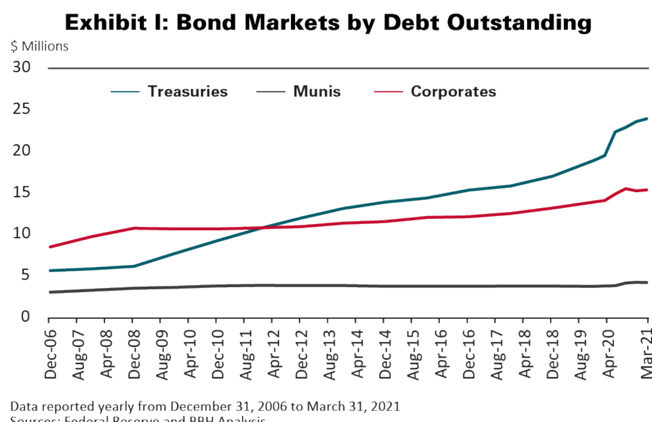
BBH Strategy Insight

August 2021

Good Things Come to Those Who Wait

For the past decade, the size of the municipal bond market has remained relatively stable, while other major bond market sectors have grown rapidly (see Exhibit I). Ongoing Federal fiscal budget deficits have prompted a dramatic increase in Treasury borrowing. Corporations have ramped up their bond issuance as well to fund stock buybacks, avoid the repatriation of overseas profits, and finance mergers and acquisitions, among other reasons. In comparison, the muni market has been left in the dust. Following the Global Financial Crisis (GFC), many states and local governments operated in a more fiscally conservative manner to help their finances recover (a good thing!). These government entities have also faced the burden of pensions and related benefit obligations consuming a growing portion of their resources, which constrained the funds available for new projects. In 2017, the Tax Cuts and Jobs Act introduced a major new limiting factor – the prohibition of tax-exempt advanced refundings.

Exhibit I: Bond Markets by Debt Outstanding



Data reported yearly from December 31, 2006 to March 31, 2021
Sources: Federal Reserve and BBH Analysis

Municipal refunding is a process by which an issuer either redeems or defeases older, more expensive debt with the proceeds from a new bond that has a lower interest cost. There are two types:

Current Refunding: Occurs within 90 days of when bonds are scheduled to mature or when they become callable

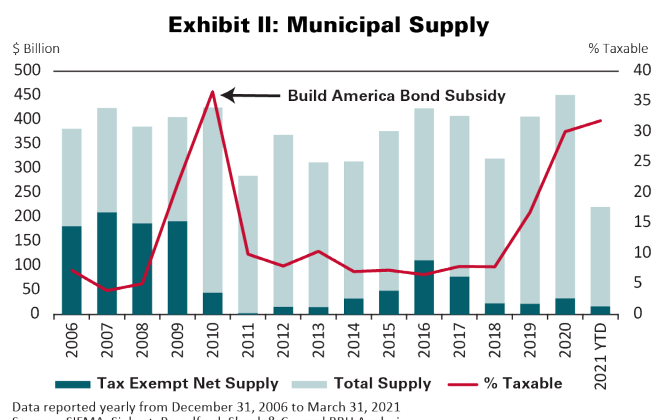
Advanced Refunding: Occurs prior to 90 days of when bonds are scheduled to mature or when they become callable, commonly three-to-five years earlier

Prior to 2017's tax reform, issuers had a one-time option to advance refund by issuing new tax-exempt debt. This flexibility was eliminated in the reform act as politicians sought to eliminate the tax expenditure† associated with refunding activity. Prior to reform, an advanced refunding transaction would leave two tax exempt muni bonds outstanding for the same project:

1) The new bond
2) The older, defeased bond (the "pre-re", short for pre-refunded)

Today, municipal issuers can still advance-refund, but they need to issue taxable bonds to do so. Prior to the tax law change, tax-exempt advanced-refundings were a major source of municipal supply, comprising 25% of total new issuance, on average. Today, advanced refundings are still a major driver of supply, but now of *taxable* municipal bonds, leaving the traditional tax-exempt market with a dearth of issuance (see Exhibit II).

