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MUNIS AREN'T TOO HEAVY IF YOU BALANCE THE WEIGHT

By Christine Albano

Sheila King, portfolio co-manager and fixed income research analyst at Eagle Asset Management, is finding a way around the relatively high prices in the short end of the municipal market to deliver tax-exempt returns to her conservative clients.

"The front end of the market looks rich in comparison [with Treasurys], especially in the one- to two-year area," said King, co-portfolio manager of Eagle's Fixed-Income Tax Advantaged and Fixed Income portfolios.

The potential for continued richness doesn't spook King, a portfolio manager who invests in many segments of the fixed income market to achieve capital preservation and diversification for her clients. She manages $800 million in assets in the firm's Tax Advantaged and Fixed Income portfolios.

Eagle is an affiliate of Carillon Tower Advisers, which has over $64 billion of assets under management and advisement.

While King remains cautious on the richness, she is actively managing a barbell strategy — buying bonds in a short and longer maturity and placing no weight in the maturities in-between. The strategy typically benefits from diversification and less risk while offering the potential to obtain higher returns as proceeds of the shorter bonds can be reinvested at higher rates.

Sheila King, co-portfolio manager and analyst at Eagle Asset Management, uses a barbell strategy to find value for her conservative clients.

The short-term bonds provide liquidity and flexibility since they roll over as they mature.

King constructs her barbell strategy using three- and four-year maturities on one end and seven to 10-year paper on the other, she said.

While she said that strategy lagged in 2018, King still feels comfortable using it in the remainder of the first quarter of 2019.

"I think that is still a good place to be with a continued roll down and turnover fairly low," King said.

At Eagle, she is also the co-portfolio manager of Tax-Aware Fixed Income strategy, which is diversified with a mix of assets that consists of 47% municipals, 24% corporates, 14% mortgages/asset-backed securities, and 13% Treasurys and Agencies. The remainder is in cash.

"I have a lot of different sectors I can invest in," she said. If municipals start to get "very rich, I'm not afraid to sell that and look elsewhere — either corporates or Treasurys or longer on the muni curve," where there is select value in the 20- to 30-year range.

Municipal managers and strategists acknowledge that the short and intermediate sector of the yield curve remains rich relative to taxable comparisons due to the heavy investor demand and lack of supply, yet the market has outperformed.

King observed that the continued growth of separately managed account demand on the short end of the yield curve is contributing to the richness.

"Richer relative value ratios illustrate the point that munis continue to become more expensive compared to UST given the technical landscape," Jeffrey Lipton of Oppenheimer & Co. Inc. wrote in a March 6 weekly report.

As of March 12, the 10-year ratio was at 78%, while the 30-year was at 95.4%, according to Municipal Market Data.

Strategic planning

After 31 years with the firm, King has seen many different types of municipal markets, from advantageous to volatile and everything in between.

"If munis become richer I can certainly find value in other markets, but right now I continue to like munis," she said. The market is "still attractive, even though there might be some richness in the percentage of Treasurys. You can still find value in certain names. The market technicals are strong and new issuance is driving the first quarter so far. If we continue to see large demand over the next two quarters, munis are going to continue to perform well."

For instance, as of March 1, the 10-year triple-A municipal-to-Treasury yield ratio dropped to a multi-year low of 79% and the average 10-year triple-A muni yield declined to 2.17% — a 13-month low, Anthony Valeri, portfolio manager at Zions Bancorp, noted last week.

Municipals have still outperformed their Treasury counterparts so far in 2019 and have shown good resilience to modest global government bond weakness, Valeri said.

Compelling municipal technicals continue to temper any weakness in overall fixed-income bond prices, resulting in tax-exempt outperformance, Lipton wrote in his report.

Much like the Fed, King is data-dependent on the economic front, and is "positioned comfortably" for the remainder of the first quarter and beyond, she said.

"Just as the Fed is, we are looking at economic numbers coming out of China and Europe and certainly seeing slowing there," King said.

That data-dependent view will help identify any needed changes in her barbell strategy.

"If there is expanded growth, we would want to be a little more conservative," waiting for yields to increase due to inflation fears, she said. "If we start to see yields increase and prices dropping, we would sell our shorter duration and buy value on the long end if it became available."

Eyeing value, minimizing risks

Part of King's strategy is owning securities for long-term, after-tax returns. She cautions higher tax bracket clients against taking short-term gains due to higher tax consequences.

"We are confident knowing we are not taking untold risks," she said. "We are focused on a conservative agenda and we are not looking to hit home runs in the fixed income market."

Eagle Asset Management's Tax-Aware Fixed Income strategy has returned 2.69% over a 5-year period, 3.97% over a 10-year period, and 5.02% since inception, as of Dec 31, 2018, beating its benchmark over each period, according to data provided by Eagle.

