

BBH Strategy Insight

November 2022

Taxable Municipal Bonds – A Little-Known Complement for Investors

Bond yields have surged this year as the Federal Reserve (Fed) continues to fight a surge in inflation. Following many years of monetary policy suppression, fixed income valuations have become much more attractive. With all the attention on inflation, Fed tightening, and rising rates, we would like to shine a light on taxable municipal bonds, a growing, and often overlooked sector. Taxable municipal bonds offer an excellent way to diversify broader taxable bond portfolios through high-quality, durable credits* that frequently offer higher yields than comparably-rated corporate debt. Strong credit resiliency further bolsters the case for taxable municipal debt in the face of ongoing economic uncertainties. BBH portfolios often include allocations to taxable municipal bonds based on their attractive risk-adjusted return benefits and the more efficient portfolio outcomes they help create.

First of All... Taxable Munis?

The Tax Reform Act of 1986 placed a limitation on the purpose type for which municipal bonds could be sold tax-exempt, thus paving the way for federally taxable municipal bonds to emerge. These types of issues generally provide for pension funding, working capital, and refunding of tax-exempt debt. Build America Bonds (BABs), Recovery Zone Economic Development Bonds, and Qualified School Construction Bonds were introduced via the American Recovery and Reinvestment Act of 2009. These types of issues are federally taxable municipal bonds where issuers receive direct payments from the U.S. Treasury to subsidize their interest costs. The Tax Cuts and Jobs Act of 2017 provided another catalyst for taxable issuance by eliminating tax-exempt advance refunding transactions. Even though the overall size of the municipal market has remained steady for the past decade, the taxable portion of it has grown steadily. Currently, taxable bonds comprise 21% of the outstanding municipal market, up from 14% at the end of 2017.

Exhibit I shows that the taxable municipal market has grown to over \$800 billion outstanding, and it offers prospective investors a large and deep market to gain meaningful exposures.

While the taxable municipal market has grown to a size that can command the attention of investors, it pales in comparison to the size of the corporate bond market as shown in Exhibit II. As we will demonstrate, the municipal market offers persistently higher credit spreads and lower historic default rates than similarly-rated corporate bonds. The taxable municipal market remains capacity constrained with niche opportunities, causing traditional investors to overlook the market for a variety of reasons, including a lack of familiarity, perception of inexperienced issuers, and separation of municipal teams from corporate teams at many firms.

BBH has successfully operated in the taxable and tax-exempt municipal markets for decades by investing the firm's capital alongside our institutional and private clients. Our municipal team is co-located side by side with other fixed income professionals, allowing us to share a common philosophy, investment approach, and actively collaborate on opportunities. For these reasons, we believe BBH is a compelling partner for investors seeking to understand the evolution of the taxable municipal market and how it can help improve the outcome of portfolios.

Exhibit I: Taxable Municipal Debt Outstanding

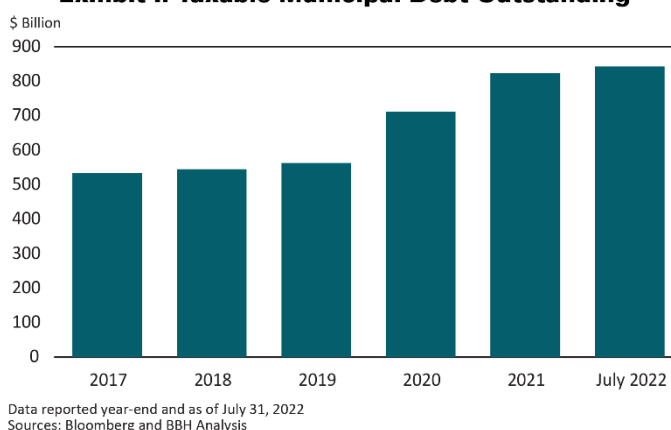
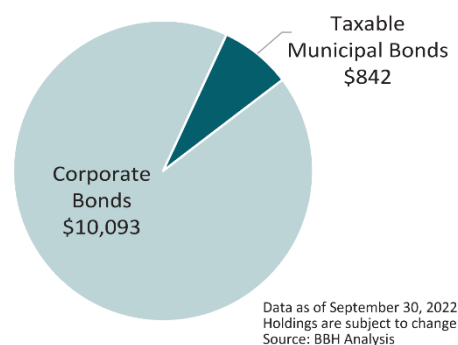


Exhibit II: Amount Outstanding (\$ Billion)



Why Should You Care?

