to our investment grade mandate. Finally, since we focus less on issue size than the Index, the Strategy has a significantly lower weighting to state GO's and a higher weighting to local GO's—especially in state-biased portfolios where we strive for diversity among in-state issuers (Figure 2).

FIGURE 2: BRECKINRIDGE WEIGHTS LOCAL GOS HIGHER, STATE GOS LOWER VS. THE INDEX



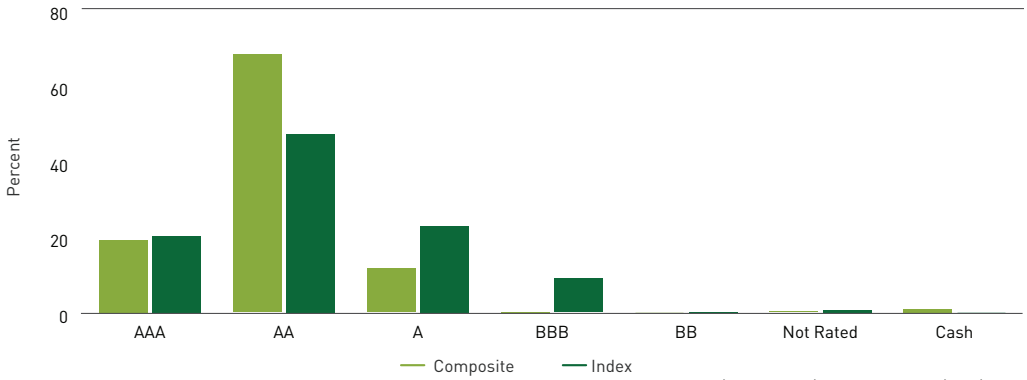
Source: Breckinridge Intermediate Tax-Efficient Composite and Bloomberg Barclays Muni (Tax-Exempt) 1-10 Year Blend (1-12) Index, as of March 31, 2021.

Credit Exposure

Index: It generally owns a higher percentage of A rated and BBB rated bonds versus the Strategy.

Breckinridge: The Strategy is weighted to AA names with a limited allocation to A and BBB credits. The Strategy invests selectively in names meeting our strict standards of credit quality (Figure 3).

FIGURE 3: BRECKINRIDGE RATING DISTRIBUTION IS HIGHER QUALITY THAN THE INDEX



Source: Breckinridge Intermediate Tax-Efficient Strategy and Bloomberg Barclays Muni (Tax-Exempt) 1-10 Year Blend (1-12) Index, as of March 31, 2021.

Note: Portfolio figures reference ratings of Moody's Investors Service and S&P Global Ratings. If Moody's and S&P provide different ratings, the chart references the lowest of the two ratings. Index figures reference Bloomberg Barclay's Quality.

Callability

Index: It has significantly more exposure to bonds with longer maturities and shorter call dates.

Breckinridge: While we buy callable bonds, we tend to limit exposure to bonds with longer maturities and shorter call dates. In our view, these types of callable bonds introduce two main risks:

- Call risk: If interest rates fall, bond issuers will be more likely to call a bond and reissue debt at the lower rates available in the market. This could reduce the bond's effective duration and disrupt expected cash flows.
- Extension risk: By contrast, if interest rates rise, bond issuers will be less likely to call a bond. This could sharply increase the bond's effective duration and cause it to lose value and liquidity rapidly.

State

Index: It is heavily exposed to issuers from California or New York due to large issuance volumes in those states (Figure 4).

Breckinridge: State exposure is managed on the individual account level. For instance, we commonly customize portfolios to invest in state-biased municipal bonds. Conversely, for national market portfolios, we focus on bonds from states with lower (or no) state income taxes.

FIGURE 4: STATES WITH TOP ISSUANCE VOLUME HAVE HIGHEST INDEX WEIGHTING;

	Issuance Volume	Percent of Bonds held by Index*	Percent of Bonds held by Breckinridge**
California	15%	16%	1%
New York	11%	14%	7%
Texas	11%	9%	17%
Illinois	4%	5%	3%
Florida	4%	4%	10%
New Jersey	3%	4%	1%
Massachusetts	3%	3%	2%
Maryland	2%	3%	2%
Pennsylvania	4%	3%	2%
Ohio	3%	3%	4%
Washington	3%	3%	8%
Arizona	2%	2%	3%
Colorado	2%	2%	2%
Connecticut	2%	2%	1%
Georgia	2%	2%	1%
North Carolina	1%	2%	1%
Virginia	2%	2%	2%
Alabama	1%	1%	3%
Kentucky	1%	1%	1%
Michigan	2%	1%	2%
Nebraska	1%	1%	1%
Nevada	1%	1%	2%
South Carolina	1%	1%	1%
Wisconsin	2%	1%	3%
District of Columbia	1%	1%	2%
Tennessee	1%	1%	2%
Hawaii	1%	1%	2%
Iowa	1%	0%	2%
Other- (11 at ~1% of composite each.)	11%	7%	11%
Other- (12 at <1% of composite each.)	2%	1%	3%
Cash Equivalent	NA	0%	1%

Data represents the average from January 1, 2015, through March 31, 2021.
*Index refers to the Barclays Muni (Tax-Exempt) 1-10 Year Blend (1-12) Index.
**Breckinridge refers to the Breckinridge Intermediate Tax-Efficient Composite.

Transaction Costs

Index: It does not account for transaction costs. Index turnover is done without cost at evaluated prices despite the average transaction cost per bond for intraday trades being 122 basis points in 2020.[2] Therefore, Index performance has a decided but hidden advantage by not including them. By the same token, any Breckinridge composite will be at a disadvantage versus the Index, because the transactions all include embedded costs.