In a fairly stable market environment, King said she focuses on keeping the turnover rate to a low of 30% to 35% in her portfolios.

"If the market is more volatile that gives you more opportunity to do more trading, and we will do that" if value presents itself, she said.

With a conservative approach to capital preservation as her goal, revenue-backed bonds, such as those backed by sales and property taxes, for instance, are currently on her radar screen as she views them as stronger than state and local general obligation bonds.

For instance, she recently purchased higher education revenue-backed bonds for their attractive spread of 32 basis points to the 2030 yield to maturity, and 71 basis points — as well as 100% of the Treasury yield — to the 2026 yield to call.

The bonds, which are rated A1 by Moody's Investors Service and AA-minus by Fitch Ratings, benefit from five years of positive operating performance and has stable enrollment and strong overall coverage of debt by student fees.

King said she is avoiding states like New Jersey, Kentucky, Connecticut, Illinois, and Pennsylvania, which are facing pension issues.

"We want to make sure states are being responsible on a budget standpoint and pension front," she explained. "It's very important, or states end up paying a lot more yield."

She said she is underweight state and local bonds — and avoiding those troubled municipalities — in lieu of states with solid financial positions, such as Washington, Texas, and Florida, and credits with stability and upgrade potential, such as airports, transportation, and special tax bonds from other states, she said.

King is also highly selective in the hospital sector, and prefers multisite hospitals in states with growing population levels over riskier single-site facilities from less populated states.

Fed forecast

King said she wasn't rattled by the January decision by the Federal Reserve Board to pause interest rate hikes.

"We were already thinking only one hike or two max in 2019, and we were positioned for that," she said, giving a nod to her barbell strategy.

The Fed's decision, she said, "really doesn't change what we were thinking already at the last quarter" and added that "the Fed came our way."

King said the Fed adopted a neutral stance in the fourth quarter and that was "the start of the 180" in their tightening pause — something Eagle expected.

The firm recognized Treasury yields at 3.25% as "the highs of the year" back in the fourth quarter.

"We knew it likely would go through 3% and probably hit 2.85%, but it was amazing how fast it happened," King said, noting that the same yield dropped to 2.55% by Jan. 3.

She said the Fed's pause, leading to less pressure and uncertainty clouding the market, may benefit munis and Treasurys, boosting confidence for retail investors in the backdrop of a slowing economy.

"Munis typically are more defensive versus corporates and other fixed income sectors, and with the economy slowing, municipals retain their value," she said.

The threat of rate increases typically spooks retail investors, King said. "Feeling the fed is on hold for a while you will see retail flow back into the market," she said, pointing to a reversal of fund flows as money came into muni funds after the January Fed announcement. "Retail investors are starting to be calmed knowing the Fed is on hold for a while, due to less uncertainty."

As the end of the first quarter nears, King said investors should look for value and take advantage of municipals' low volatility, while also monitoring fund flows and potential price richness on the short end.

She advised investors to stay fully invested and keep cash to a minimum.

"There's a lot of demand for munis and if you're sitting on a lot of cash you will have a hard time buying bonds at a good value."

Disclosure

A statement in the above article omits important information in its description of Carillon Tower Advisers' assets under management and advisement. Here is the correct information: Carillon Tower Advisers and its affiliates (ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management – a division of Scout Investments, and Scout Investments) together have a total of approximately $64 billion in assets under management and advisement as of Jan. 31, 2019. The breakdown of those assets is as follows: ClariVest Asset Management: $7.3 billion; Cougar Global Investments: $1.2 billion; Eagle Asset Management: $30 billion; Reams Asset Management $20.6 billion; Scout Investments: $5.4 billion.

The above article makes reference to performance of the Eagle Tax-Aware Fixed Income strategy. Eagle outperformed its benchmark for the 5-year, 10-year and since inception time periods on a gross basis. On a net of fees basis, the strategy underperformed the benchmark (Please see the gross and net performance versus the benchmark below).

Quarterly Performance as of December 31, 2018

		Fourth Quarter	Year to Date	One Year	Three Year	Five Year	10 Year	Since Inception (Jan. 1, 1993)
Eagle Tax-Aware Fixed Income	Gross	1.63%	1.11%	1.11%	2.06%	2.69%	3.97%	5.02%
Eagle Tax-Aware Fixed Income	Net	1.42%	0.25%	0.25%	1.20%	1.84%	3.13%	4.18%
60% Bloomberg Barclays Int. Gov/Credit /40% Bloomberg Barclays Seven-Year Municipal Index		1.80%	1.19%	1.19%	1.77%	2.31%	3.35%	4.84%