Exhibit II: Municipal Supply



Data reported yearly from December 31, 2006 to March 31, 2021
Sources: SIFMA, Siebert, Brandford, Shank & Co, and BBH Analysis

But, leave it to creative public finance bankers to find a small loophole in the form of delayed-delivery bonds. Typically, municipal new issue bonds settle in less than a month. In contrast, delayed-delivery bonds usually settle in four-to-twelve months. This means a municipality may issue tax exempt debt now and take advantage of current rates, but

† A tax expenditure represents foregone government income such as from tax credits, tax exclusions (such as for traditional municipal bonds), tax deductions (such as from charitable contributions), and preferential tax rates (such as for long-term capital gains).

not settle the bonds until a future date that falls within the 90-day current refunding window.

Delayed-delivery bonds present some unique challenges that limit the size of the potential buyer base for the securities. We often find opportunities in areas of the market in which participation is limited. In this case, broker-dealers often apply their own credit constraints on the investors permitted to participate in these deals because of the extended settlement periods. In one instance, only public mutual funds and ETFs were allowed to participate. We have also faced situations in which investors do not wish to hold unsettled positions on certain statement dates and others who impose limits that govern maximum delay periods.

From an investment perspective, these bonds possess all of the credit and interest rate risk of normal bonds, but without any income during the delay period. In order to entice demand for these securities, issuers must offer a price discount, or additional yield that only begins accruing after settlement. We look to our valuation process to help us judge whether this additional yield is simply adequate, or attractive.

Whenever we approach a potential opportunity, we first must get comfortable with the credit profile of the issuer before thinking about valuation math. The basic question with delayed delivery bonds is whether the extra yield that the securities offer once they settle adequately compensates for the foregone income and accounting challenges during the delay period.

Exhibit III shows two examples. We purchased the State of California bond, but passed on Cleveland Clinic.

Exhibit III: Municipal Bond Activity

	Identifier	State of California	Cleveland Clinic
Maturity date	A	9/1/2029	1/1/2029
New issue date	B	4/21/2021	7/15/2021
Settlement date	C	9/1/2021	10/5/2021
Delay period (yrs)	= C - B	0.36	0.22
Short-term yield	E	0.03%	0.03%
Yield for a comparable bond	F	0.83%	0.86%
Fair value for delayed settle bond	G	0.87%	0.88%
Actual yield for Delayed Delivery Bond	H	1.08%	0.90%
Yield Difference	= H - G	21 bps	2 bps

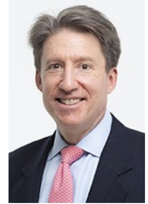
Data reported as of June 30, 2021
Source: BBH Analysis
Identifiers correspond with the characteristics in the first column and are used to illustrate the basis for our calculation.

In a longer-term context, we viewed the base spread of 8 basis points for the double-A rated State of California as fair, and the extra yield associated with the forward delivery as quite attractive. Excess yield of 21 bps for an eight-year bond, implies that the new issue price was 1.5 points below its fair value. In the second example, even though Cleveland Clinic is a fine credit that we have owned before, we viewed the base spread of 20 bps as expensive compared to its longer-term spread range, and not offering a meaningful discount attributable to the bond's forward delivery.

One aspect of delayed delivery bonds that we find attractive is that the return potential associated with the discounted new issue pricing should be realized by settlement date. Said differently, the price discount should disappear as the settlement date approaches... you just have to wait. At this point, we have the option of selling the bond, or holding onto it, but in either case portfolio returns have benefited.

Unlike a year ago when most of the market was on sale, finding attractive values in today's muni market has become more difficult as credit spreads have approached record lows and the investors have faced a supply / demand imbalance. At today's valuations, it is clear that many investors have moved down in credit quality or into longer maturities in pursuit of yield. In contrast, we have increasingly invested in securities with non-standard coupon structures to enhance yield without compromising credit quality or exposing our portfolios to undue interest rate risk.

For us, delayed delivery bonds offer similar benefits – high quality, intermediate-maturity bonds with greater return potential… all you have to do is wait.



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RISKS

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax.

For more complete information, visit www.bbhfunds.com for a current Fund prospectus. You should consider the fund's investment objectives, risks, charges and expenses carefully before you invest. Information about these and other important subjects is in the fund's prospectus, which you should read carefully before investing.

Shares of the Fund are distributed by ALPS Distributors, Inc. and is located at 1290 Broadway, Suite 1000, Denver, CO 80203.

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