The taxable municipal market has provided higher returns than investment-grade (IG) corporate bonds while exhibiting substantial correlation benefits when paired with corporate bonds. High-grade corporate bond investors should seek allocations to taxable municipal bonds to potentially enhance returns and reduce risk.

Exhibit III shows that taxable municipal bonds have persistently offered higher credit spreads than comparable quality corporate bonds. We attribute this to the difference in relative size between the markets, the erratic historical issuance pattern of taxable municipal bonds, and investors unfamiliarity with the municipal market. While liquidity in the taxable municipal market has improved, it remains well below that of the high-grade corporate bond market. Earning higher yields for accepting lower liquidity is an important part of our investment strategy that requires a long-term orientation.

Of the major credit sectors, municipal bonds possess the strongest credit resiliency, which we view as particularly important in today's environment. Municipal bonds are a major funding vehicle for public policy, and many are backed by revenues from essential services or derived from critical infrastructure. Consequently, the municipal market has a much higher credit quality orientation than corporate bonds. Exhibit IV illustrates how the municipal market contrasts from the high-grade corporate market by credit rating, with the municipal market offering an overall higher average credit quality.

Municipal bonds have experienced extremely low default rates, and generally demonstrate less volatility than Corporates. As Exhibit V shows, municipal bond defaults have been lower than corporate bond defaults for each respective credit rating category.

Exhibit VI shows the historical volatility exhibited by intermediate maturity taxable municipal bonds has fallen between the volatility of intermediate maturity Treasuries and intermediate maturity A-rated corporate bonds.

We believe the risks to investors are not dissimilar to those of IG corporate bonds, where we have demonstrated that credit spreads persistently offer compensation above and beyond credit losses. Additionally, municipal bond historical losses and volatility have been less than corporate bonds.