Composite data shown gross and net of fees as of Dec. 31, 2018.
The performance data quoted represents past performance. Past performance does not guarantee future results. Investment return and principal value will fluctuate so that an investor's portfolio, when redeemed may be worth more or less than their original cost. Current performance may be lower or higher than the performance information quoted. To obtain current month-end performance information, please call your financial advisor or visit eagleasset.com

Performance Disclosures

Income earned from investments in municipal bonds, while exempt from federal taxes, may be subject to state and local income taxes. All capital gains, as well as income earned from other sources, are subject to taxation. Income from municipal securities may also be subject to the Alternative Minimum Tax. Municipal securities typically provide a lower yield than comparably rated taxable investments in consideration of their tax-advantaged status. Investments in municipal securities may not be appropriate for all investors, particularly those who do not stand to benefit from the tax status of the investment. Please consult an income-tax professional to assess the impact of holding such securities on your tax liability.

Past performance does not guarantee or indicate future results. No inference should be drawn by present or prospective clients that managed accounts will achieve similar performance in the future. Investment in a portfolio, investment manager or security should not be based on past performance alone. Because accounts are individually managed, returns for separate accounts may be higher or lower than the average performance stated. Individual portfolio/performance results may vary due to market conditions, trading costs and certain other factors, which may be unique to each account. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market. Investing involves risk and you may incur a profit or a loss. Investment returns and principal value will fluctuate so that an investor's portfolio, when redeemed, may be worth more or less than their original cost. Diversification does not ensure a profit or guarantee against a loss.

All performance data is shown on a time-weighted and size-weighted basis and is shown before (gross) and after (net) the deduction of management fees, custodial fees and miscellaneous charges to client accounts; all performance is shown after transaction costs. Calculations include reinvestment of all income and gains. Performance figures include all internal, retail Tax-Aware Fixed Income accounts of Eagle Asset Management, a St. Petersburg, Florida-based firm. A client's return will be reduced by the advisory fees. Eagle's fees are set forth in Eagle's Form ADV, Part II. Over a period of five years, an advisory fee of 1 percent could reduce the total value of a client's portfolio by 5 percent or more. Investing in equities may result in a loss of capital. Current performance may be lower or higher than the performance information quoted.

All composite performance data through 2017 have been verified by an internationally recognized accounting firm. Performance data for 2018 and the current year have not been audited and subject to revision. Thus, the composite returns shown here may be revised and Eagle will publish any revised performance data. Eagle believes that the performance shown is reasonably representative of its management style and is sufficiently relevant for consideration by a potential or existing client.

Risks Associated with Fixed Income Investing

Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration). The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody's and Standard & Poor's. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities (see below for a discussion of the risk associated with convertible securities). However, the overall return on Government bonds tends to be less than these other types of fixed-income securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

Convertible securities and preferred stock may be subject to greater risk than pure fixed-income instruments as they do not have a fixed par value at maturity. Investments in high-yield bonds and convertible securities are subject to the client's authorization, as set forth in the Investment Management Agreement. Such investments may be subject to greater risks than other fixed-income investments, if the financial condition of the issuer or adverse changes in general economic conditions impair the ability of the issuer to pay income and principal. Periods of rising interest rates or economic downturns may cause highly leveraged issuers to experience financial stress, and thus markets for their securities may become more volatile. Because no established secondary market exists, there may be thin trading of high-yield bonds, which increases the potential for volatility.

Index Descriptions

The benchmark for Tax-Aware Fixed Income accounts is a blend of 60 percent Bloomberg Barclays Intermediate Government/Credit Index and 40 percent Bloomberg Barclays Seven Year Municipal Index. The Bloomberg Barclays Intermediate Government/Credit Index represents the intermediate component of the U.S. Government/Credit Index. The Bloomberg Barclays Seven Year Municipal Index is the seven-year component of the Municipal Bond Index. The index is referred to for comparative purposes only and the composition of an index is different from the composition of the accounts included in the performance shown. Indices are unmanaged and one cannot invest directly in the index.

About Eagle Asset Management

Eagle Asset Management, an affiliate of Carillon Tower Advisers, provides a broad array of fundamental equity and fixed income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.

About Carillon Tower Advisers

Carillon Tower Advisers is a global asset management company that combines the exceptional insight and agility of individual investment teams with the strength and stability of a full-service firm. Together with our partner affiliates – ClariVest Asset Management, Cougar Global Investments, Eagle Asset Management, Reams Asset Management (a division of Scout Investments) and Scout Investments – we offer a range of investment strategies and asset classes, each with a focus on risk-adjusted returns and alpha generation. Carillon Tower believes providing a lineup of institutional-class portfolio managers – spanning a wide range of disciplines and investing vehicles – is the best way to help investors seek their long-term financial goals.

To learn more about the Eagle Tax-Aware Fixed Income Strategy, visit eagleasset.com

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