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Why Should My Clients Pay a Fee for Managed Municipal Bonds?

Many advisors have avoided fee-based municipal bond managers, preferring to build laddered bond portfolios for their clients from their firm's inventory or retail bond trading platform. In today's highly competitive, low yield environment, paying a fee to a bond manager seems counterintuitive to many advisors.

The municipal bond landscape has changed dramatically since the financial crisis, making it more difficult, in our opinion, for individual advisors to effectively build portfolios. The regulatory environment has also changed, raising significant new issues involving client suitability and potential advisor liability. Additionally, there are a growing number of cost-effective professional management options, many offering client-tailored portfolios.

In this paper, we examine some of the reasons advisors have retained oversight and trading in their clients' bond portfolios, and why moving to managed bond portfolios may be in the best interest of both the client and the advisor.

Reasons for Building Clients' Portfolios Yourself

Many advisors have traditionally built their clients' municipal portfolios themselves. Years of experience in municipal bonds lend some advisors a comfort level that this piece

of the client's overall allocation is the "easy part." Some advisors may believe they can buy bonds and forget about them. Laddered municipal portfolios seem straightforward, and advisors often work on platforms that give them reasonable access to a steady supply of bonds. Advisors often express some combination of the following to us:

- Munis are easy – I buy high quality general obligation or revenue bonds and hold them until they mature.
- I buy local issuers that I know will be fine.
- I keep a close eye on trading levels and I know I get good pricing.
- Yields are too low to pay a management fee.
- My overall fees are more competitive if I do that part myself, for free.
- My firm has good access to municipal bonds at competitive yields.
- Yields are too low to own bonds. I'm positioning my clients in fixed-income alternatives like master limited partnerships, high yield funds, or income-producing alternatives.

These perspectives may have applied in the past, but we believe that there have been

fundamental changes in the municipal bond market that should lead advisors to re-think their approach.

What is different about today's municipal market?

The market for municipal bonds has changed dramatically since 2007. We believe the financial crisis and subsequent recession transformed the municipal landscape in a number of key ways:

1. Municipal bonds are harder to buy and sell.

The supply of municipal bonds has shrunk. Despite historically low rates, the annual issuance of new tax-exempt municipal bonds has declined substantially from the peak levels of 2007. As a result, the total value of municipal bonds outstanding has begun to shrink in recent years after expanding rapidly throughout the 1990s and 2000s. At the same time, new regulations on banks have resulted in a decline in the amount of bonds that dealers hold for trading. According to Federal Reserve statistics, dealer inventories have shrunk by 54% since 2010. As a result, it can be harder to buy and sell bonds, causing bid/ask spreads to be much wider than they were in past years.

Also, tax-exempt alternatives are disappearing for investors in high tax, low supply states. Puerto Rico and its agencies (triple-tax-exempt options in all fifty states) are on the verge of default, leaving residents of so-called "specialty states" with, in our opinion, few alternatives to replace scarce state tax-exempt bonds. Without access to the larger institutional marketplace, advisors

may find it hard to buy in-state bonds at attractive prices for these clients.

2. Bond pricing in the municipal market can penalize small investors.

In a January 2012 study, the U.S. Government Accountability Office (US GAO) found that individual investors buying and selling municipal bonds generally trade at much less favorable (retail) prices than institutional investors.¹ The study found that the price individual investors pay for bonds is an average of 2.21% higher than the price paid by an institutional investor to buy the same bond on the same day. Anecdotally, over our more than 20 years in the muni market, we have seen retail investors charged mark-ups far higher than 2.21%, and these have not been isolated instances.

While this phenomenon is not new to the municipal market, it is becoming increasingly visible to individual investors. With the advent of online trade reporting through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA, <http://emma.msrb.org>) web site, individuals can now see municipal market trades in almost real time. For example, savvy investors can see the bond they bought for \$101.00 was traded between institutions earlier the same day for \$99.50, which can raise difficult questions for advisors.

3. Municipal credit quality is more important than ever.

From the early 2000s through 2007, approximately 50% of all newly issued municipal bonds were sold with guarantees from AAA-rated municipal

bond insurance companies. Municipal investors came to depend heavily on the uniformity of AAA insured bonds, in many cases forgoing any analysis of the underlying issuer itself due to the comfort level provided by the insurer's guarantee. When the bond insurance sector collapsed in 2008, many investors and advisors were left to assess the underlying credit risk in their portfolios. Without any insurance wrap, municipal bonds now trade based on the credit quality of the issuer pledge and the bond structure. While investors have bond ratings to help guide them, these are an incomplete measure of investment risk, and advisors and investors must do their own analysis to determine credit risk and appropriate valuations. Additionally, many bond ratings are stale, with three or more years passing between issuers' rating reviews. This means advisors and investors have no current third-party measure of credit quality.