Breckinridge: We account for and manage transaction costs. With more than $37 billion of exposure in municipal bonds as of March 31, 2021, we work with an extensive network of broker dealers which supports our best execution efforts.

Taxes

Index: Indices do not consider the tax consequences of removing bonds and for holding alternative minimum tax (AMT) securities if a client is subject to the AMT. Additionally, the Index does not account for individual tax considerations.

Breckinridge: We seek to maximize after-tax income and tax efficiency,[3] including exclusions to AMT bonds. We also consider the tax advantages or disadvantages a client may encounter by investing in particular states. For many clients, the tax-free income is the most important feature of municipal bonds. For other investors, having exposure to taxable municipal bonds is another way of potentially increasing portfolio yield in that segment of the municipal bond market.

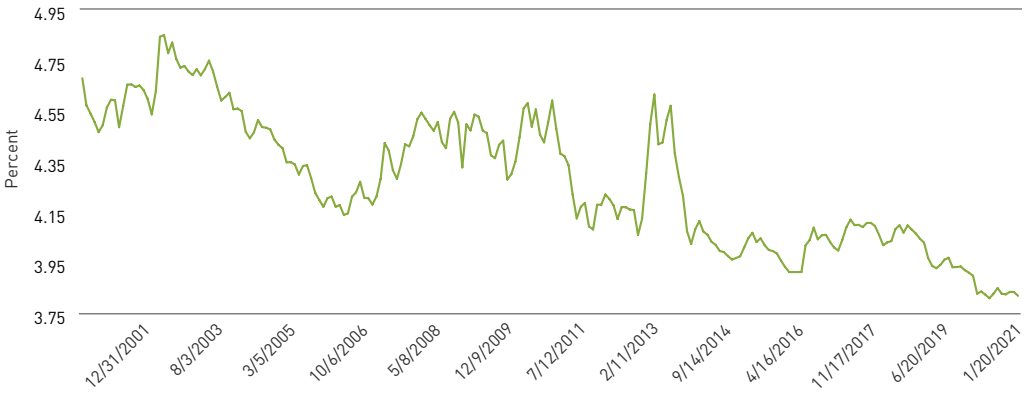
In addition, tax-loss harvesting and tax swaps, two proactive portfolio strategies, are available in actively managed strategies that are not offered in passively managed or index strategies.

Duration

Index: Duration is a key risk factor that that can be actively managed. For example, a bond with a one-year duration would only lose 1 percent in value if rates were to rise by 1 percent. In contrast, a bond with a duration of 10 years would lose 10 percent if rates were to rise by that same 1 percent. Conversely, if rates fell by 1 percent, bonds with a longer duration would gain more while those with a shorter duration would gain less. Duration of unmanaged indexes change—sometimes substantially—as influenced by market conditions. For example, among other factors, index duration is governed by changes in the amount and composition of new-issue supply. Figure 5 illustrates a fairly consistent shortening of duration for the BBG Managed Money Short Intermediate (1-10) Municipal Bond Index and the BBG 1-10 Year Blend (1-12) Municipal Bond Index during the last two decades.

Breckinridge: Breckinridge actively manages duration, building portfolios with exposure to bonds across the yield curve as appropriate to the strategy's stated maturity objective. By doing so, portfolio managers seek to hedge risks of both falling and rising rates.

FIGURE 5: OPTION-ADJUSTED DURATION



Source: Bloomberg Barclays data from December 31, 2001 through January 29, 2021.

Liquidity

Index: It has no liquidity costs to manage.

Breckinridge: We try to ensure ample liquidity of holdings to meet clients' cash needs and to execute our investment strategy. Breckinridge invests in what has historically been the most liquid part of the municipal bond market: investment grade securities from sectors such as GO and essential revenue bonds.

Strategic Positioning When Investors Need it Most

In our strategies, we aim to preserve capital and to create a reliable income stream with customized tax efficiencies for our clients. These goals supersede the aim to mirror relevant benchmarks, especially given that the benchmarks do not adequately represent the available municipal market, the risk profiles of many of our clients or the allocation that will maximize risk-adjusted, after-tax income for them. Simply put, while we want to outperform the benchmark, we do not let it dictate our management.

By design, Breckinridge tax-efficient strategies offer investment grade positioning, allowing us to potentially outperform during "risk-off" periods when broader markets are falling. In our view, the times when risk is out of favor are precisely when investors need this investment grade mandate the most.

In some respects, benchmarks are useful. They offer a birds-eye view of asset classes to compare relative value, and they provide historical context for performance. However, benchmarks have their limitations. For some asset classes, such as municipal bonds, benchmarks can be less useful because they can neither adequately represent actual trading activity and market composition nor match the risk tolerances and investment objective of many clients.

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FOOTNOTES:

1. Breckinridge Capital Advisors and the Municipal Securities Rulemaking Board (MSRB), as of March 31, 2021.
2. MSRB. The spread reflects the average difference between dealer purchase price and sell price per bond (face value of $1,000) for intraday trades. For illustrative purposes, a $1 spread on a bond purchased by a dealer at par $100, would be a sale price of $100.1 (or $1001.00 per bond). The MSRB figure is an average of the individual differences between all buys and sales of the same CUSIP on the same day and is not par weighted. The result excludes Breckinridge cross trades, trades where the spread of the buy/sell is negative, 0 or above 20 points, and trades where the coupon is null. Such trades have been excluded to eliminate potential data input errors and the presence of floating-rate bonds, which do not have spreads (i.e., they trade at par). Since large buy/sell spreads (i.e., over 20 points) are not common, we have excluded these as they may signal a reversal of price and yield, or some other type of error in data entry.
3. Breckinridge is not a tax advisor and does not offer tax advice.