Exhibit III: Taxable Muni vs. Corporate "A or Better" Spreads

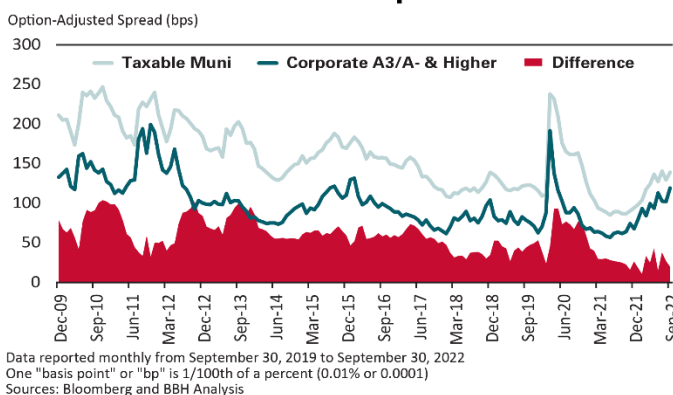


Exhibit IV: Index Credit Rating Distribution

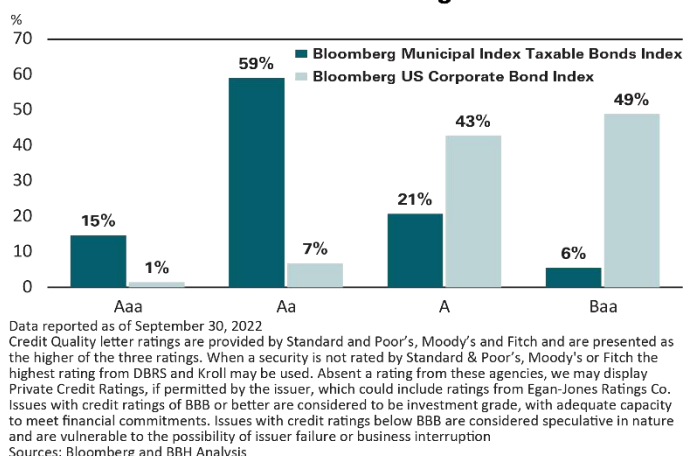
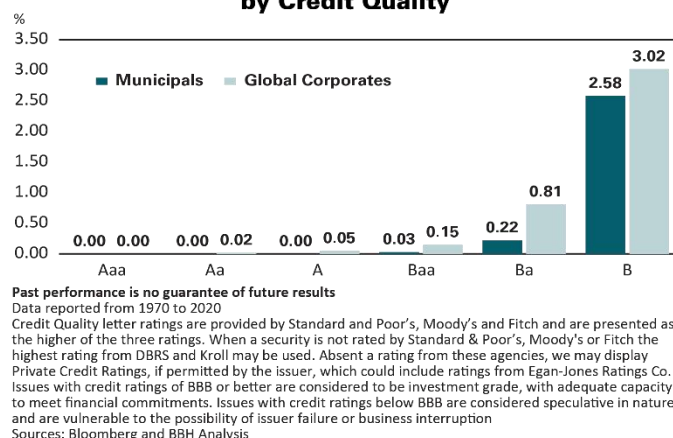


Exhibit V: Average 1-Year Default Rates by Credit Quality



The risk-adjusted return benefits of taxable municipal bonds have also produced notable correlation benefits to IG corporate bonds. Exhibit VII shows the historical risk and return characteristics of numerous combinations of taxable municipal and corporate bonds. A 40% allocation to taxable municipal bonds enhanced annual returns by 0.30% per year while simultaneously reducing volatility by 0.40% per year over the past 15 years.

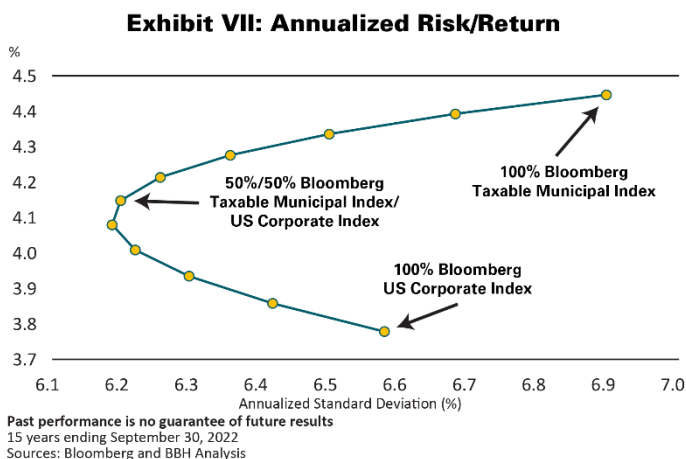
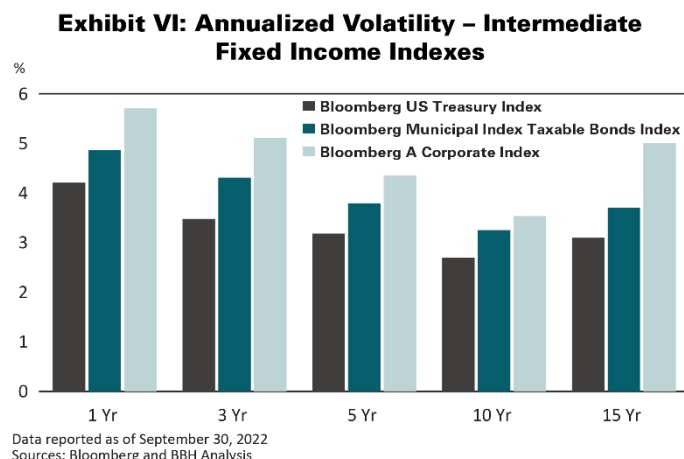


Exhibit VIII below contrasts the characteristics of the Bloomberg Taxable Municipal Index, the Bloomberg U.S. Corporate Index, and a 50/50 blend of the two indexes. While the yield on taxable municipal bonds is lower and the duration is higher than corporates, the taxable municipal index has a considerably higher credit quality orientation. The blended portfolio has only moderately longer duration, a higher Sharpe ratio**, and a much more balanced credit quality composition.