At the same time, high profile defaults have shaken up the landscape. Detroit's bankruptcy has raised questions about the sanctity of the G.O. pledge that have yet to be answered. The Detroit and Jefferson County, AL defaults have also threatened utility revenue bonds and have raised concerns over the erosion of credit quality in many states and cities. Thus, we believe thorough, ongoing credit analysis is now more important than ever in the municipal market.

4. Increased advisor liability and potential new standards for determining suitability.

If volatile rates lead to client losses on a position, or if a credit event causes a

holding to default, advisors now face the potential for greater liability. In July 2012, FINRA implemented a new suitability rule (FINRA Rule 2111)² that places more responsibility on advisors to know their clients, to know the securities they recommend, and to document that the overall portfolio is suitable for that investor. Rule 2111 requires that a firm or associated person "have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer." Under the new rule, not only must the advisor have a reasonable basis to believe that a particular bond is suitable at the time of purchase, but he or she must also monitor that it remains suitable for the entire holding period. The rule also requires that a series of transactions or an investment strategy be suitable in its entirety for that particular customer for the entire period that it is in place. FINRA's commentary on Rule 2111 specifically mentions a laddered bond portfolio, directing that not only must each bond be evaluated as suitable, but the portfolio and its expected performance as a whole must also be suitable for that client. Furthermore, the advisor must document this suitability assessment and their ongoing due diligence.

How do I justify to my client paying a fee to a bond manager?

Advisors rarely thrive by simply offering the lowest fee. Advisors attract and keep good clients because they offer them high quality advice and service. In today's municipal market, the best service may be to hire a professional bond manager. With a

manager structuring portfolios, investment risk for both the investor and the advisor is mitigated, with returns net of fees that can equal or better self-managed portfolios. Hiring a manager may be the most cost-effective fixed income solution.

It seems intuitive that buying bonds for your clients independently would be a lower cost alternative than using a municipal bond manager. However, your client may actually save a considerable amount of money by using a professional bond manager due to the cost of bond trading incurred in the “retail” market.

Let’s use the example of a prospective client who has \$250,000 to invest in a municipal bond portfolio (please see the disclosure for important information).

Scenario A – Buying individual municipal bonds

Client initial investment	\$250,000
Average retail mark-up on individual bonds ¹	X 2.21%
Client’s portfolio cost, Year 1	\$5,525

Scenario B – Using a municipal portfolio manager

Client initial investment	\$250,000
Fee of a managed municipal portfolio	X 0.25%
Client’s portfolio cost, Year 1	\$625

* Ascent’s maximum fee, included for comparison purposes only

The client’s advantage in year one from using the managed municipal portfolio - \$4,900

In the above example, the client would experience a substantial benefit in the first year from using the managed municipal portfolio. Without considering reinvestment savings, the client would enjoy the benefit of ongoing credit due diligence for nearly nine years before the cost of using a manager exceeded the savings realized on the initial bond purchases.

Additionally, because the client would put nearly \$5,000 more of their money to work up front, they could be able to generate additional incremental income each year in the portfolio. Assuming the client reinvests interest and principal repayments, a 10-year ladder could save the client an additional \$552.50 every year (\$25,000 matured principal reinvested x 2.21%) going forward, almost fully offsetting the annual cost of the managed portfolio.

Conclusion

Financial advisors face the difficult task of managing clients’ wealth in an increasingly complex investment landscape. At the same time, they must cope with a regulatory framework that continues to become more stringent. Portfolio strategies and investment solutions that were successful in the past may no longer be optimal, or even workable. Municipal portfolios, for example, long thought of as the easy part of a client’s overall investment strategy, now require far more attention.

Moving your clients to a managed bond account could help navigate this new regulatory and market environment, while potentially lowering costs. We believe this win-win prospect makes it a good time to consider making the transition.



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¹ United States Government Accountability Office, GAO-12-265, "Municipal Securities: Overview of Market Structure, Pricing, and Regulation," January 2012.

² Financial Industry Regulatory Authority, Regulatory Notice 12-25, "Suitability: Additional Guidance on FINRA's New Suitability Rule," May 2012.

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Please note that example(s) provided herein are for informational and illustrative purposes only. Said examples are included in order to showcase the potential differences between managing a client's municipal bonds yourself (incorporating a 2.21% mark up that is said to be the average retail mark-up on individual bonds according to US GAO) and engaging a municipal bond manager (incorporating Ascent's fee for such services for comparison purposes only). Said example is merely an example and contains data that could vary from situation from situation. Please conduct your own due diligence in determining whether utilizing a municipal bond manager is in the best interest of your particular client(s) as nothing herein takes into account any

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