Exhibit VIII: Characteristics

	Bloomberg Taxable Municipal Index	50%/50% Bloomberg Taxable Municipal Index/US Corporate Index	Bloomberg US Corporate Index
Portfolio Characteristics			
Yield to Worst	5.20%	5.44%	5.69%
Duration (Years)	9.08	8.04	7.01
Trailing 15-Year Performance			
Return	4.45%	4.15%	3.78%
Volatility	6.90%	6.20%	6.58%
Sharpe Ratio	0.54	0.55	0.46
Credit Quality Distribution			
AAA	14.7%	8.1%	1.4%
AA	59.0%	32.9%	6.8%
A	20.7%	31.8%	42.8%
BBB	5.5%	27.2%	48.9%

Past performance is no guarantee of future results

Data as of September 30, 2022

Credit Quality letter ratings are provided by Standard and Poor's, Moody's and Fitch and are presented as the higher of the three ratings. When a security is not rated by Standard & Poor's, Moody's or Fitch the highest rating from DBRS and Kroll may be used. Absent a rating from these agencies, we may display Private Credit Ratings, if permitted by the issuer, which could include ratings from Egan-Jones Ratings Co. Issues with credit ratings of BBB or better are considered to be investment grade, with adequate capacity to meet financial commitments. Issues with credit ratings below BBB are considered speculative in nature and are vulnerable to the possibility of issuer failure or business interruption.

Sources: Bloomberg and BBH Analysis

** Sharpe ratio is the return earned in excess of the risk-free rate per unit of return volatility.

Putting It All Together...

We believe the often overlooked and under-appreciated taxable municipal market warrants the attention of investors. We have shown that taxable municipal bonds can not only potentially enhance returns, but they can also generate diversification benefits to traditional high-grade corporate portfolios. Beyond the benefits provided by the sector, the vastly diverse and fragmented municipal market offers reliable security selection opportunities for bottom-up investors, like BBH. We believe that our active approach that blends a strong valuation framework with credit underwriting that emphasizes durability can unlock the benefits of taxable municipal bonds, just as we have done in traditional tax-exempt bonds for many years.



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Issuers with credit ratings of AA or better are considered to be of high credit quality, with little risk of issuer failure. Issuers with credit ratings of BBB or better are considered to be of good credit quality, with adequate capacity to meet financial commitments. Issuers with credit ratings below BBB are considered speculative in nature and are vulnerable to the possibility of issuer failure or business interruption.

Opinions, forecasts, and discussions about investment strategies represent the author's views as of the date of this commentary and are subject to change without notice. References to specific securities, asset classes, and financial markets are for illustrative purposes only and are not intended to be, and should not be interpreted as recommendations.

Diversification does not eliminate the risk of experiencing investment losses.

Definitions

Bloomberg Taxable Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. To be included in the index, bonds must be rated investment-grade. They must have an outstanding par value of at least \$7 million and be issued as part of a transaction of at least \$75 million. The bonds must be fixed rate and must be at least one year from their maturity date.

Bloomberg US Corporate Bond Index represents the corporate bonds in the Bloomberg US Aggregate Bond Index, and are USD denominated, investment-grade fixed-rate, corporate bonds with maturities of 1 year or more.

The Bloomberg A Corporate Index measures the A-rated, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

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The Indexes are not available for direct investment.

RISKS

Investors in the Fund should be able to withstand short-term fluctuations in the fixed income markets in return for potentially higher returns over the long term. The value of portfolios changes every day and can be affected by changes in interest rates, general market conditions and other political, social and economic developments.

Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, maturity, call 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.

As the Fund's exposure in any one municipal revenue sector backed by revenues from similar types of projects increases, the Fund will also become more sensitive to adverse economic, business or political developments relevant to these projects.

The Fund also invests in derivative instruments, investments whose values depend on the performance of the underlying security, assets, interest rate, index or currency and entail potentially higher volatility and risk of loss compared to traditional stock or bond investments.

Asset allocation decisions, particularly large redemptions, made by an investment adviser whose discretionary clients make up a large percentage of the Fund's shareholders may adversely impact remaining Fund shareholders.

For more complete information, visit www.bbhffunds.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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